Answers

1 Briefing notes

To: Audit engagement partner

From: Audit manager

Subject: Rick Group – Audit planning

Introduction

These briefing notes are prepared to assist with planning the audit of the Rick Group (the Group) for the financial year ending 30 September 20X5. The notes contain an evaluation of the audit risks, which should be considered in planning the Group audit. The notes also evaluate the audit strategy, which has been prepared by Neegan Associates for the audit of Daryl Co and recommend further audit procedures to be performed by the component auditors. Finally, the briefing notes address the issue of a potential joint audit, should a new subsidiary be acquired in Farland next year.

(a) Audit risk evaluation

Annual incentive scheme

The amount to be recognised in respect of the annual incentive scheme could be material given that the bonus can be as much as 5% of employees' salary. Based on prior year's figures, the total bonus payable would have been $8·2 million, representing 14% of prior year's profit before tax, and therefore material to the financial statements.

The annual incentive scheme gives rise to an inherent risk at the financial statement level. Employees whose bonus payment is linked to profitability have an incentive to maximise profit, and given that senior executives are involved with the scheme, there is a risk of management bias in the financial statements. The audit team should therefore be alert to situations where revenue could be overstated and expenses understated.

There is also an audit risk relating to the obligation for the Group to pay the bonus, which should be recognised as an accrual at the year end. There is a risk that the liability recognised is over or understated in value given the potential complexity involved in calculating the bonus payment, the calculation of which is based on a range of selected targets for different employees.

Legal case

In January 20X5, a legal case was brought against the Group. From the information provided, it is not possible to determine if it is material, however, there should be appropriate consideration as to whether the court case gives rise to an obligation at the reporting date.

According to IAS® 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised as a liability if there is a present obligation as a result of past events which gives rise to a probable outflow of economic benefit which can be reliably measured. There is therefore an audit risk that if any necessary provision is not recognised, liabilities and expenses will be understated.

If there is a possible obligation at the reporting date, then disclosure of the contingent liability should be made in the notes to the financial statements. There is a risk of inadequate disclosure if the Group finance director refuses to make appropriate disclosure in the notes – this is an audit risk whether the situation gives rise to a provision or a contingent liability, as provisions also have disclosure requirements which may not be complied with.

Group finance director's attitude

There may be a further issue related to the legal case regarding the attitude of the Group finance director, who appears to have dismissed the accounting implications of the legal case and is reluctant to discuss the matter with the audit team. This could indicate that the Group finance director is deliberately obstructing the work of the audit team, and perhaps has something to hide. This indicates a potential wider issue, that the Group finance director is imposing a limitation on the scope of the audit. The Group audit strategy should consider this issue, and the audit engagement partner may wish to discuss the issue with the Group audit committee as a matter of urgency.

This increases the risk that the legal claim will not be recognised appropriately in the financial statements, and the audit team must approach this issue with a heightened degree of professional scepticism.

There may be other areas in which professional scepticism should be applied, for instance, in respect of the amortisation of intangible assets, which will be discussed later in the briefing notes, and where the Group finance director appears to be using inappropriate justifications for the Group's accounting treatment of licence fees.

Daryl Co – local accounting rules

Daryl Co is a significant component of the Group, with its assets equating to 17·9% of the Group's total projected assets.

This company is the only component of the Group which does not use IFRS® Standards as its financial reporting framework. Daryl Co's financial statements will be prepared under local accounting rules and audited by Neegan Associates on that basis. In accordance with IFRS® 3 *Business Combinations*, for the purpose of consolidation the Group's accounting policies must be applied to all balances and transactions which form part of the consolidated financial statements. There is an audit risk that

the Group's policies are not applied correctly, meaning that the amounts consolidated in respect of Daryl Co are not recognised, measured or disclosed appropriately.

Daryl Co – possible impairment

The goodwill in relation to Daryl Co is material to the Group financial statements, at 4·9% of total assets.

According to IAS 36 *Impairment of Assets*, goodwill should be tested for impairment annually, which is the Group's accounting policy. The audit strategy prepared by Neegan Associates indicates that Daryl Co is loss making this year, which is an indication of impairment. Therefore management will need to factor this into their impairment review. As the Group's performance in the past has been strong, no goodwill impairment has been recognised, and management may lack experience in dealing with a loss-making subsidiary as part of their impairment testing. There is also an incentive for impairment losses not to be recognised, due to the annual incentive scheme which is based on profit.

For these reasons, there is an audit risk that goodwill could be overstated, and expenses understated, if any necessary impairment loss is not correctly determined and recognised.

Reliance on component auditors

Given the materiality of Daryl Co, the Group audit team needs to consider the extent of reliance which can be placed on the audit of the company conducted by Neegan Associates. The independence and competence of Neegan Associates will need to be evaluated by the Group audit team, though presumably as the audit firm already has experience of Neegan Associates from previous years' audits, this evaluation will already have been performed. However, independence is threatened by the fact that Neegan Associates has been engaged in providing a non-audit service to Daryl Co since 1 October 20X4. This matter is discussed further in the section of the briefing notes dealing with the component auditor's strategy. Any material misstatements which may remain uncorrected in Daryl Co will impact on the consolidated financial statements, leading to audit risk at the Group level.

Post year-end acquisition of Michonne Co

The acquisition of Michonne Co is planned to take place within a month of the reporting date. It is therefore a significant event which is taking place after the year end and as such, it falls under the scope of IAS 10 *Events After the Reporting Period*. According to IAS 10, a non-adjusting event is an event which is indicative of a condition which arose after the end of the reporting period, and which should be disclosed if they are of such importance that non-disclosure would affect the ability of users to make proper evaluations and decisions. The required disclosure includes the nature of the event and an estimate of its financial effect or a statement that a reasonable estimate of the effect cannot be made. In addition, IFRS 3 requires disclosure of information about a business combination whose acquisition date is after the end of the reporting period but before the financial statements are authorised for issue.

There is therefore an audit risk that the disclosure in relation to the acquisition of Michonne Co is not complete or accurate.

Trend in revenue

The financial information shows that total revenue is projected to increase by 25·6% this financial year. This is a significant increase and it could indicate that revenue is overstated. However, the number of subscription members is projected to increase by 30·1%, so possibly the increase in revenue is simply as a result of the Group attracting more customers – but this is a very significant increase and will need to be substantiated.

However, when looking at revenue per customer per year, this is projected to fall from $96·65 in 20X4 to $93·33 in 20X5. Revenue per customer per month is therefore projected to fall from $8·05 in 20X4 to $7·78 in 20X5. These trends seem to contradict the introduction of the new premium subscription package, which should bring in additional revenue per customer. Possibly the premium subscription has not been taken up by many customers. It is, however, unusual to see a downwards trend in revenue per customer per month, given that the price of a regular subscription has remained the same as in the previous year, at $8·20 per month. Possibly the figures are impacted by the free trial period offered to new customers. These trends will need to be investigated to ensure that revenue is being measured appropriately and recognised at the correct point in time.

There is also a risk arising from the Group invoicing customers in advance, with revenue recognised when the bill is sent to the customer. Possibly this could lead to early recognition of revenue, i.e. recognising prior to the Group providing a service to its customers. IFRS 15 *Revenue from Contracts with Customers* requires that revenue is recognised when a performance obligation is satisfied by transferring a promised good or service to a customer, and when providing a service over time, it can be difficult to determine how much service has been provided and therefore the amount of revenue which can be recognised at a particular point in time. There is therefore a risk of overstatement of revenue if the requirements of IFRS 15 are not adhered to.

Amortisation of licences

The licences recognised as intangible assets are highly material to the Group, representing 74·4% of total assets. Given that each licence is for a fixed period, it is appropriate to amortise the cost of each licence over that fixed period in accordance with IAS 38 *Intangible Assets*, which requires that the cost of an intangible asset with a finite useful life should be amortised on a systematic basis over its life.

Therefore, the Group's accounting policy to amortise all licences over a five-year period may be too simplistic, especially given the significance of the balance to the Group financial statements. Some of the licences have a shorter life, as the licences vary

between three and five years, indicating that the determination of amortisation for the class of assets as a whole may not be accurate, leading to overstatement of intangible assets and overstatement of profit.

The finance director's assertion that the accounting policy is 'the most prudent' is not appropriate. The accounting policy should be based on the specific, relevant IAS 38 requirements. It could be a means of earnings management, i.e. to minimise the amortisation charge and maximise profits.

The auditor should also consider whether this issue has arisen in previous years' audits. The Group may have changed its estimation technique with regard to amortisation of intangible assets; if this is the case, the rationale for the change must be understood.

(b) (i) Evaluation of component auditor's audit strategy

Materiality

ISA 320 *Materiality in Planning and Performing an Audit* acknowledges that the determination of materiality involves the exercise of professional judgement. There are no set rules about how a level of materiality should be arrived at. A percentage is often applied to a chosen benchmark as a starting point in determining materiality for the financial statements as a whole, and it is acceptable to use a benchmark of 1% of total assets as a basis for materiality. However, this would normally be used for a capital-intensive business, not for a company like Daryl Co, which is service based.

A percentage of profit is deemed an appropriate method of calculating materiality in a profit-making business. However, as we have seen with Daryl Co, this can be distorting in a year of significant losses. It is not common to ignore materiality based on profit or revenue completely. The fact that the company has made a loss this year does not mean that materiality should be based on assets alone.

Neegan Associates should revisit how materiality has been determined. It may be appropriate to use a different materiality level for profit and loss balances, for example, one based on revenue or an adjusted profit figure is more appropriate than the reported profit (or loss) before tax. ISA 320 states that where circumstances give rise to an exceptional decrease or increase in profit, the auditor might conclude that materiality for the financial statements as a whole is more appropriately determined using a normalised profit before tax from continuing operations figure based on past results.

The fact that materiality has been set at a higher level this year is not likely to be appropriate given that the company is loss making and facing unusual trading conditions with the loss of many customers. This indicates that the audit is likely to be higher risk, so a lower level of materiality should be applied and as such implies that appropriate professional judgement has not been applied.

There must be full documentation of how materiality has been determined on the audit file. This should cover the rationale for determining different materiality levels which have been decided upon for different classes of transaction and balances.

Audit of payroll

The audit work planned on payroll appears to be limited due to the audit firm, Neegan Associates, having performed a payroll service for Daryl Co since 1 October 20X4. This is not appropriate and will not provide sufficient and appropriate audit evidence regarding the $6 million payroll expense. Given that payroll is material to the company's financial statements, based on Neegan Associates' own materiality threshold of $1·4 million, further testing will be required.

An ethical threat to auditor's independence is raised by the provision of the payroll service to the client. There is a significant self-review threat which means that Neegan Associates is over-relying on the work they have performed on payroll as a non-audit engagement and are not planning to audit the $6 million at all.

Providing this type of non-audit service might be allowed in the jurisdiction where Neegan Associates operates. However, according to ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)*, when performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements which are relevant to the group audit. Such requirements may be different or in addition to those applying to the component auditor when performing a statutory audit in the component auditor's jurisdiction.

Therefore, the IESBA *International Code of Ethics for Professional Accountants* (the *Code*) should be applied. The *Code* states that for a listed company, a firm shall not provide accounting or bookkeeping services, including payroll services, which results in financial information which forms the basis of financial statements on which the firm will provide an opinion. Therefore, as Daryl Co is listed, the service should not have been provided.

There also needs to be discussion of the situation with Neegan Associates and the management of Daryl Co and the Group, with the objective of ensuring that an alternative provider is found for the payroll accounting services.

Sale of property

In the individual financial statements of Daryl Co, under local accounting rules the sale of property to the Group chief executive officer (CEO) does not need to be disclosed. However, from the Group perspective, it meets the definition of a related party transaction under IAS 24 *Related Party Disclosures*, and will need to be disclosed in the consolidated financial statements. As the transaction would also be considered to be material by nature, the Group audit team must therefore provide instructions to Neegan Associates on the additional audit work to be performed which will enable sufficient and appropriate evidence to be obtained in respect of the transaction and disclosure. These procedures will be outlined in the next section of these briefing notes.

The cash proceeds arising on the sale of the property are well below the materiality level determined by Neegan Associates, so this might justify the minimal audit procedures which have been planned in relation to the individual financial statements. However, the procedures do not consider how the profit or loss being made on the disposal is determined or whether the asset has been properly removed from the accounting records. The carrying amount of the asset itself may be material to the financial statements of the company.

There may be an incentive to recognise a higher profit than is appropriate on this transaction due to trading difficulties encountered by the company during the year, so the transaction may be at risk of material misstatement with the objective of maximising the profit recognised.

There is no evidence that the transaction is *bona fide* – the CEO has not yet paid for the property and the whole transaction could be an attempt to window dress the financial statements. Overall, this evaluation has indicated that there are problems in how Neegan Associates has planned the audit of Daryl Co. The audit work which is planned will not provide sufficient, appropriate audit evidence in relation to the issues identified.

Therefore the Group audit team will need to consider the overall planning of the audit of Daryl Co and the level of testing they subsequently request that Neegan Associates carries out to satisfy themselves of the accuracy of the figures presented in Daryl Co's financial statements for inclusion in the consolidated financial statements.

(ii) Audit procedures on sale of property

- Review board minutes to see if the property sale has been deliberated, i.e. has the rationale for the transaction been discussed, and formally approved by the company's board.
- Agree the $50,000 sale price to the legal documentation relating to the sale of the property to the Group CEO.
- Confirm the carrying amount of the property at the date of disposal to underlying accounting records and the non-current asset register.
- Confirm that the asset has been removed from the company accounts at the date of disposal.
- Obtain management's determination of profit or loss on disposal, re-perform the calculation based on supporting evidence, and agree the profit or loss is recognised appropriately in the company statement of profit or loss.
- Obtain an estimate of the fair value of the property, for example, by comparison to the current market price of similar properties and consider the reasonableness of the transaction and sale price.
- Obtain written representations from company management that all matters related to this related party transaction have been disclosed to the Group management and to the Group audit team.
- Obtain written representation from the Group CEO regarding the transaction, to confirm the amount which is outstanding, and the likely timescale for payment.
- Review cash receipts after the reporting date to confirm whether or not the $50,000 has been received from the Group CEO.

(c) Discussion and justification for a joint audit of Michonne Co

In a joint audit, two or more audit firms are responsible for conducting the audit and for issuing the audit opinion. The main advantage of a joint audit of Michonne Co is that the local audit firm's understanding and experience will be retained, and that will be a valuable input to the audit. At the same time, Atlanta & Co can provide additional skills and resources if necessary.

Farland may have different regulations to the rest of the Group, for example, there may be a different financial reporting framework. It therefore makes sense for Lucille Associates, the local auditors, to retain some input to the audit as they will have detailed knowledge of such regulations.

The fact that the company is located in a distant location means that from a practical point of view it may be difficult for Atlanta & Co to provide staff to perform the majority of the audit work. It will be more cost effective for this to be carried out by local auditors.

Two audit firms can also stand together against aggressive accounting treatments. In this way, a joint audit can enhance the quality of the audit. The benchmarking which takes place between the two firms raises the level of service quality.

Disadvantages of a joint audit of Michonne Co

The main disadvantage is that for the Group, having a joint audit is likely to be more expensive than appointing just one audit firm. However, the costs are likely to be less than if Atlanta & Co took sole responsibility, as having the current auditors retain an involvement will at least cut down on travel expenses. Due to the size of the respective firms, Lucille Associates will probably offer a cheaper audit service than Atlanta & Co.

For the audit firms, there may be problems in deciding on responsibilities, allocating work, and they will need to work very closely together to ensure that no duties go underperformed, and that the quality of the audit is maintained. There is a risk that the two firms will not agree on a range of matters, for example, audit methodology, resources needed and review procedures, which would make the working relationship difficult to manage.

Problems could arise in terms of liability because both firms have provided the audit opinion; in the event of litigation, both firms would be jointly liable. While both of the firms would be insured, they could blame each other for any negligence which was discovered, making the litigation process more complex than if a single audit firm had provided the audit opinion.

Recommendation

On balance, the merits of performing a joint audit outweigh the possible disadvantages, especially if the two audit firms can agree on the division of work and pool their expertise and resources to provide a high-quality audit.

Conclusion

The briefing notes indicate that there are several significant audit risks to be addressed, in particular, there are risks relating to the foreign subsidiary and relating to the revenue and the accounting treatment applied to intangible assets. In respect of the component audit firm, there are some concerns over the adequacy of their audit planning, which will need further consideration in developing the Group audit strategy. Finally, performing a joint audit on Michonne Co appears to be a good way to perform a high-quality audit on this new subsidiary.

2 (a) (i) Fraud

If the full extent of the fraud is $40,000, then the audit team is correct to determine that the fraud is immaterial to the financial statements. However, without performing further procedures it is not possible to reach that conclusion. There is no auditor-generated evidence to support the assertion that $40,000 is the total amount of stolen funds. Relying solely on a conversation between the Group finance director and the manager who carried out the fraud and a list of invoices provided by the Group finance director is not acceptable as this evidence is not sufficiently reliable.

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

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

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

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

Tutorial note: *Anti-money laundering legislation is likely to impose a duty on auditors to report suspected money laundering activity. Suspicions relating to fraud are likely to be required to be reported under this legislation. Therefore credit will be awarded for relevant consideration of whether Saul & Co should report the fraud on this basis.*

(ii)
and **(iii)** Audit evidence

Development costs

Given that the development costs are material to the Group financial statements, more audit work should have been carried out to determine whether it is acceptable that all, or some, of the $600,000 should have been capitalised. There is a risk that research costs, which must be expensed, have not been distinguished from development costs, which can only be capitalised when certain criteria have been met. Currently, there is not sufficient, appropriate audit evidence to conclude that the accounting treatment is appropriate, and intangible assets could be materially misstated.

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

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

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

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

Further evidence should be obtained to distinguish between research costs and development costs, and to support whether the development costs meet the recognition criteria in IAS 38 *Intangible Assets*, and to confirm whether all of the $600,000 should be capitalised. Further evidence should be obtained, including:

– A discussion with the project manager to obtain their view on the likely launch date for the new product, anticipated level of demand, any problems foreseen with completion of the project.

– A further review of a sample of the costs included in the $600,000, including evaluation of whether the costs are capital or revenue in nature.

– For the sample of costs, review purchase invoices and ensure they are in the name of the company to confirm the rights and obligations assertion of the capitalised costs.

– Results of any market research to support the assertion that the new product will generate future economic benefit.

– A discussion with management to identify how they have incurred development costs without carrying out any research first.

– Assuming that the Group finance director makes the supporting documentation, including assumptions, available to the audit team, the assumptions should be reviewed for reasonableness, with the auditor considering whether they are in line with business understanding and with other audit evidence obtained.

Trade receivables

The trade receivable is material to the Group financial statements and currently there is not sufficient, appropriate audit evidence to determine whether the amount should remain recognised within current assets. The Group financial statements could be materially misstated if any necessary reduction in value is not recognised.

Agreeing the balance to invoices and order forms may provide evidence of existence but it does not provide evidence on the recoverability of the balance. Including the balance owed by Hamlyn Co in the direct confirmation sample was appropriate given the materiality of the amount involved, but again this would not indicate the recoverability of the balance, even if Hamlyn Co had replied, so additional procedures would have always been required. Therefore there does not appear to be appropriate audit evidence to confirm the valuation of the trade receivable.

Discussing the situation with the credit controller will provide some relevant background information, but on its own it is not sufficiently robust evidence to support the continued recognition of the balance. Further evidence should be obtained including:

– Any written correspondence between the Group and Hamlyn Co indicating the measures which the Group has taken to attempt to recover the debt, and the response from Hamlyn Co.

– Search public registers for evidence of whether Hamlyn Co has been placed in administration or receivership (e.g. Companies House or equivalent), this will indicate the need for an impairment review if it is listed.

– Review of post year-end cash receipts for any amounts received from Hamlyn Co.

(b) Critique of auditor's report

Headings and structure

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

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

Qualified opinion

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

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

Basis for qualified opinion

This paragraph should contain further information on the reasons for the modification including a description and quantification of the financial effects of the material misstatement. In this case, the paragraph should refer to the overstatement of trade receivables of $450,000, and the overstatement of profit by the same amount. Currently, the paragraph refers to an overstatement of $500,000, which contradicts the conclusion based on audit evidence.

Emphasis of matter paragraph

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

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

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

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

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

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

3 (a) Lavenza Co

(i) Matters to consider before accepting the review engagement

Before accepting the review engagement to review and provide an assurance report on Lavenza Co's cash flow forecast, ISAE 3400 *The Examination of Prospective Financial Information* identifies a number of matters which need to be considered:

The intended use of the information

Moritz & Co must consider, for example, whether the cash flow forecast and assurance report will be used solely for the purpose of the increase in Lavenza Co's overdraft facility. If Lavenza Co is planning to use the assurance report for purposes other than an extension to its current overdraft, for example, to arrange new loan finance from the company's bank, this must be made clear to Moritz & Co.

Whether the information will be for general or limited distribution

Moritz & Co needs to consider who will receive the report and potentially rely upon it as this will impact on the firm's assessment of the risk associated with the engagement. If the cash flow forecast is intended for general distribution, this will increase the level of risk for Moritz & Co as a larger audience will rely on it. In this case, if the information will be used solely in support of the application to the bank and will not be made available to other parties, this should be confirmed before accepting the engagement and will reduce the risk of the assignment.

The period covered by the cash flow forecast and the key assumptions used

Moritz & Co must also consider the period covered by the cash flow forecast and the key assumptions which have been used in its preparation. Short-term forecasts are likely to be easier to verify and provide assurance on than longer term projections. ISAE 3400 states that a prospective financial information (PFI) engagement should not be accepted when the assumptions used in its preparation are clearly unrealistic or when the practitioner believes that the PFI will be inappropriate for its intended use. In the case of Lavenza Co, although the forecast is only for 12 months, the growth rates assumed in relation to its operating cash receipts may, for example, be judged to be unrealistic given recent trends in its business and the requested overdraft facility of $17 million for the next six months may prove to be insufficient.

The scope of the work

Moritz & Co will need to consider the specific terms of the engagement, the level of assurance being sought by Lavenza Co and the form of the report required by the bank. Moritz & Co will need to identify clearly the elements which it is being asked to report on – for example, is it being asked to report on the cash flow forecast only or is the firm also being asked to report on accompanying narrative or other PFI. Due to the uncertainty of forecasts and the inevitable subjectivity involved in their preparation, Moritz & Co will need to confirm that it is only being asked to provide negative assurance as to whether management's assumptions provide a reasonable basis for the cash flow forecast and to give an opinion as to whether it is properly prepared on the basis of these assumptions.

Resources and skills

The firm needs to consider whether it has sufficient staff available with the appropriate skills and experience needed to perform the PFI engagement for Lavenza Co. Moritz & Co should also consider whether it can meet the deadline for

completing the work and whether it will have access to all relevant information and client staff. Given the company's predicted need for cash in the next six months, presumably the extended overdraft facility will need to be provided very soon and this may lead to Moritz & Co being under pressure to meet a tight reporting deadline.

Client integrity

ISQC 1 *Quality Control for Firms that Perform Audits and Reviews of Financial Information, and Other Assurance and Related Services Engagements* requires Moritz & Co to consider the integrity of Lavenza Co's management in relation to the acceptance decision. In particular, the firm should consider management's reasons for appointing a different firm from its auditors and the potential for management bias in the preparation of a cash flow forecast in support of its required overdraft facility.

In addition to the matters identified by ISAE 3400 and ISQC 1, Moritz & Co should also consider the following ethical matters before accepting the review engagement:

Ethical matters

Given that Moritz & Co are not the auditors, the firm's independence from Lavenza Co will not have been previously considered. In this regard, it is important to ensure that there are no threats to the firm's objectivity which might prevent it from accepting the appointment. If the firm is not independent and its objectivity is compromised, the reliability of the assurance report will be undermined.

Moritz & Co should also consider why the auditors have not been asked to provide the assurance report on Lavenza Co's cash flow forecast. In order to provide an assurance report on PFI, a good understanding of the client and its business is required and the incumbent audit firm will usually have the requisite knowledge and understanding. Moritz & Co should therefore consider whether the use of a different firm creates a risk that the client may be hoping that the firm may not be in a position to effectively challenge the key assumptions underlying the preparation of the forecast. When a professional accountant is asked to perform work for a non-audit client, they should be given permission by the client to contact its auditors in order to obtain relevant information. If this permission is not given, the appointment should be declined.

Overall, Moritz & Co must assess the risks associated with the review engagement and should not accept an engagement when the assumptions are clearly unrealistic or when the firm believes that the prospective financial information will be inappropriate for its intended use.

(ii) Examination procedures on cash flow forecast

- Cast the cash flow forecast to confirm its mathematical accuracy.
- Confirm the consistency of the accounting policies used in the preparation of the forecast financial statements with those used in the last audited financial statements.
- Agree the opening cash position of $9,193,000 to the cash book and the bank statement.
- Discuss the key assumptions underlying the preparation of the forecast with management, including:
  - the predicted growth rates in operating cash receipts of 13·4% over the year compared to an equivalent growth rate of only 7·3% in operating cash payments.
  - the stated collection and payment periods in relation to receivables and payables.
  - confirm that the assumptions appear reasonable and are consistent with the firm's knowledge and understanding of the client.
- Analytically review the forecast trends in cash flows comparing with them with historical cash flow statements and other forecast data which is available for the sector and local economy and investigate any significant differences.
- Agree the settlement discount of 8% and the late payment penalty of 5% penalty terms with suppliers to supporting contractual documentation; agree to purchase ledger payments in order to confirm that discounts are taken and penalties are paid.
- Agree the predicted collection and payment periods to the most recent sales ledgers and purchase ledgers.
- Recalculate the patterns of cash flows based on management's historical analysis of credit sales to confirm that the forecast has been properly prepared on the basis of these assumptions.
- Perform sensitivity analyses on the cash flow forecast by varying the key assumptions (in particular, in relation to growth rates and payment periods) and assessing the impact of these variations on the company's forecast cash position.
- Agree the salary payments to the latest payroll records and cash book payments analyses to confirm accuracy and completeness.
- Obtain and review a breakdown of the forecast overhead payments and compare it to historical management accounts and current budgets. Review the schedule to ensure that non-cash items such as depreciation, amortisation and bad debts have not been included.
- For a sample of overhead costs, review the supporting documentation such as invoices and utility bills and agree the amount paid each month to the cash book.

- Obtain and review budgets and analyses of costs to date for the new shops and the online marketing campaign ensuring that the forecast includes all of the budgeted costs and does not include any costs which have already been incurred. Agree a sample of costs to supporting documentation such as invoices, quotations and lease agreements.
- Review board minutes for discussion of the new shops and the marketing campaign.
- Review the outcomes of previous management forecasts and assess their accuracy compared to actual data.
- Assess the competence and experience of the preparer of the forecast.
- Discuss possible cost omissions with the preparer of the forecast, for example, Lavenza Co's cash flow forecast does not include finance costs, tax payments and does not include any capital expenditure other than the new shops.
- Obtain written representations from management confirming the reasonableness of their assumptions and that all relevant information has been provided to Moritz & Co.
- Request confirmation from the bank of the potential terms of the additional finance being negotiated, to confirm the interest rate.
- Consider whether the finance charge in the forecast cash flow appears reasonable.

Tutorial note: *Credit will be awarded for relevant numerical analysis of the cash flow forecast applied appropriately within the answer.*

(b) Beaufort Co – ethical and professional issues arising

Long association of senior audit personnel

Frances Stein's eight-year tenure as audit engagement partner creates a familiarity threat for Moritz & Co. The threat arises because using the same senior audit personnel on an audit assignment over a long period of time may cause the auditor to become too familiar and too trusting with the client resulting in less professional scepticism being exercised and the possibility of material misstatements going undetected. According to the IESBA *International Code of Ethics for Professional Accountants* (the *Code*), with listed audit clients key audit partners must be rotated after seven years unless exceptional circumstances arise. In this case, the *Code* permits the partner's tenure to be extended for one further year where this is deemed to be necessary in order to maintain audit quality. The *Code* also clarifies that if an existing audit client becomes listed, the length of time which the partner has already served on the client is included in the period to be considered. In the case of Beaufort Co, therefore, Frances Stein has already served as a key audit partner for the maximum possible period of eight years and following the listing of the client next year, it would be appropriate for her to be replaced by another audit partner. The code does allow an exception, which states that with the agreement of those charged with governance, she could serve for a maximum of an additional two years. After this, she may not serve as a key partner on the audit for a minimum of five further years.

Fee dependence

Over dependence on an audit client for fee income leads to a self-interest and intimidation threat for the auditor. The self-interest threat arises as the firm will have a financial interest in the client due to its dependency on the client and its concern about the impact on its business if it were to lose the client. In the case of a listed client, the *Code* states that an audit firm's independence is threatened and should be reviewed if the total fees from a single client exceed 15% of its total fee income for two consecutive years. In this case, the 15% limit has been exceeded in both 20X4 and 20X5 and following the listing of the company's shares in September 20X5, Moritz & Co is required to review its dependence on the client. If retained as a client, the level of fees should be disclosed to those charged with governance and it should be discussed whether prior to the audit opinion being issued, having an independent pre-issuance or post-issuance review performed on the engagement by an external party or by the firm's professional regulatory body is enough to mitigate the threat.

Provision of bookkeeping and accounting services

The provision of bookkeeping and accounting services for Beaufort Co creates a self-review threat for Moritz & Co. The self-review threat arises because the auditor is generating figures for inclusion in the financial statements on which they will then give an opinion. As a result, the auditor may be less likely to highlight errors if they are aware that another member of the firm has calculated the figures. For a listed client, the *Code* states that a firm is not permitted to provide accounting and bookkeeping services. The *Code* does, however, make an exception for divisions of a company if the services are of a routine and mechanical nature, a separate team is used and the service which the firm provides relates to matters which are immaterial to the division and the company. Following Beaufort Co's listing in September 20X5, therefore, Moritz & Co will no longer be able to provide the payroll services for Beaufort Co although it may still be able to maintain the financial records for the small division if the conditions stated in the *Code* are satisfied.

Share prospectus

Moritz & Co has been asked to assist in the preparation of the share prospectus document and to provide an accountant's report on financial data, business risks and a business plan which recommends the shares to investors. Performance of these services for Beaufort Co would create an advocacy threat for the auditor. The advocacy threat arises because the auditor is effectively being asked to promote and represent their client's position to the point where the auditor's objectivity is compromised. The *Code* prohibits an auditor from acting in this way for an audit client and Moritz & Co should politely decline to assist in the preparation of the document and to endorse the recommendation to investors to purchase the shares. It may be possible, however, for the auditor to provide an accountant's report on some elements of the prospectus. Moritz & Co may be able to provide an opinion on the financial information if, for example, it limits the form of opinion to stating that it has been properly compiled on the basis stated within the document and that this basis is consistent with the accounting policies of the company.

Review of audit appointment

Margaret Shelley's comment that Beaufort Co is currently reviewing the audit appointment and that it is looking for an audit firm which is capable of taking it through the listing process and providing a full range of services in the future represents an intimidation threat to the auditor's objectivity. The intimidation threat arises because Margaret Shelley is applying pressure on Moritz & Co to offer a range of services which will result in breaches of the *Code* for the audit firm. She is effectively intimidating the firm by threatening to appoint another audit firm if Moritz & Co does not comply. Moritz & Co should explain its ethical duties to those charged with governance and identify clearly the services which it will not be able to provide if it continues as the company's auditor after the stock market listing in September 20X5.

Marks

1 (a) Audit risk evaluation

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

In addition, ½ mark for relevant trends or calculations which form part of the evaluation of audit risk (max 3 marks).

Materiality calculations should be awarded 1 mark each (max 4 marks).

– Annual incentive scheme
– Legal case
– Group finance director's attitude (2 marks)
– Daryl Co – local accounting rules (2 marks)
– Daryl Co – possible impairment
– Reliance on component auditor (2 marks)
– Post year-end acquisition of Michonne Co
– Trends in revenue – analytical review
– Revenue recognition (2 marks)
– Amortisation of licences

Maximum marks 24

(b) (i) Evaluation of Neegan Associates' audit strategy

Up to 1 mark for each issue evaluated:

Materiality
– Using assets as basis for materiality is appropriate in some circumstances
– Materiality should not be based on assets alone
– A materiality based on normalised profit could be used
– Unlikely that a higher level of materiality is appropriate given company's loss-making status
– Full documentation is needed on how materiality is determined

Payroll
– Further procedures necessary given the materiality of the payroll
– Requirement of ISA 600 that same ethical guidelines should be applied
– Self-review threat from Neegan Associates providing the service – explained
– The service should not have been provided due to Daryl Co's listed status

Sale of property
– Transaction should be disclosed in Group accounts and is material by nature
– No consideration of whether the profit on disposal has been properly determined
– Risk that the transaction is subject to bias given that company is loss making
– Property might not even have been sold, could be window dressing
– No procedures to confirm asset has been removed from the financial statements or on the recoverability of the amount outstanding
– Conclusion on audit quality

Maximum marks 10

Marks

(ii) Audit procedures on sale of property

- Review board minutes to see if the property sale has been discussed and formally approved by the company's board
- Agree the $50,000 sale price to the legal documentation relating to the sale of the property to the Group CEO
- Confirm the book value of the property at the date of disposal to underlying accounting records and non-current asset register
- Confirm that the asset has been removed from the company accounts at the date of disposal
- Obtain management's determination of profit or loss on disposal, re-perform the calculation based on supporting evidence, and agree the profit or loss is recognised appropriately in the company statement of profit or loss
- Obtain an estimate of the fair value of the property, for example, by comparison to the current market price of similar properties
- Obtain written representations from company management that all matters related to this related party transaction have been disclosed to the Group management and to the Group audit team
- Obtain written representation from the Group CEO regarding the transaction, to confirm the amount which is outstanding, and the likely timescale for payment
- Review cash receipts after the reporting date to confirm whether or not the $50,000 has been received from the Group CEO

Maximum marks 6

(c) Joint audit

Up to 1 mark for each relevant point discussed:

Justification in favour of joint audit
- Retain local auditors' knowledge of company
- Local auditors' knowledge of local regulations
- Atlanta & Co can provide additional skills and resources
- Cost effective – reduce travel expenses, local firm likely to be cheaper
- Enhanced audit quality

Possible disadvantages of joint audit
- Employing two audit firms could be more expensive
- Problems in allocating work and determining responsibilities
- Auditor liability issues
- Recommendation

Maximum marks 6

Professional marks
Generally 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made.

Maximum marks 4

Maximum **50**

Marks

2 Generally up to 1 mark for each relevant point of discussion/action:

(a) (i) Fraud

- Cannot determine whether fraud is immaterial without obtaining further evidence
- Insufficient to rely on a conversation between Group finance director and the alleged fraudster as a source of evidence
- Group finance director could be involved and attempting to conceal the true extent of the fraud
- Audit team needs to use professional scepticism in relation to assertions made about the fraud
- Financial statements could be materially misstated/Group finance director refusing to adjust
- Auditor should consider reporting responsibilities to management/those charged with governance (TCWG)
- Potential to report externally after taking legal advice
- Consideration of client confidentiality

Maximum marks 6

(ii) Sufficiency and appropriateness of audit evidence and

(iii) Further actions/further evidence to be obtained

Development costs

- Development costs are material and the audit work performed is insufficient to determine whether research costs have been inappropriately capitalised
- Intangible assets could be materially overstated and profit overstated
- Agreeing amounts to invoices does not confirm the nature of the expenditure
- Arithmetically checking the spreadsheet does not provide assurance on the assumptions which underpin the projections
- The Group finance director refusing to allow full access to the spreadsheet increases risk and the audit team should apply professional scepticism
- Attitude and actions of the Group finance director should be discussed with TCWG
- Reliance on a written representation is not appropriate
- Further evidence (1 mark for each evidence point explained)

Trade receivables

- The specific trade receivable is material and the audit work performed is insufficient to determine whether an allowance should be recognised
- There is an audit risk that trade receivables are materially overstated and profit overstated
- Agreement to invoice and including in a circularisation does not provide evidence on recoverability
- Discussion with credit controller provides background but is not a robust source of evidence
- Further evidence (1 mark for each evidence point explained)

Maximum marks 11

(b) Critique of draft auditor's report

Generally up to 1 mark for each point explained:

- Combination of opinion and basis for opinion paragraphs not appropriate
- Headings not correct – should be qualified opinion and basis for qualified opinion
- Qualified opinion paragraph wording is ambiguous and needs clarification
- Basis for qualified opinion paragraph should contain further details on the rationale for the auditor's opinion
- Explanation of proper use of emphasis of matter paragraph
- Fraud is immaterial and not fundamental to users' understanding
- Not professional to mention fraud in the auditor's report
- Difficulties in the audit should be reported to TCWG, not to the shareholders in the auditor's report
- Unprofessional and possible libellous wording used in relation to the Group finance director
- Not appropriate to mention resignation in the auditor's report – should be discussed with TCWG

Maximum marks 8

Maximum **25**

Marks

3 (a) Lavenza Co

(i) Matters to consider before accepting the review engagement

Up to 1 mark for each matter explained:

- Intended use of the cash flow forecast
- Distribution of the information
- Period covered by the cash flow forecast and key assumptions used
- Scope of the work
- Resources and skills
- Client integrity
- Ethical matters

Maximum marks 6

(ii) Examination procedures on cash flow forecast

Generally 1 mark for each specific procedure described:

- Cast the forecast to confirm accuracy
- Confirm consistency of accounting policies with those used in last audited financial statements
- Agree opening cash position to cash book and bank statement
- Discuss key assumptions underlying forecast with management
- Analytically review cash flow trends comparing with historical data
- Agree discount and penalty terms with customers and suppliers to agreed contractual documentation; agree to purchase ledger payments to confirm that discounts taken and penalties paid
- Agree average collection and payment periods to recent sales and purchase ledgers
- Recalculate patterns of cash flows based on management's assumptions
- Perform sensitivity analyses varying key assumptions
- Agree salaries to latest payroll records
- Obtain and review breakdown of overhead costs
- For sample of overhead costs, review supporting documentation
- Obtain and review budgets and analyses of costs to date for new shops and marketing campaign
- Review board minutes for discussion of new shops and marketing campaign
- Review outcomes of previous management forecasts
- Assess competence and experience of preparer of forecast
- Discuss possible cost omissions with preparer, e.g. finance costs, capital expenditure, tax payments
- Obtain written representations from management (with justification)
- Request confirmation from the bank of potential terms of additional finance to confirm the interest rate
- Consider whether finance charge in forecast cash flow appears reasonable

Maximum marks 9

Marks

(b) Beaufort Co – ethical issues arising as result of planned listing

Generally up to 1 mark for each issue explained:

Long association of senior audit personnel
- Familiarity threat – explained
- Rotation with appropriate cooling-off period

Fee dependence
- Self-interest and intimidation threats to auditor – explained
- Independent quality control pre-issuance review should be performed and full disclosure made to TCWG

Provision of bookkeeping and accounting services
- Self-review threat – explained
- Which cannot be reduced to acceptable level following Beaufort Co's listing on stock market

Share prospectus
- Advocacy threat – explained
- Moritz & Co should decline to assist in preparation of document and to endorse recommendation to investors to purchase shares
- Opinion on the financial information should be limited to confirming that it is properly compiled on basis stated in document and is consistent with company's accounting policies

Review of audit appointment
- Intimidation threat to auditor's objectivity – explained
- Moritz & Co should explain ethical duties to client and clearly identify services it will not be able to provide following stock market listing

Maximum marks	10
Maximum	**25**