Pale Co

1. It is 1 July 20X5. You are a manager in the audit department of Chief & Co, a firm of Chartered Certified Accountants. You are assigned to the audit of Pale Co which has a financial year ending 30 September 20X5.

Pale Co manages timber plantations, its core business being the management of timber plantations and the production and sale of a range of timber products. It is not currently a listed entity.

The following **exhibits** provide information relevant to the question:

1. Partner's email – an email which you have received from Harvey Rebus, the audit engagement partner.
2. Background information – information relevant to audit planning.
3. Notes from meeting – summary of business developments discussed at a recent meeting between the chief finance officer (CFO) and the audit engagement partner.
4. Key performance indicators – a summary of financial and non-financial information.
5. Notes from phone call – a summary of issues raised by the CFO during a discussion with the audit engagement partner.

1. Partner's email

To: Audit manager

From: Harvey Rebus, Audit engagement partner

Subject: Audit planning for Pale Co

Date: 1 July 20X5

Hello

I have provided you with some information which you should use to help you in planning the audit of Pale Co for the financial year ending 30 September 20X5.

As you know, Pale Co is a new audit client of our firm. I hope you are looking forward to working on this interesting new client which is the first timber company we have secured as an audit client. You should also be aware that the management team is planning for Pale Co to achieve a stock market listing within the next two years.

Based on the analysis I have done on this industry, it is appropriate for overall materiality to be based on profit before tax as this is a key focus for investors and providers of finance.

I require you to prepare briefing notes for my own use, in which you:

(a) Evaluate the significant business risks to be considered in planning the audit of Pale Co.

(10 marks)

(b) Evaluate and prioritise the significant audit risks to be considered in planning the audit of Pale Co for the financial year ending 30 September 20X5.

(16 marks)

Note: In relation to the company's timber plantation asset (referred to in Exhibit 4) **you are only required to consider audit risks relating to changes in fair value.** Any other relevant audit risks relating to the timber plantation asset will be dealt with separately, later in the planning stage of the audit.

(c) Design the audit procedures to be performed in relation to the change in fair value of the timber plantation asset caused by the recent storms. Your procedures should include those relating to the evaluation of the expert appointed by management and the work they have performed.

(6 marks)

(d) Using Exhibit 5, explain the ethical issues and other audit planning implications which arise in relation to the phone call from the company's chief finance officer, Mark York.

(8 marks)

Thank you

2. Background information

Pale Co owns and manages several large timber plantations. Approximately 5% of the trees are harvested each year. The company immediately processes the timber which is harvested from felled trees in its own sawmills (a facility where trees are processed into logs and other timber products). The processed timber, which is mainly logs and planks of wood, is then sold to a range of customers including construction companies and furniture manufacturers. Approximately 30% of the timber is exported.

Your firm was appointed as auditor to Pale Co in March 20X5 following the resignation of the previous auditor, Hare Associates. As part of your firm's client acceptance procedures, communication was received from Hare Associates indicating that their reason for resignation was due to the retirement of the partner responsible for the audit and that they had no issues to bring to your attention regarding the audit.

Pale Co has a small internal audit department with two staff who report to the company's CFO, as the company does not have an audit committee.

3. Notes from meeting

Meeting date: 10 June 20X5

Attendees: Harvey Rebus, audit engagement partner

Mark York, chief finance officer (CFO)

Accounting policies

Mark York confirms that Pale Co applies the requirements of IAS® 41 *Agriculture* as follows:

- Standing timber, which means trees which are growing in the timber plantation prior to being felled, are biological assets, measured at fair value less costs to sell. The change in fair value less costs to sell is included in profit or loss for the period in which it arises.
- Felled trees are agricultural produce which are measured at fair value less costs to sell at the point of harvest. Immediately after felling, trees are processed, so that the value of felled trees awaiting processing is minimal at any point in time.
- Processed timber such as logs are measured in accordance with IAS 2 *Inventories*.

A technical expert from the audit firm has confirmed that the accounting policies outlined above appear appropriate in the context of Pale Co's activities.

International expansion

Pale Co's operations are currently all based in its home jurisdiction. However, the board has recently approved the acquisition of several large areas of tropical rainforest in Farland, a remote developing country. The expansion will allow the company to process new types of timber for which there is significant demand from luxury furniture manufacturers. The acquisition of the areas of the rainforest will cost $25 million and the purchase is due to take place in August 20X5. The cost of $25 million is equivalent to the fair value of the rainforest. Farland uses the same currency as Pale Co so the expansion is not creating any foreign exchange risk exposure to the company.

The purchase is being funded through a share issue to existing and new shareholders, who are mainly family members of the Pale family, who established the company 20 years ago. A share issue was the only option for funding the international expansion as the company is at the limit of its bank borrowing agreement.

An international development agency has agreed to provide a grant of $20 million to assist Pale Co in its Farland expansion, on condition that the expansion represents sustainable and ethical business practice. The grant is provided specifically for training the local workforce and building accommodation for the workforce in a town near to the rainforest.

The grant is due to be received in September 20X5 and relevant expenditure will commence in

November 20X5. Mark York is planning to recognise half of the amount received as income in this year's financial statements, on the basis that it "will cover some of management's expenses in planning the international expansion".

Gold Standard

The company is proud to have recently been awarded an industry 'Gold Standard' accreditation for its sustainable timber management. To achieve the Gold Standard, which denotes the highest possible level of sustainable timber management and ethical business practice, the company must adhere to a number of strict standards. This includes maintaining the biodiversity of the timber plantation, ensuring that rare species of tree are not harvested, and that animal habitats within the timber plantation are preserved. To maintain the Gold Standard accreditation, one condition is that at least 80% of timber sold must be harvested according to the strict standards set by industry regulators. The Gold Standard applies to all of the company's activities, including the Farland expansion.

Contract with Royal Co

The company's revenue has increased this year, largely due to it signing a significant contract with a new customer, Royal Co. The contract was signed on the basis of Pale Co receiving the Gold Standard accreditation for its timber.

Legal case

A group of employees has recently commenced legal action against the company, claiming that breaches of health and safety guidelines regularly take place. The company has made some redundancies this year, which has put pressure on the remaining staff to work harder in order to maintain productivity; the employees are alleging that this has caused an increase in the number of accidents at work, some of which have resulted in fatalities. The company's management and legal advisors believe that the legal claim, which amounts to $19 million, is unjustified and will not be successful. Mark York does not intend to recognise a provision for the claim or make any disclosure in the financial statements in relation to this issue as it is at such an early stage in the legal proceedings.

News report

Mark informed us that a news report has emerged in Farland, alleging that Pale Co paid a government official a sum of $15,000 in order to secure the purchase of tropical rainforest which is taking place next month. Mark wanted to make us aware of the story, which is spreading quickly on social media, and to inform us that these incentive payments are routine business practice in Farland.

Use of expert – change in fair value due to recent storms

In the last month, several storms caused damage to some areas of timber plantation. An independent expert has been appointment by management to determine the extent of damage caused and to quantify any financial implications, including determination of the change in fair value of the standing trees which have been damaged by the storm. The expert's report indicates a large number of trees have been completely destroyed, and many have been badly damaged. Based on the expert's report, management has determined that a reduction in fair value of $7·5 million should be recognised in respect of the timber plantation asset recognised in the statement of financial position.

4. Key performance indicators

Exhibit 4 - Key performance indicators

The information in the table below will be published as part of the Annual Report, in a section titled 'Key results for the year', which forms part of management's commentary on the company's performance. The financial information is before recognising the change in fair value of the timber plantation caused by the recent storm, and also before accounting for the government grant.

	Projected 30 September 20X5 $ million	Actual 30 September 20X4 $ million	% change
Financial key performance indicators:			
Revenue	42·5	40·3	+5·5%
Operating profit	22·0	21·0	+4·8%
Profit before tax	**16·5**	**12.5**	**+32%**
Social and environmental key performance indicators:			
% timber harvested in line with 'Gold Standard'	82%	85%	
Number of employees	1,300	1,420	
Total staff days lost due to accidents at work	78	65	

You are also provided with the following information relating to balances which are extracted from management accounts as at 30 June 20X5:

Total assets – $550 million (20X4 – $540.5 million)

Timber plantation – $500 million (20X4 – $490 million) – this amount, relating to standing timber, is before accounting for any change in value caused by the recent storms referred to in Exhibit 3.

Cash – $4·5 million (20X4 – $6·8 million) – cash levels are depleted this year due to inflationary pressures and demands for higher wages from our employees, which we have met.

5. Notes from phone call

Notes from a phone call yesterday between Harvey Rebus, audit engagement partner and Mark York.

Request from Mark York
Pale Co publishes a wide range of non-financial social and environmental Key Performance Indicators (KPIs) as part of the Annual Report, including the three shown as part of Exhibit 4. Mark has asked if our firm can provide assurance on these KPIs as part of performing the annual audit. Mark has suggested that in order to pay for this extra work, the agreed audit fee will be increased by 20%, assuming that the assurance provided on the KPIs is favourable.

Requirement

Respond to the instructions in the email from the audit engagement partner.

(40 marks)

Note: The split of the mark allocation is shown in Exhibit 1 – Partner's email.

Professional marks will be awarded for the demonstration of skill in communication, analysis and evaluation, professional scepticism and judgement and commercial acumen in your answer.

(10 marks)

(50 marks)

James & Co

2. It is 1 July 20X5. You are an audit manager in James & Co, a firm of Chartered Certified Accountants. Your role includes performing post-issuance audit quality reviews, and you are currently reviewing the audit of the Bond Group (the Group), which had a financial year ended 31 January 20X5, and in respect of which an unmodified audit opinion was issued last month. The Group supplies computer components, specialising in graphics cards.

You are reviewing the Group audit file as well as the audit files for three of the Group's subsidiaries. All three of these subsidiaries are significant components of the Group and have a financial year end of 31 January 20X5. Each subsidiary's audit opinion was also unmodified.

You have been provided with the following **exhibits**, which provide information about the Bond Group and the points you have identified for each subsidiary in the group:

1. Cameron Co – points you have identified from your review of the information provided by the component auditor.
2. Dean Co – points you have identified during your audit quality review.
3. Horner Co – points you have identified during your audit quality review.

1. Cameron Co

Your firm audits all Group companies with the exception of Cameron Co, a subsidiary which was acquired during the last financial year.

Cameron Co was acquired by the Group in April 20X4, and is audited by Carrey Associates, a small local firm. Cameron Co also outsources its internal audit function to Carrey Associates. The section of the external audit working papers provided by Carrey Associates and relevant to internal controls contains very little documentation other than a cross reference to the files maintained by the internal audit team, and a statement that 'we can rely on the internal controls as they were tested by our firm in May 20X4'.

In respect of Carrey Associates, the Group audit working papers contain the following statement: 'our firm can rely on the work of Carrey Associates, as one of James & Co's audit partners left the firm to become an audit partner at Carrey Associates, and he was involved with the audit of Cameron Co'. Other than some background about Carrey Associates which had been printed off from the firm's website to provide background information, there is nothing else on file in relation to the firm.

The Group audit working papers also include a note relating to the consolidation of Cameron Co into the Group financial statements. Cameron Co prepares its individual financial statements using local accounting rules, which is allowed under national regulation; it does not use IFRS® Standards which is applied by the rest of the Group. The Group audit partner commented in the working papers that 'local accounting rules are very similar to IFRS Standards so there is no need to perform any additional audit work in relation to the consolidation of Cameron Co due to it using different accounting policies to the rest of the Group'.

2. Dean Co

Dean Co owns a small number of shares in Corden Co, amounting to a 2% shareholding. The investment is accounted for as a financial asset at fair value through profit or loss, as required by IFRS® 9 *Financial Instruments*. Corden Co's shares are not traded in an active market, and the value of $68,000 which is recognised in Dean Co's financial statements is management's estimate of fair value, based on an offer received for the shareholding in April 20X4.

The audit team checked the arithmetic of management's computation but did not obtain further audit evidence, because according to the audit conclusion 'the value of the shareholding is below the Group materiality level'. The latest financial statements of Corden Co, prepared to 31 January 20X5, are included in the audit file to provide 'background information', and show that the company has net assets of $550,000.

Materiality for the Group consolidated financial statements was determined to be $350,000.

3. Horner Co

During the audit of Horner Co, the audit team became aware of a breach of data protection regulation, whereby an employee of the company had made its customer database available to a third party. This disclosure is in contravention of the regulation.

The audit working papers refer briefly to this situation, and conclude that 'it has little to do with the audit, as no one outside of the company is aware'. No further investigations were made by the audit team, and the audit manager noted in the working papers that 'the matter does not need to be discussed any further with Horner Co's or the Group's management teams as I have received assurance that the person responsible for the breach of regulation has been dismissed'.

Requirements

In relation to the matters described in Exhibits 1, 2 and 3, comment on the quality of the planning and performance of the Group audit and the audit of the components of the Group, discussing the quality management and other professional issues raised in respect of:

(a) Cameron Co

(8 marks)

(b) Dean Co

(5 marks)

(c) Horner Co

(7 marks)

Professional marks will be awarded for the demonstration of skill in analysis and evaluation, professional scepticism and judgment, and commercial acumen in your answer

(5 marks)

(25 marks)

Matty Co

3. It is 1 July 20X5. You are a manager in Beth & Co, a firm of Chartered Certified Accountants, responsible for the audit of Matty Co for the year ended 31 March 20X5.

You have been provided with the following exhibits:

1 Audit completion review – provides details of matters which have been brought to your attention by the audit supervisor.
2. Update and draft auditor's report – provides an update on the outcome of initial discussions with the client and details of the auditor's report which has now been drafted by the audit supervisor.

1. Audit completion review

Matty Co is a listed transport company which provides train and bus services for the public on a national basis. The audit of Matty Co for the year ended 31 March 20X5 is nearly complete and you are reviewing the audit working papers. Matty Co is a new audit client for Beth & Co this year. The previous auditors issued an unmodified opinion on the financial statements for the year ended 31 March 20X4.

Matty Co's draft financial statements recognise revenue of $60·1 million (20X4 – $94·3 million), profit before tax of $10·5 million (20X4 – $22·1 million) and total assets of $28·4 million (20X4 – $31·1 million). Materiality has been set by the audit engagement partner at $1.05million.

The audit supervisor has brought the following matters to your attention:

Railway operating licence and going concern

Matty Co has operated a national railway service for the last 19 years. Matty Co's national railway operations have been the subject of adverse publicity over the last 12 months in relation to the unreliability of its services including the late running of its trains.

The licence to operate the national railway is put out to tender by the national government every five years. Matty Co's existing licence is due for renewal on 28 February 20X6. The current tendering process is approaching completion and despite the recent operational problems, Matty Co was informed on 30 June 20X5 that the company was the government's preferred option. This was on the understanding that the company would address the recent criticisms of its poor service levels. The company was also informed that the tender would still be subject to a detailed review in one month's time prior to its being awarded. The national railway generated $40·2 million of revenue in 20X5 ($47·2 million in 20X4) and contributed pre-tax profit of $11·2 million this year ($13·3 million in 20X4).

Purchased customer list

On 1 April 20X4, Matty Co paid $6·9 million to acquire the customer list of Jess Coaches, a business which was terminating its operations. Jess Coaches hires out coaches and drivers to private and public sector customers. Its customer list includes many highly reputable listed companies and government bodies with a customer relationship and trading history going back more than 30 years.

On the basis of this trading history and the associated customer loyalty, the management of Matty Co assessed the useful life of the customer list as indefinite. The draft statement of financial position as at 31 March 20X5 recognises the customer list as an intangible asset at a total carrying amount of $6·9million.

In the second half of the reporting period, however, two of Jess Coaches' largest clients moved to a new competitor. The management of Matty Co believe that while it would be difficult to identify a sales value for the customer list at the reporting date, they estimate the value in use of the customer list to be $7·2 million.

2. Update and draft auditor's report

It is now 22 July 20X5 and all matters, in relation to the purchased customer list have now been satisfactory resolved.

Following the submission of a customer petition to the government complaining about the company's poor service levels, on 19 July 20X5 the government released a statement announcing that it had withdrawn Matty Co's preferred bidder status and was reopening the tender process for the national railway licence.

The company's finance director has provided details of a short disclosure note he plans to include in the financial statements which refers to the uncertainties in relation to the current status of the tender and possible going concern issues which might arise for the company as a result. The disclosure note concludes with a statement that the management of Matty Co is very confident that the company will be successful in the tender process and that it will retain the national railway licence for at least a further five years.

Requirements:

(a) Using the information in Exhibit 1, comment on the matters to be considered and explain the audit evidence you would expect to find during your review of the audit working papers on 1 July 20X5, in relation to the issues identified.

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

(i) Railway operating licence and going concern (7 marks)
(ii) Purchased customer list (8 marks)

(15 marks)

(b) With reference to Exhibit 2, and assuming that no further adjustments will be made to the financial statements in relation to the railway operating licence, evaluate the appropriateness of the draft auditor's report produced by the audit supervisor.

(5 marks)

Professional marks will be awarded for the demonstration of skill in analysis and evaluation, professional scepticism and judgment, and commercial acumen in your answer

(5 marks)

(25 marks)

End of Question Paper

Answers

Suggested Solution:

1. **Pale**

Briefing notes

To: Harvey Rebus, audit engagement partner
From: Audit manager
Subject: Audit planning in relation to Pale Co
Date: 1 July 20X5

Introduction

These briefing notes have been prepared to assist in planning the audit of Pale Co. The notes begin with an evaluation of the business risks facing the company and continue by evaluating the audit risks which should be considered in planning the audit. The notes also include the recommended principal audit procedures which have been designed in respect of a change in fair value to the company's timber plantation following a recent storm. Finally, the notes discuss some ethical and other professional issues arising from a recent phone call with the company's chief finance officer (CFO) which impact on our audit planning.

(a) Business risks

International expansion

The expansion into Farland introduces a business risk in that the company will be managing operations in a foreign country for the first time. Farland is remote, so it may be difficult for Pale Co's management team to plan regular visits to the new operations, so establishing robust management oversight and controls could be difficult. In addition, Farland may have different laws and regulations compared to the company's home jurisdiction, so there is a heightened risk of non-compliance. Even the type of trees growing in the rainforest will be different, and management may not have experience in their harvesting, processing and the sale of timber products. All of these issues create a risk that the international expansion may not be successful, and at the same time will represent a drain on management's time and resources. Operations in the home country of Pale Co may suffer as a result.

Gold Standard accreditation

There is a risk that the Gold Standard accreditation may not be renewed, with implications for reputation, and more specifically for the new contract with Royal Co, which largely accounts for an increase of 5.5% in the company's revenue this year. Several of the Key Performance Indicators (KPIs) which need to be met to retain the Gold Standard seem to be in jeopardy, for example there has been a decline in the percentage of timber which is harvested in line with Gold Standard requirements, and the projected metric of 82% is only just above the required level of 80%. In addition, the Gold Standard is linked to ethical business practice, and there are some indications that the company's business ethics is questionable – for example the legal case being brought by employees and the incentive payment made to a government official. If the Gold Standard accreditation is lost, Royal Co, and other customers may cancel contracts, resulting in a loss of revenue and cash flow.

Legal case

The legal action against the company by its own employees is a significant risk. If the issue becomes public knowledge there will be reputational problems, and the amount that is being claimed, $19 million, exceeds the company's cash balance. If the legal claim were to go against the company, it would struggle to find the funds to pay the damages given that it is already at the limit of its borrowing arrangements. The situation could also indicate poor governance of the company, if decisions are being made which puts the lives of employees at risk and results in days lost due to accidents at work, and the matter seems to be dismissed as unimportant by the management team and legal advisors.

Damage to assets caused by storms

The recent storms have caused significant damage to the company's timber plantation asset. Unpredictable weather patterns could cause further harm or even totally destroy the company's timber plantations. Assuming that trees will be replanted to replace the damage caused by the storm, it can take many years for trees to grow to a harvestable size, so the company faces a significant depletion of its future cash inflows for years to come. This risk is very difficult to mitigate, perhaps the diversification into tropical rainforest is a way to reduce the risk exposure of the company's operations being concentrated in one geographical area.

Liquidity

The financial information provided indicates that the company's liquidity position has deteriorated over the year. The company has only $4.5 million of cash – a reduction of 33.8% compared to the end of the last financial year. While this has been explained as due to inflationary pressures, management should be doing more to maintain a reasonable level of cash in order to properly manage its working capital. The company may become unable to meet obligations as they fall due especially if the industrial action continues to restrict the possibility of export sales which account for 30% of the company's revenue.

Industrial action

The industrial action at the country's ports has already meant lost sales, and as explained above, there is a risk that revenue and cash inflows will continue to be negatively impacted. Export sales account for 30% of total revenue, approximately $12.75 million, making this a potentially very significant issue should the industrial action continue. Customers may begin to look elsewhere for their supply of timber, leading to cancelled future orders and contracts.

There is also an issue that the increased storage of timber which is awaiting export to foreign customers will incur additional storage costs.

Incentive payment

The fact that the payment is being reported in the media indicates that there is something unusual about the payment and in fact, the incentive payment could be a bribe. The reputational risk to the company is high, especially given that it should be adhering to a high standard of business ethics in accordance with its Gold Standard accreditation. Customers may not wish to associate themselves with a supplier which engages with unethical and possibly illegal payments. The company could face legal action if indeed the payment is a bribe, and aside from this exacerbating the reputational risk, it has very little cash available to pay any fine or penalty imposed.

If the incentive payment is a bribe, there could be implications for the government grant, which contains stipulations regarding ethical business practices. In the worst case the grant may need to be repaid if the terms and conditions are found not to have been complied with.

Tutorial note: *Credit will be awarded for discussion of other relevant business risks, for example, the solvency issue raised by it being at the limit of its borrowing agreement, the lack of cash other than relating to the government grant available for establishing operations in Farland, the lack of an audit committee and independent internal audit team, the reputational damage which may be caused by the legal case and incentive payment, and the inflationary pressures which will make costs hard to control.*

(b) Evaluation of audit risks

Materiality

For the purposes of these briefing notes, the following overall materiality level will be used to assess the significance of identified risks and as requested this has been based on the profitability of the company.

Benchmarks

5 – 10% of profit before tax = range of $825,000 - $1,650,000

This benchmark is only a starting point for determining planning materiality and professional judgement will need to be applied in determining a final level to be applied during the course of the audit. This is the first year that Chief & Co has audited the company, which increases detection risk, together with the specialisms of auditing an agricultural business. Therefore, materiality has been based on 7.5% of profit before tax at $1,237,500 and has been set at $1,250,000.

Financial analysis

Revenue is projected to increase by 5.5%, and profit before tax by 32% which suggest that there is a significant decrease, and potential understatement, in expected costs, potentially due to the interpretation of accounting policies or judgments made by management in respect of the fair value of the forest and provisions regarding legal claims. There is a risk that expenses are understated and assets (namely the forest) are overstated.

New client

This is the first year that Chief & Co has audited the company, which increases detection risk, as our firm does not have experience with the client, making it more difficult to detect material misstatements.

In addition, there is a risk that opening balances and comparative information may not be correct. The prior year figures were not audited by Chief & Co, therefore we should plan to audit the opening balances carefully, in accordance with ISA 510 *Initial Audit Engagements – Opening Balances*, to ensure that opening balances and comparative information are both free from material misstatement.

Tutorial note: *Credit will also be awarded for discussion of Pale Co operating in a specialised industry, which could create a detection risk given the audit firm's lack of experience in auditing clients in this industry.*

Going concern

There are several indicators that despite its projected increase in revenue and profit, the company faces going concern problems. These indicators include, but are not limited to, operational problems including the destroyed timber plantation and industrial action, reputational damage caused by the legal claim and possible illegal payment, financial problems caused by lack of cash and the fact that its results are likely to be much worse than that projected by management when the decrease in fair value of the destroyed timber plantation is taken into account.

IAS 1 *Presentation of Financial Statements* requires that management provide a note to the financial statements which discusses any material uncertainty over the company's ability to continue as a going concern. If management fails to disclose this note, or provides the note but with inadequate detail, then the requirements of IAS 1 may not have been followed, creating a significant audit risk.

Government grant

A government grant of $20 million has been awarded to Pale Co, this is significantly above the materiality threshold which has been determined at $1.25million. Mark York has suggested that he will recognise $10 million of the amount received in profit for the year – projected profit before tax (before any adjustments) is $16.5 million so increasing the profit by this amount would be highly material to the financial statements.

The audit risk relates to whether this should be recognised as income in the current accounting period. IAS® 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that government grants are recognised in profit or loss on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate. Mark York is planning to recognise half of the grant as income this year, however, this is not appropriately justified. The grant has not been awarded to compensate for management time in planning the international expansion so the appropriate accounting treatment would seem to be that the entire amount of the grant should be recognised as deferred income in this financial year, as the expenditure for which the grant is specifically provided has not yet been incurred. Therefore, there is a risk that the company will recognise the income too early, leading to overstated profit and understated liabilities.

Tutorial note: *Credit will also be awarded for discussion relating to the company's use of the grant for building accommodation for employees, and relevant audit risks e.g. the recognition of the accommodation as Property, Plant and Equipment and treatment of the part of the grant relating to the construction of assets.*

There could be a further issue in that the terms of the grant may require complete or partial repayment if the conditions of the grant are not satisfied, for example if Pale Co does not retain its Gold Standard accreditation or if the circumstances of the employees' legal case is considered to be indicative of unethical business practice by the company. The company should evaluate whether the terms are likely to be met, and if not, should consider whether it would be appropriate to recognise a provision or disclose a contingent liability in the notes to the financial statements. According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets* a provision should be recognised where a present obligation exists as a result of a past event which can be reliably measured and is probable to result in an outflow of economic benefit.

The risk is therefore that this has not been considered by management, leading possibly to understated liabilities or inadequate disclosure as required by IAS 37.

Reduction in fair value of timber plantation

The company's timber plantation asset, prior to recognising any change in fair value, is highly material based on the threshold calculated of $1.25million.

The company has correctly obtained an expert's opinion on the change in fair value of the destroyed and damaged trees caused by the storm. The expert's valuation has helped management to determine that a reduction in fair value of $7.5 million should be recognised in the financial statements within profit. This amount is material as it meets the threshold materiality rate. When the loss in value is recognised, it will reduce the projected profit from $16.5million to $9million. There is a risk that management will not recognise the fair value adjustment in full due to the impact it will have on profit. This is therefore a significant issue for the audit planning.

There is a risk that the expert's valuation is not appropriate, for example if the expert does not have appropriate expertise to perform this specialist valuation, which would lead to issues in whether the valuation can be relied upon. In addition, the expert has considered only the value of the destroyed and damaged trees and not considered any other impact of the storm, for example if other assets such as roads and buildings have been affected by the storm and should be tested for impairment.

Therefore, based on the issues discussed above, there is a risk that the loss is not fully recognised in profit for the year, and the carrying amount of non-current assets is overstated.

Legal case

The legal case could also give rise to a risk of understated liabilities or inadequate disclosure if the company fails to provide for the $19 million claimed by employees or to disclose the matter as a contingent liability. It will be a matter of significant judgement to decide whether the legal claim is likely to go against Pale Co or not at this early stage, however the matter is material and therefore warrants careful consideration. Due to its sensitive nature, the auditor may also consider the issue to be material by nature.

Pressure on results

The company is not a listed entity, but the existing and new shareholders will be looking for a return on their investment in the form of a dividend payment. In addition, in the run up to a potential stock market flotation there will be pressure for the company to show good financial performance. The company also has ambitious international expansion plans. Pressure to return a better performance creates an incentive for management bias which means that management may use earnings management techniques, or other methods of creative accounting, to create a healthier picture of financial performance than is actually the case. This creates an inherent risk of material misstatement, at the financial statement level.

The fact that the projected profit before tax is 32% higher than the previous year's figure could indicate that operating expenses are understated. Management bias could also have led to some of the accounting treatments suggested by Mark York, which work to improve the company's profit for the year.

Corporate governance

The company does not have to comply with corporate governance requirements as it is not a listed entity. However, it is good practice to have an established audit committee, especially for a large company like Pale Co which is seeking a stock market flotation in the relatively near future. The internal audit team is small and lacking in independence as they report directly to the CFO. This means that the scope of their work is likely to be quite limited due to insufficient resources, and any recommendations made could potentially be ignored by Mark York. This has implications for controls over financial reporting, which could be deficient, and increases control risk. There is a high scope for errors in financial reporting processes and for deliberate manipulation of balances and transactions, as the internal audit team does not have sufficient resources for thorough monitoring and reporting.

Impact of the audit risks on the engagement planning

The audit risks have been considered with regard to the estimated magnitude and likelihood of any misstatement, as well as taking into consideration any associated detection risk. Both the potential adjustments to the fair value of the forest asset ($7.5million) and the adjustment to the proposed accounting treatment of the government grant ($10million) clearly meet the threshold materiality of $1.25million, and in aggregate, they would reduce the estimated profit to a loss of $1.5million. Ensuring the appropriate disclosures and accounting treatment in respect of the legal claim (which may result, upon investigation, in a further increase in the loss by up to $19million) is also a material item by amount of it exceeding the materiality threshold. Chief & Co will need to ensure that they have sufficient staff and resources available, including but not limited to, an assessment of the validity of the legal claim and a review of the valuation of the forest.

(c) Change in fair value of the timber plantation asset

- Obtain the expert's report on the value of the destroyed and damaged timber plantation to:
    - Gain understanding and allow evaluation of the methodology and assumptions used, e.g. the basis of determining the amount of any income which may be generated from the timber to be salvaged from damaged trees.
    - Confirm the geographical extent of damage by the storm.
    - Confirm the basis of determining whether trees have been completely destroyed or damaged.
- Discuss the expert's methodology and assumptions with management to confirm their rationale and compliance with the measurement requirements of IAS 41.
- Obtain confirmation of the expert's qualifications and experience in assessing storm damage to timber plantation assets and quantifying financial losses.
- Obtain confirmation that the expert is independent from Pale Co and its management team.
- If possible, visit the site of the storm damage to form a view on the scale of the destruction and to evaluate whether any assets other than the trees have been destroyed or damaged.
- Discuss with management the actions which have been taken in response to the storm, e.g. the extent of progress made to clear the destroyed trees and harvest the damaged trees.
- Obtain any documentation relating to any potential sale of damaged trees, e.g. customer orders, to confirm any realisable value of damaged trees.
- From the non-current asset register, confirm the carrying amount of the standing trees prior to any change in fair value being recognised.
- Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures.
- Develop an auditor's estimate of the fair value of the timber plantation, in accordance with the IAS 41 requirements, and compare to management's estimate of the change in fair value.
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the storm damage is covered by insurance.

(d) Ethical issues

Assurance on Key Performance Indicators (KPIs)

There are several issues to consider with regard to providing this service. A significant issue relates to auditor objectivity. The KPIs include financial and non-financial metrics. The financial metrics, including revenue, operating profit and profit before tax will be extracted from, or reconciled to, the figures as shown in the audited financial statements.

While the KPIs will not form part of the audited financial statements, they will be published in the Annual Report and therefore form part of the 'other information' in relation to which the auditor has responsibilities under ISA 720 *The Auditor's Responsibilities Relating to Other Information.* ISA 720 requires that auditors read other information in order to identify any material inconsistencies between the financial statements and the other information.

There is therefore a potential self-review threat to objectivity in that the audit firm has been asked to provide assurance on these KPIs which would be read by the audit team as part of their review of other information. The team performing the assurance work would be reluctant to raise queries or highlight errors which may have been made during the external audit when reading the other information.

Tutorial note: *Credit will be awarded for discussion of other relevant threats to objectivity created by providing an assurance service on the KPIs, including the advocacy threat and self-interest threats.*

The IESBA *International Code of Ethics for Professional Accountants* (the Code) provides guidance when auditors provide additional services to an audit client. Chief & Co needs to evaluate the significance of the threat and consider whether any safeguards can reduce the threat to an acceptable level. For example, a partner who is independent should be involved in reviewing the audit work performed.

There is also an ethical issue in respect to the fee proposed by Pale Co for the assurance engagement. If the firm decides to take on the engagement, it should be treated as an engagement separate from the audit and with a separate fee charged for the work and confirmed in a separate engagement letter. The suggestion to simply amend and increase the audit fee and to determine it on a contingent basis, as in the fee is only payable if the assurance is favourable, is not appropriate. Contingent fees can give rise to a self-interest threat, as it is in the financial interest of the audit firm to give a favourable assurance opinion in order to secure the income. The Code prohibits the use of contingent fees for audit services, but they are allowed for other types of work, depending on factors such as the nature of the engagement and the range of possible fee outcomes. The most prudent course of action, should Chief & Co take on the engagement, would be to charge the fee on a non-contingent basis, separate from the audit fee, to remove any ethical issues relating to the fee.

Aside from ethical issues, Chief & Co must also consider whether they have the competence to perform the work. Providing assurance on non-financial KPIs is quite a specialist area, and it could be that the audit firm does not have the appropriate levels of expertise and experience to provide a quality service. In particular, the firm would need to ensure that it fully understands the Gold Standard accreditation. Given that this is a specialised industry, and this is the first client which Chief & Co has in the industry, it is questionable whether the firm has the competence to carry out the work.

Aside from competence, the firm should also consider whether it has resources in terms of staff availability to complete the work to the desired deadline and to perform appropriate reviews of the work which has been completed.

Conclusion

These briefing notes highlight that the company faces significant business risk, in particular in relation to its financial position and the recent storm damage. There are a number of significant audit risks which will need to be carefully considered during the planning of the audit, to ensure that an appropriate audit strategy is devised. Going concern should be a key focus of the audit. We need to perform detailed work on the highly material change in fair value of the timber plantation due to the recent storm, as detailed in the notes. Finally, there are several ethical matters to be discussed with management and incorporated into our audit planning. The assurance engagement on the company's KPIs should only go ahead once all ethical implications have been carefully evaluated and appropriate safeguards put in place.

Marking Guide:

(a) Business risks

Up to 2 marks for each business risk evaluated. In addition, ½ mark for each relevant trend or calculation which form part of a relevant explanation of the risk (max 2 marks).

- International expansion
- Gold Standard accreditation
- Legal case
- Damage to assets caused by storm
- Liquidity
- Industrial action
- Incentive payment

Maximum marks **10 marks**

(b) Audit risks

Up to 3 marks for each audit risk evaluated unless otherwise indicated. Marks may be awarded for other, relevant risks not included in the marking guide.

Appropriate materiality calculations (max 2 marks) and justified materiality level should be awarded to a maximum of 1 mark.

In addition, ½ mark for each relevant trend or calculation which form part of a relevant explanation of the risk (max 2 marks).

- New client (up to 2 marks)
- Going concern
- Government grant (up to 4 marks)
- Change in fair value of standing trees
- Legal case
- Pressure on results
- Corporate governance (up to 2 marks)

Maximum marks **16 marks**

(c) Audit procedures

1 mark for each well explained audit procedure, examples of which include:

- Obtain the expert's report on the value of the storm-damaged timber plantation to understand methodology and overall results.
- Discuss the expert's methodology and assumptions with management to confirm their rationale and compliance with accounting requirements.
- Obtain confirmation of the expert's qualifications and experience.
- Obtain confirmation that the expert is independent.
- Visit the site of the storm damage to form a view on the scale of the destruction.
- Discuss with management the actions which have been taken in response to the storm.
- Obtain any documentation relating to the potential sale of damaged trees.
- From the non-current asset register, confirm the carrying amount of the standing trees prior to any change in fair value being recognised.
- Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures.
- Develop an auditor's estimate of the change in fair value and compare to management's estimate.
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the storm damage is covered by insurance.

Maximum marks **6 marks**

(d) Ethical and audit planning implications

1 mark for each point discussed:

- KPIs are 'other information' which the auditor must review for material inconsistencies
- Self-review threat to objectivity (additional credit to be awarded for other relevant threats to objectivity explained)
- Assurance can be provided on the KPIs if safeguards can reduce threat to an acceptable level
- Example of safeguard e.g. separate team to perform the work, separate partner review
- Fee for the assurance work must be separate from the audit fee
- Fee for audit cannot be on a contingent basis
- Fee for assurance work can be on a contingent basis but more prudent if not on that basis
- Competence issues due to specialist nature of the work
- Resource issues i.e. staff availability to perform the work

Maximum marks **8 marks**

Professional marks

Communication

- Briefing note format and structure - use of headings/sub-headings and an introduction
- Style, language and clarity - appropriate layout and tone of briefing notes, presentation of materiality and relevant calculations, appropriate use of the CBE tools, easy to follow and understand
- Effectiveness and clarity of communication - answer is relevant and tailored to the scenario
- Adherence to the specific requests made by the audit engagement partner

Analysis and Evaluation

- Appropriate use of the information to determine and apply suitable calculations
- Appropriate use of the information relating to the fair valuation exercise on the forest asset to design appropriate audit procedures
- Effective prioritisation of the results of the audit risk evaluation to demonstrate the likelihood and magnitude of risks and to facilitate the allocation of appropriate responses
- Balanced discussion of the issues connected to the auditor's responsibilities in relation to ethical decisions when considering non-assurance engagements for an audit client.

Professional scepticism and professional judgement

- Appropriate application of professional judgement to draw conclusions and make informed decisions following recognition of unusual or unexpected movements, missing/incomplete information or challenging presented information as part of the risk evaluation
- Determination and justification of a suitable materiality level, appropriately and consistently applied
- Identification of possible management bias and consideration of the impact on the financial statements and the possible reasons for management's preference for certain accounting treatments
- Effective application of technical and ethical guidance to effectively challenge and critically assess how management has responded to the legal claim and the adequacy of any provision or disclosure requirements.

Commercial acumen

- Use of effective examples and/or calculations from the scenario to illustrate points or recommendations

- Appropriate use of the industry information to evaluate business risks
- Recognition of the increased risks to the future competitiveness of the company given the information provided in the scenario and any impact on going concern.

10 marks

50 marks

2. **James Co**

(a) Cameron Co

There are problems indicated by the review in relation to both the audit of Cameron Co's individual financial statements by Carrey Associates, and in the way the Group auditor has dealt with the issue of there being a new component auditor involved in the Group.

Internal audit

First, it is not appropriate that Carrey Associates has relied on the work performed by the internal audit team. A significant self-review threat to the objectivity of Carrey Associates arises from the firm providing both internal and external audit services to Cameron Co. The IESBA *International Code of Ethics for Professional Accountants* suggests that providing an audit client with an internal audit service creates a significant self-review threat because in subsequent audits the audit team will use the internal audit work performed, leading to potential over-reliance. There is therefore a risk that the audit has not been performed with sufficient objectivity and professional scepticism. In addition, it is not clear whether appropriate safeguards are in place to reduce the threats to an acceptable level, for example by ensuring that the two services were provided by separate teams.

There is a risk that insufficient audit evidence has been obtained over internal controls. This is a breach of ISA 315 (Revised 2019) *Identifying and Assessing the Risk of Material Misstatement*, which requires the auditor to obtain an understanding of the internal controls relevant to the audit, including an evaluation of the design and implementation of the internal controls. It appears that this audit work has not been performed at all, due to over-reliance.

There is a further issue with the timing of when the internal controls had been tested, which took place in May 20X4. The financial year ended on 31 January 20X5, so it appears that the controls had not been evaluated for the last eight months of the financial year. ISA 330 The Auditor's Responses to Assessed Risks, states that if the auditor intends to rely on controls over a period of time the tests performed must be able to provide audit evidence that the control operated effectively over that period. This exacerbates the risk discussed above, as there could have been significant changes in internal controls during that period, which had not been identified by the external audit team.

This raises concerns over the quality of the audit which has been performed by Carrey Associates. Given that Cameron Co is a significant component of the Group, any material misstatements which have not been detected by the component auditor could have implications for the Group financial statements, which could also be materially misstated.

In addition to the self-review threat to objectivity, a threat of management responsibility arises, whereby the audit firm is making decisions and using judgment which is properly the responsibility of management. An audit firm should not assume management responsibility. This raises concern over Carrey Associates general approach to ethical issues, and whether the ethical threats raised have been properly evaluated by the firm.

Group auditor evaluation of Carrey Associates

The comment made in the Group audit working papers indicates that there has been no understanding obtained by the Group auditor in relation to the component auditors. This is a significant quality management problem and a breach of ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* which requires that the group audit team obtain an understanding of the component auditor and be involved with the component auditor's risk assessment to identify risks of material misstatement. This is especially the case given that Cameron Co is a new component of the group, and this is James & Co's first experience of working with Carrey Associates.

The fact that an audit partner has left James & Co to work as an audit partner at Carrey Associates has no bearing on whether James & Co should have obtained an appropriate understanding of Carrey Associates. An understanding of whether Carrey Associates follow the same ethical framework as the rest of the Group and an understanding of their competence is required. It appears that the Group audit has been conducted without this necessary understanding being obtained, which is a breach of ISA 600.

In addition, a familiarity threat to objectivity arises because of the connection that the Group audit team will have with the audit partner now working for Carrey Associates and who worked on the audit of Cameron Co. The familiarity threat means that the Group audit team may have over-relied on the work of the component auditor and failed to apply appropriate professional scepticism.

Use of local accounting rules

Cameron Co uses local accounting rules in its individual financial statements, which is acceptable. However, for the purpose of consolidation, the same accounting policies must be applied across all Group companies, as required by IFRS 3 *Business Combinations*. The fact that the Group audit partner has concluded that no work is needed in relation to the accounting policies indicates poor quality audit work and insufficient audit evidence has been obtained. Adjustments may have been necessary to Cameron Co's balances and transactions prior to consolidation; with no audit work being performed to assess whether this is the case there is a risk of material misstatement in the Group financial statements.

The fact that it is the Group audit partner who reached this conclusion indicates a lack of competence and raises concerns over the quality of the audit as a whole.

(b) Dean Co

Insufficient audit evidence has been obtained in relation to the financial asset. The audit team should not just have accepted management's valuation of $68,000, which could be based on inappropriate assumptions. An offer of $68,000 may have been received, but this has also not been verified by the audit team. As there is no active market for the shares, fair value should be based on an exit price at the measurement date and should reflect assumptions which market participants would use including risk. Even if the offer was genuinely received, this is not an appropriate basis for valuation of shares, especially given that the offer was made nine months before the year end. An appropriate level of professional scepticism has not been used in the audit of the financial asset.

Fair values should be determined close to the financial year end, and the $68,000 might reflect out-of-date perceptions of the value of Corden Co. From the information provided, it seems that the financial asset could be impaired and is likely to be overstated in value. Dean Co's 2% shareholding is recognised at $68,000; however, 2% of the net assets of Corden Co at 31 January 20X5 amounts to only $11,000. If the financial asset is overvalued, then any necessary adjustment would have a profit implication, and this is not mentioned in the audit working papers.

Using Group materiality in the audit of a subsidiary is not appropriate. The value of the financial asset is less than Group materiality, but it might be material to Dean Co's individual financial statements. It is not clear that the individual audit team determined an appropriate level of materiality as part of their planning of the individual company audit. The Group audit team should determine component materiality to be used by component auditors in their audit of subsidiary balances and transactions, and component materiality should be lower than materiality for the Group financial statements as a whole. Therefore, it seems likely that the Group audit team has not communicated an appropriate level of component materiality to the team auditing Dean Co.

While the possible adjustments in relation to the financial asset are not material to the Group, they could be material to Dean Co's individual financial statements, and there is a risk that an inappropriate audit opinion has been issued in relation to this subsidiary's individual financial statements.

(c) Horner Co

There has been a breach of relevant law and regulations. The audit team should have considered the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. ISA 250 states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

The auditor is required by ISA 315 (Revised 2019) to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore, the auditor should ensure that a full knowledge and understanding of the relevant data protection laws and regulations is obtained in order to evaluate the implications of non-compliance.

ISA 250 requires that when non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore, procedures should have been performed to obtain evidence about the suspected non-compliance, for example, to discuss the breach with management to understand how it happened, whether due to deliberate action or unintentional mistake, and who was responsible. In addition, the audit team should have performed further procedures, for example discussion with the company's legal advisors to understand the legal consequences of the breach. From the information provided it seems that the audit team failed to obtain more information or evidence due to their belief that the situation had little to do with the audit. The audit has therefore not been performed appropriately, as the requirements of ISA 250 have not been followed. The matter could be immaterial in monetary terms, but without further investigation, it is not possible for the audit team to reach this conclusion. However, in many jurisdictions fines and penalties associated with data protection breaches are often significant. Also, the matter could be material by nature, so regardless of the monetary amounts involved, further work should have been performed.

ISA 250 requires the matter to be discussed with management and where appropriate with those charged with governance. It appears that some discussion was held, as the audit manager is aware that the employee has been dismissed. However, the discussions should have been fully documented and raised to the level of Group management, as the matter could impact on the Group and not just on Horner Co.

The audit team should have considered the potential implications for the financial statements. The non-compliance could lead to regulatory authorities imposing fines or penalties on the Group, which may need to be provided for in both the individual and Group financial statements. Audit procedures should have been performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed. The individual and Group financial statements could be materially misstated and given that an unmodified audit opinion has already been issued, this is a significant issue for James & Co to now consider.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the company or the Group fail to make the necessary disclosures to the regulatory authorities, James & Co should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so. It seems that this has not been considered so far, but the audit firm can still make any necessary disclosures.

The *Code* requires auditors to comply with the principle of confidentiality, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. Further advice on disclosure in the public interest is given in the *Code*, which gives examples of situations where disclosure might be appropriate. These examples include references to an entity being involved in bribery and breaches of regulation which might impact adversely on public health and safety. The *Code* also clarifies that in exceptional circumstances where the auditor believes there may be an imminent breach of a law or regulation, they may need to disclose the matter immediately to an appropriate authority. The decision to disclose will always be a matter for the auditor's judgement and where the disclosure is made in good faith, it will not constitute a breach of the duty of confidentiality.

Tutorial note: *Credit will also be awarded for discussion of relevant ethical threats to objectivity which may arise in relation to the non-compliance, including intimidation and self-interest threats.*

<u>Marking Guide:</u>

Generally, up to 2 marks for each well explained point

(a) **Cameron Co**

- Internal audit – self-review threat and lack of professional scepticism (1 mark)
- Internal audit – insufficient audit work on internal controls including no understanding or evaluation of year-end controls obtained
- Internal audit – threat of assuming management responsibility and general risk that ethical code has not been followed by Carrey Associates
- Timing and reliance on controls testing
- Group audit firm has not evaluated Carrey Associates or obtained understanding of the firm
- No audit work performed by Group audit team on Cameron Co's different accounting policies – Group consolidation could be misstated
- Implications of former partner joining the component audit firm – familiarity and over reliance (1 mark)
- Possible lack of competence of the Group audit partner (1 mark)

Maximum marks **8 marks**

(b) **Dean Co**

- Lack of application of professional scepticism regarding valuation of financial asset
- Asset likely to be overvalued – could have material impact on Dean Co's financial statements

- Inappropriate application of Group materiality at component level

Maximum marks **5 marks**

(c) **Horner Co**

- Auditor is incorrect and laws and regulations do impact the audit and financial statements
- Auditor needs to gain understanding of applicable laws and regulations
- Further evidence should be obtained, and the matter discussed with Group management
- Provisions for fines and penalties have not been considered
- Auditor may have a legal duty to disclose, or consider disclosing in the public interest
- The audit firm may wish to seek legal advice regarding the situation (1 mark)

Maximum marks **7 marks**

Professional marks

Analysis and evaluation

- Effective appraisal of the information to make suitable recommendations for appropriate courses of action
- Appropriate assessment of the ethical and professional issues relating to the assignment, using examples where relevant to support overall comments

Professional scepticism and professional judgment

- Effective challenge and critical assessment of the conduct and extent of the audit work and evidence obtained with appropriate conclusions.
- Demonstration of the ability to probe into the reasons for quality issues including the identification of missing information or additional information which would be required
- Appropriate application of professional judgement to draw conclusions and make informed decisions about the actions which are appropriate in the context and stage of the engagement.

Commercial acumen

- Appropriate recognition of the potential impact of breaches of laws and regulations on the Group as a whole or the legal implications for James & Co
- Assessment of the conclusions from the quality review on the audit engagement and any potential impact on the reputation of James & Co

(5 marks)

Total **25 marks**

3. **Matty Co**

(a) **Matters and evidence**

(i) **Railway operating licence**

Matters

Uncertainties in relation to going concern

IAS 1 *Presentation of Financial Statements* requires management to disclose material uncertainties in relation to going concern and ISA 570 (Revised) *Going Concern* requires the auditor to assess the adequacy of this disclosure. Therefore, the principal matter raised by the unresolved status of the licence tender is the potential impact on Matty Co's financial performance and financial position if the company is unsuccessful in the tender process. This in turn creates uncertainties in relation to the going concern status of the company. The licence is due for renewal on 28 February 20X6 which is 11 months from the reporting date and therefore within the foreseeable future for the purpose of the going concern review. Although the company has been informed that it is the preferred bidder, there are still significant doubts as to whether the licence will be renewed given the government's requirement that the company addresses the recent criticisms and the pending review in one month's time.

The revenue generated from the national railway licence represents 66.9% of Matty Co's revenue for year and is highly material to the company's statement of profit or loss for the year and critical to its operations. It is also significant that the national railway licence contributed profit before tax of $11.2 million which is 106.7% of this year's profit; without this contribution to the company's profit this year, the company would be loss-making. In addition to these considerations, even with the inclusion of the national railway licence in this year's results, Matty Co's performance is deteriorating as evidenced by its declining revenue (down by 36.3%) and profit before tax (down by 52.5%). The company's assets are also down by 8.7% on the prior year which may be indicative of a business which is struggling to renew its capital expenditure and maintains its liquidity.

Evidence

- A review of the press reports in relation to the late running of Matty Co's trains and the quality of its service to assess the seriousness and significance of the issue.
- A review of any correspondence files between Matty Co and the government transport department in order to identify any developments in the licence renewal process and consider their impact on the likely renewal of the licence.
- Notes of discussions held between the auditor and the management of Matty Co in relation to any contingency plans if the company fails to secure the national railway licence; for example, any other licences or opportunities which may exist in the market and any emergency sources of finance which might be available to the company.
- A review of the company's board minutes for evidence of management discussion of the status of the tender process and of any contingency plans.
- A review and analysis of budgets and cash flow forecasts by the auditor in order to assess the ability of the company to survive as a going concern for the foreseeable future.
- Copies of the company's bank facilities reviewed to assess the feasibility of the company's ability to operate within them should they be unsuccessful in winning the contract.
- Written representations from management in relation to the status of the tender process and management's expectations of its expected outcome.

(ii) Purchased customer list

Matters

Assessment of useful life

The carrying amount of the customer list purchased from Jess Coaches is highly material to Matty Co's draft statement of financial position as it exceeds the materiality threshold set by the partner of

$1.05million. According to IAS 38 *Intangible Assets*, a reporting entity should recognise intangible assets initially at cost and should assess whether an intangible asset's useful life is finite or indefinite. An assessment of a useful life as indefinite is only appropriate if on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the intangible is expected to generate net cash inflows for the entity. This assessment requires a significant level of judgement to be exercised and the subjectivity of the carrying amount creates a high level of risk for the auditor. In this case, the trading history of Jess Coaches prior to its acquisition by Matty Co may provide some evidence that there is no foreseeable limit to the period over which the purchased customer list can be expected to generate cash flows. However, this assumption needs to be assessed carefully by the auditor. Intangible assets with an indefinite life should not be amortised according to IAS 38.

Impairment review

IAS 38 also requires a reporting entity to test intangibles with an indefinite useful life annually for impairment. This impairment review would involve a comparison of the carrying amount of the customer list to its recoverable amount which, given the difficulty in identifying a sales value for the customer list, is likely to be based on an assessment of its value in use. The assessment of value in use is a highly subjective exercise which involves an estimate of the future cash flows the entity expects to derive from the customer list, expectations about possible variations in the amount or timing of these future cash flows and the time value of money represented by the current market risk-free rate of interest. Management's assessment of value in use as $7.2 million appears to be very close to the asset's carrying amount of $6.9 million and it is possible that management may have manipulated its assumption to avoid the recognition of an impairment loss. The auditor will therefore need to carefully review and consider management's assessment of value in use and the assumptions implicit in its calculation.

In addition to these considerations, the emergence of a new competitor which is capable of taking major customers away from Jess Coaches and the loss of two key customers already, are indicators that the intangible asset may indeed be impaired. If the recoverable amount of the intangibles is therefore less than their total carrying amount of $6.9 million at the reporting date, an impairment loss should be recognised in the statement of profit or loss for the year and the intangibles should be written down accordingly.

Evidence

- A copy of the purchase agreement to identify the details of the acquisition including the purchase consideration, the assets acquired, and the date of the acquisition agreed to the detail included in the accounting records.
- Agreement of the purchase consideration of $6.9 million to the company's cash book and bank statement to confirm purchase price.
- A review of Jess Coaches' trading history and any market research which has been performed on the ability of the purchased customer list for evidence of how it will generate future revenue for Matty Co.
- A copy of the client's schedule calculating the value in use of the purchased customer list as $7.2 million and a confirmation of the schedule's mathematical accuracy.
- A review and assessment of the company's cash flow forecast which has been used to support the value in use of $7.2 million agreed to the value in use calculation.
- A discussion with management in relation to the basis of the calculation of value in use and an assessment by the auditor of the reasonableness of management's key assumptions.
- A sensitivity analysis performed by the auditor varying these key assumptions and an assessment of the materiality of the potential impact of varying the assumptions on the calculation of the value in use of the customer list.
- A review of Matty Co's management accounts for the reporting period and for the post reporting date period to date in order to identify and quantify the cash flows generated by Jess Coaches' customer list and any significant variances investigated.

- A comparison of the discount rate used in the value in use calculation to published market rates and notes of discussions with management in relation to the basis of any adjustments made by management, in order to ensure that an appropriate rate has been used.
- Written representations from management confirming that to the best of its knowledge, the assumptions used in the calculation of value in use are reasonable and appropriate and that in its opinion, the purchased customer list is not impaired and its carrying amount is fairly stated.

(b) Appropriateness of the draft auditor's report

The finance director has agreed to include a short note to the financial statements to disclose information relating to the material uncertainty relating to going concern. The note must be reviewed for completeness and if the auditor assesses that the client's disclosure is not adequate, a modified audit opinion would be appropriate in relation to a material misstatement as a result of the inadequate disclosure.

The form of the opinion would be qualified 'except for' or adverse depending on the auditor's judgement of the matter's pervasiveness to the financial statements. In this case, adverse may be the appropriate form of audit opinion given that the disclosure note is described as 'short' and that management may appear to negate the significance of the uncertainties by stating that they are 'very confident' that they will be successful in the tender process. A full description of the status of the tender negotiations as at the date of the auditor's report and their potential impact on the financial statements should then be detailed in the 'Basis for Qualified or Adverse Opinion' paragraph.

However, if on the other hand, the outcome of the auditor's assessment is that the client's financial statement disclosures are considered by the auditor to be appropriate, the material uncertainty in relation to going concern should be disclosed in a separate section entitled 'Material Uncertainties related to Going Concern' which should appear immediately below the 'Basis for Opinion Paragraph' and not in the Key Audit Matters (KAM) section of the auditor's report. According to ISA 570, the Material Uncertainty Related to Going Concern section should:

- Draw attention to the note in the financial statements which discloses the going concern issue; and
- State that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the that auditor's opinion is not modified in respect of the matter.

Matty Co is a listed entity and according to ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, KAM disclosures are required in the auditor's report for high-risk areas, significant judgements and the effect of significant events or transactions which occurred during the period. The assessment of the useful life of the customer list as indefinite and management's conclusion that the intangibles are not impaired, are areas of both significant judgement and high risk given the materiality of the intangibles. The auditor should consider disclosing these matters in the KAM section of the auditor's report.

Marking Guide:

(a) Matters and evidence

Generally, up to 1 mark for each matter explained and each piece of evidence recommended.

Railway licence

Matters

- Management should disclose material uncertainties and auditor should assess adequacy of this disclosure
- Significant uncertainty exists over renewal of licence
- Materiality of national railway licence contribution to revenue/profit

- Without national railway licence, company would be loss-making
- Company has deteriorating performance, declining revenue, profit and assets
- Company may be unable to renew capex and maintain liquidity

Evidence

- A review of the press reports in relation to the late running of Matty Co's trains and the quality of its service to assess the seriousness and significance of the issue.
- A review of any correspondence files between Matty Co and the government transport department in order to identify any developments in the licence renewal process and consider their impact on the likely renewal of the licence.
- Notes of discussions held between the auditor and the management of Matty Co in relation to any contingency plans if the company fails to secure the national railway licence; for example, any other licences or opportunities which may exist in the market and any emergency sources of finance which might be available to the company.
- A review of the company's board minutes for evidence of management discussion of the status of the tender process and of any contingency plans.
- A review and analysis of budgets and cash flow forecasts by the auditor in order to assess the ability of the company to survive as a going concern for the foreseeable future.
- Copies of the company's bank facilities reviewed to assess the feasibility of the company's ability to operate within them should they be unsuccessful in winning the contract.
- Written representations from management in relation to the status of the tender process and management's expectations of its expected outcome.

Maximum marks **7 marks**

Purchase of customer list

Matters

- Materiality of customer list (1/2 mark)
- Accounting rules of intangible assets with indefinite life
- Assessment is matter of significant judgement and high audit risk
- Indefinite useful life must be substantiated
- Must test intangible with indefinite useful life annually for impairment
- Accounting rule for impairment review
- Possible manipulation by management to avoid impairment loss
- Loss of two major customers/new competitor- possible impairment indicators
- If recoverable amount is less than carrying amount, impairment loss should be recognised in P/L for year.

Evidence

- A copy of the purchase agreement to identify the details of the acquisition including the purchase consideration, the assets acquired, and the date of the acquisition agreed to the detail included in the accounting records.
- Agreement of the purchase consideration of $6.9 million to the company's cash book and bank statement to confirm purchase price.
- A review of Jess Coaches' trading history and any market research which has been performed on the ability of the purchased customer list for evidence of how it will generate future revenue for Matty Co.
- A copy of the client's schedule calculating the value in use of the purchased customer list as $7.2 million and a confirmation of the schedule's mathematical accuracy
- A review and assessment of the company's cash flow forecast which has been used to support the value in use of $7.2 million agreed to the value in use calculation.

- A discussion with management in relation to the basis of the calculation of value in use and an assessment by the auditor of the reasonableness of management's key assumptions
- A sensitivity analysis performed by the auditor varying these key assumptions and an assessment of the materiality of the potential impact of varying the assumptions on the calculation of the value in use of the customer list.
- A review of Matty Co's management accounts for the reporting period and for the post reporting date period to date in order to identify and quantify the cash flows generated by Jess Coaches customer list and any significant variances investigated.
- A comparison of the discount rate used in the value in use calculation to published market rates and notes of discussions with management in relation to the basis of any adjustments made by management, in order to ensure that an appropriate rate has been used
- Written representations from management confirming that to the best of its knowledge, the assumptions used in the calculation of value in use are reasonable, appropriate and that in its opinion, the purchased customer list is not impaired and its carrying amount is fairly stated.

Maximum marks	**8 marks**

(b) Appropriateness of draft auditor's report

Generally, 1 mark for each reporting implication explained.

- Inappropriate disclosure - modified opinion due to material misstatement
- Opinion would be qualified or adverse based on auditor's judgement of pervasiveness.
- Discussion of pervasiveness - disclosure paragraph may lack detail/ be contradictory.
- If disclosures not adequate, matter should be detailed in 'Basis for Qualified/ Adverse Opinion' paragraph
- Disclosure adequate, uncertainties should be disclosed in separate section/ 'Material Uncertainties related to Going Concern /Not KAM
- KAM disclosures required for high-risk areas, significant judgements and the effect of significant events or transactions that occurred during the period
- Inclusion as KAM - carrying amount of customer list/ management's conclusion that intangibles not impaired

Maximum marks	**5 marks**

Professional marks

Analysis and evaluation

- Identification of omissions from the analysis or further analysis which could be carried out in respect of the railway operating licence and the purchased customer list.
- Balanced assessment of the information to determine the appropriate audit opinion in the circumstances

Professional scepticism and judgement

- Effective challenge and critical assessment of information, evidence and assumptions supplied and demonstration of professional judgement in identifying appropriate evidence to support conclusions for the audit engagement team.
  Appropriate application of professional scepticism and judgement to draw conclusions and make informed decisions which are appropriate in the context of the engagement.

Commercial acumen

- Appropriate recognition of the wider implications of the information obtained during the audit regarding the railway licence, and the potential impact for Matty Co.

Maximum marks	**5 marks**