
Answers

1 Briefing notes

To: Mo Iqbal, audit engagement partner

From: Audit manager

Subject: Audit planning in relation to the Ryder Group

Introduction

These briefing notes have been prepared to assist in planning the audit of the Ryder Group (the Group). The notes begin with an evaluation of the audit risks which should be considered in planning the audit. The notes then identify and explain the additional information required to plan the audit of a significant disposal which is expected to take place shortly after the financial year end. The notes also include the recommended principal audit procedures which have been designed in respect of an investment made in a joint arrangement and a government grant received in the year. Finally, the notes discuss several ethical matters arising from requests made by the Group audit committee.

(a) Evaluation of significant audit risks

Planned disposal of Primal Burgers Co and acquisition of Valentine Co – events after the reporting date

The Group is planning a significant restructuring. The disposal of Primal Burgers Co is planned to take place shortly after the year end, and the disposal will have a material impact on the Group financial statements given that Primal Burgers Co accounts for 23.2% of projected Group total assets and 30.9% of projected Group revenue.

The acquisition of Valentine Co, which is planned to take place in the first quarter of the next financial year, will be material to the Group, with the anticipated cost of investment and the fair value of identifiable net assets of Valentine Co representing 21.1% and 17.9% of projected Group assets respectively.

Both events will fall under the scope of IAS[®] 10 *Events after the Reporting Period*, meeting the definition of a non-adjusting event. IAS 10 requires that non-adjusting events 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 is 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. The audit risk is that incomplete or inaccurate disclosure relating to the acquisition and disposal is provided in the notes to the financial statements.

Disposal of Primal Burgers Co – assets held for sale and discontinued operations

The planned disposal should be accounted for under IFRS[®] 5 *Non-current Assets Held for Sale and Discontinued Operations*, which requires that once certain conditions are met, a disposal group of assets should be classified as held for sale. The conditions include:

- management is committed to a plan to sell
- the asset is available for immediate sale
- an active programme to locate a buyer is initiated
- the sale is highly probable, within 12 months of classification as held for sale
- the asset is being actively marketed for sale at a sales price reasonable in relation to its fair value
- actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

Assuming that the conditions are met, which seems likely given that the board approved the sale in March 20X5 and that potential purchasers have already expressed an interest, the assets held in the disposal group should be reclassified as assets held for sale and measured at the lower of carrying amount and fair value less costs to sell. The assets should not be depreciated after reclassification. IFRS 5 also requires that immediately prior to classifying an asset or disposal group as held for sale, impairment is measured and recognised in accordance with the applicable IFRS Standards, which in this case would be IAS 16 *Property, Plant and Equipment* and IAS 36 *Impairment of Assets*.

Several audit risks arise as a result of the disposal. First there is a risk that the assets are not treated as a disposal group for the purpose of IFRS 5 and have continued to be depreciated. Assets are possibly overvalued if an impairment review has not been performed or assets not measured at the lower of carrying amount and fair value less costs to sell. The fact that Primal Burgers Co's revenue is projected to fall by 3.9% indicates that impairment of assets could be an issue, increasing the risk of misstatement.

There is also a risk relating to disclosure, as assets and liabilities held for sale should be recognised separately from other assets and liabilities in the statement of financial position, and if they have not been appropriately reclassified, then non-current assets and liabilities will be overstated.

There is also an audit risk that Primal Burgers Co is not treated as a discontinued operation in accordance with IFRS 5. A discontinued operation is defined as a component of an entity which either has been disposed of or is classified as held for sale, and represents a separate major line of business or a geographical area of operations and is part of a single co-ordinated plan to dispose of a separate major line of business or geographical area of operations. Given the materiality of Primal Burgers Co and its products being a separate line of business for the Group, it meets the definition of a discontinued operation. In accordance with IFRS 5, the post-tax profit or loss of the discontinued operation and the post-tax gain or loss recognised on

the measurement to fair value less cost to sell or on the disposal of the disposal group should be presented as a single amount on the face of the statement of comprehensive income. In addition, detailed disclosure of revenue, expenses, pre-tax profit or loss and related income taxes is required either in the notes or in the statement of comprehensive income in a section distinct from continuing operations. The risk is that the necessary disclosures are not made, leading to incorrect presentation of Group profit or loss and incomplete information in the notes to the Group financial statements.

Disposal of Primal Burgers Co – potential for manipulation

A further audit risk relating to the disposal of Primal Burgers Co is that the results of the subsidiary could be manipulated to make it look more favourable to any potential purchaser. The financial information indicates that this subsidiary's revenue has declined and therefore it could be that management attempts to manipulate the financial statements to present a healthier financial performance to potential buyers. For example, costs could be suppressed or shifted to other Group companies to maintain the profit of Primal Burgers Co and make it more attractive to purchasers.

Tutorial note: *Credit will be awarded for the evaluation of other relevant audit risks relating to the disposal, for example, in relation to the presentation of information in the Group statement of cash flows.*

Investment in Peppers Co

The Group will be investing \$48 million in Peppers Co; this represents 10.1% of projected Group assets and therefore is material to the Group financial statements. From the information provided, it seems that the investment is a joint venture, with control of Peppers Co shared between the Group and Smiths Co. IFRS 11 *Joint Arrangements* defines a joint venture as a joint arrangement whereby the parties who have joint control of the arrangement have rights to the net assets of the arrangement. IFRS 11 requires that a joint venturer recognises its interest in a joint venture as an investment and shall account for that investment using the equity method in accordance with IAS 28 *Investments in Associates and Joint Ventures*. Audit risk arises if the Group fails to apply equity accounting to the investment, which may lead to an under or overstated value of investment and incorrect presentation of income and expenses relating to the joint venture in the Group statement of profit or loss.

Mondays Coffee drive-through – capital expenditure

During the year, there has been significant capital expenditure relating to 50 new drive-through coffee shops. The total amount capitalised is \$43 million, of which \$15 million relates to acquiring operating licences. The audit risk relates to the classification of the licences within property, plant and equipment, they should instead be recognised as intangible assets. This error is material, with the \$15 million cost of the licences representing 3.2% of projected Group assets. If the error is uncorrected, property, plant and equipment is overstated and intangible assets are understated.

A consequence of the misclassification is that the \$15 million should be amortised over its specific useful life of three years, so assuming that a full year's worth of amortisation should have been expensed, this amounts to \$5 million. Currently, the amount has been treated as property, plant and equipment and depreciated over a 20-year life, so \$0.75 million has been expensed. Therefore expenses are understated by \$4.25 million. This is material, representing 21.3% of Group profit before tax. There is therefore an audit risk that Group profit is significantly overstated.

Tutorial note: *Credit will be awarded for the evaluation of other relevant audit risks, for example, including the risk that revenue and capital expenditure incurred in establishing the coffee shops is not appropriately recognised, and that a 20-year estimated life appears long given the nature and usage of the assets involved.*

Mondays Coffee drive-through – reportable operating segment

According to the Group finance director, revenue from the new drive-through coffee shops accounts for almost all of the increase in revenue from Mondays Coffee Co. The financial information shows that Mondays Coffee Co revenue is projected to increase by \$45 million this year. Total Group revenue is projected to be \$320 million; \$45 million is 14.1% of this total.

The revenue from the drive-through coffee shops could be a reportable operating segment under IFRS 8 *Operating Segments*. An operating segment is a component of an entity:

- which engages in business activities from which it may earn revenues and incur expenses,
- whose operating results are reviewed regularly by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and
- for which discrete financial information is available.

IFRS 8 requires an entity to report financial and descriptive information about its reportable segments. Reportable segments are operating segments or aggregations of operating segments which meet specified criteria, including that its reported revenue is 10% or more of the combined revenue of all operating segments.

It seems that the drive-through coffee shops should be treated as a reportable segment given that discrete information is available through the Group's management information system, the results are reviewed, and it generates more than 10% of Group revenue. The audit risk is that disclosure is not provided at all in relation to this reportable segment, or that disclosure is incomplete in the final version of the financial statements.

Tutorial note: *Credit will also be awarded for evaluation of the significance of the increase in revenue from the new drive-through coffee shops, and whether this could indicate overstatement of revenue. Other relevant audit risks will be credited, for example, relating to possible system changes introduced to incorporate the drive-through coffee shops in the financial reporting system.*

Government grant

The Group received a government grant of \$20 million, representing 4.2% of projected Group assets and therefore material to the Group statement of financial position. In addition, if the \$20 million grant receipt had not been recognised in full as income this financial year, the projected Group profit before tax would be \$0. The recognition as income is therefore extremely significant to the Group financial statements.

The grant should be accounted for in accordance with IAS 20 *Accounting for Government Grants and Disclosure of Government Assistance* which requires government grants to be recognised in profit or loss on a systematic basis over the periods in which the entity recognises as expenses the related costs for which the grants are intended to compensate.

The two parts of the grant should be accounted for separately. The amount relating to capital expenditure should be deferred on the statement of financial position and assuming that the grant will be used to upgrade items of property, plant and equipment, the grant should then be recognised in profit or loss over the periods in which depreciation expense on the assets to which it relates is recognised. The part of the grant relating to promotional activity should be recognised in profit or loss in the same period as the relevant expenses – which may be this year, or could be the next financial year, depending on when the expenses relating to the advertising campaign are incurred.

It is likely that if funds are not used in the manner intended by the government, i.e. that half of it is used to make the assets more environmentally friendly, then some or all of the grant would be repayable. This would mean that a provision or contingent liability should be recognised, and there is an audit risk that liabilities are understated if any amount probable to be repaid is not accounted for as a provision, or that insufficient disclosure is made in the note to the financial statements if a contingent liability arises.

Therefore the audit risk is that Group profit is overstated by a maximum amount of \$20 million, and liabilities understated by the same amount. The accounting treatment could be a deliberate attempt to enhance the appearance of the Group profit for the year, and this issue should be approached with a high degree of professional scepticism during the audit.

Audit committee lack of financial reporting expert

Since January 20X5, the Group audit committee does not have a financial reporting expert. It is a requirement of best practice corporate governance principles that the board should satisfy itself that at least one member of the audit committee has recent and relevant financial experience and that the committee as a whole shall have competence relevant to the sector in which the Group operates. The Group is in breach of this principle, as there has not been a financial reporting expert member of the audit committee for a significant period during the financial year, and this represents a control risk. One of the roles of the audit committee is to monitor the integrity of the financial statements of the Group and, in particular, to review significant financial reporting judgements contained in them. Without a financial reporting expert on the audit committee to provide this oversight, there is a risk that inappropriate judgements are made and a higher risk that errors or deliberate manipulation of the financial statements are not addressed.

(b) Additional information required to plan the audit of the disposal of Primal Burgers Co

- The individual financial statements of Primal Burgers Co, to ascertain the detail of the amounts recognised – this will assist the audit team in planning to audit the compliance with measurement and disclosure requirements of IFRS 5 and to confirm materiality of the balances involved.
- A copy of the vendor's due diligence report produced by Usami & Co, to ascertain key findings, e.g. valuations of assets and liabilities; this will help in planning to audit the measurement of the disposal group and whether any impairment should be recognised.
- Further information surrounding the reasons for disposal, from the Group board minutes at which approval was given for the disposal, to enable the auditor to develop an understanding of management's rationale and how the disposal fits in with the Group restructuring as a whole.
- Information regarding the potential acquirers of Primal Burgers Co and the stage of negotiations, this will help the audit team develop an expectation as to whether the disposal is likely to take place after the year end and the potential sales price.
- Any preliminary determination by management of the anticipated profit or loss on disposal and expectation of any impairment to the value of assets held in the disposal group.
- Obtain a copy of management's assessment/workings of the impact on the Group's financial position on the sale of Primal Burgers Co and the overall impact of the restructure of the Group.

(c) (i) Principal audit procedures in respect of the classification of the investment in Peppers Co

- Obtain the legal documentation supporting the investment and agree the details of the investment including:
 - o The date of the investment
 - o Amount paid
 - o Number of shares purchased
 - o The voting rights attached to the shares
 - o The nature of the profit sharing arrangement between the Group and Smiths Co
 - o The nature of access to Peppers Co's assets under the terms of the agreement
 - o Confirmation that there is no restriction of the Group's shared control of Peppers Co.

- Review board minutes to confirm the approval of the investment and to understand the business rationale for the investment.
- Review minutes of relevant meetings between the Group and Smiths Co to confirm that control is shared between the two investors and to understand the nature of the relationship and the decision-making process.
- Obtain documentation such as Peppers Co's organisational structure to confirm that the Group has successfully appointed members to the board of the company and that those members have equal power to the members appointed by Smiths Co.

(ii) Principal audit procedures in respect of the government grant received

- Obtain the documentation relating to the grant and review to obtain an understanding of:
 - o The terms of the grant including the amount received, and in particular requirements relating to the specific use of the funds
 - o The date by which the funds must be used
 - o Any clauses relating to repayment of some or all of the grant should certain conditions arise.
- Agree the amount received to bank statements and Ryder Co's cash book.
- Obtain and review the Group's capital expenditure forecast to confirm the amount planned to be spent on capital expenditure relating to environmental matters.
- Discuss the use of the grant to fund an advertising campaign with an appropriate person, e.g. Group marketing director, and review any plans to use the funds for promotional purposes to confirm that recycling features in the campaign, as intended by the government.
- Confirm, through agreement to marketing plans, whether any funds will be spent during this financial year.
- Obtain a written representation from management that the grant received will be used for the specific purposes required by the government.

(d) Ethical issues

Partner to serve on audit committee

The Group audit committee has requested that a senior partner from Squire & Co could assume a role on the Group audit committee while a replacement for the financial reporting expert committee member is being sought. Should a partner from Squire & Co take this appointment, a self-review threat to objectivity arises because an audit committee member is in a position to exert influence over the financial statements, and the audit team would be less likely to challenge issues during the audit, thereby losing their professional scepticism. A self-interest threat also arises because the audit firm's interests become closely aligned to the interests of the Group, impacting on auditor objectivity.

Tutorial note: *Credit will also be awarded for discussion of other relevant threats to objectivity including the familiarity threat, and threat of assuming management responsibility.*

For these reasons, the IESBA *International Code of Ethics for Professional Accountants* (the *Code*) states that a partner or an employee of the audit firm shall not serve as a director or officer of an audit client. Therefore, Squire & Co cannot provide a senior partner, or any other member of staff, to serve on the Group's audit committee.

Referral fee

The Group audit committee understands that Squire & Co cannot provide a corporate finance service, but could recommend another firm, Ranger Associates, for this work, for which the firm would earn a referral fee. The *Code* states that this creates a self-interest threat to objectivity and to professional competence and due care. The self-interest threat arises from the income generated from the referral, and this may result in the audit firm recommending another firm for the work without proper consideration of their competence to perform the engagement.

The *Code* does not prohibit referral fees but the significance of the threats should be evaluated and safeguards applied to reduce the threats to an acceptable level. Safeguards may include:

- Disclosing to the Group in writing the arrangement for a referral fee to be received from Ranger Associates, and
- Obtaining advance agreement from the Group that the arrangement is acceptable.

Therefore the matter should be discussed again with the Group audit committee, and if the committee confirms agreement with the proposed referral fee, Squire & Co can recommend Ranger Associates to perform the corporate finance work for the Group.

Internal audit

A further threat arises from the audit committee's request for Squire & Co to work with the Group internal audit team to design and evaluate internal controls relating to revenue. The *Code* suggests that providing an audit client with an internal audit service might create a self-review threat to objectivity. This is because in subsequent audits the audit team may use the internal audit work performed in their audit of revenue. They may over-rely on the internal controls designed and evaluated by the audit firm or will not apply an appropriate level of scepticism when assessing the work.

In addition, a threat of management responsibility arises, whereby the audit firm is making decisions and using judgement which is properly the responsibility of management. The *Code* states that taking responsibility for designing, implementing,

monitoring and maintaining internal control is assuming management responsibility. According to the *Code*, an audit firm must not assume management responsibility for an audit client because the threat to independence created is so significant that no safeguards could reduce it to an acceptable level.

Specifically in relation to public interest entities, the *Code* further states that an audit firm shall not provide internal audit services which relate to a significant part of controls over financial reporting, financial accounting systems which are significant to the financial statements or amounts or disclosures which are material to the financial statements.

Therefore, Squire & Co should politely decline the request made by the audit committee and ensure that the committee is fully aware of the ethical issues raised by their requests.

Conclusion

These briefing notes indicate that there is a range of audit risks to be considered in planning the forthcoming Group audit, many of the more significant risks relate to the Group's plans to restructure. The notes contain recommended audit procedures which have been designed in relation to two material audit issues, and finally three ethical issues have been identified and evaluated. Our firm should not provide internal audit assistance to the Group, nor allow a partner to serve on the Group audit committee. However, a referral fee from Ranger Associates is acceptable, provided the Group agrees to the arrangement.

2 Lifeson Co

(a) (i) Sale and leaseback transaction

Matters

Transfer of control

The auditor needs to consider the correct treatment of the sale and leaseback transaction as required by IFRS 16 *Leases* which requires that an assessment should be performed based on the criteria specified in IFRS 15 *Revenue from Contracts with Customers* as to whether control of the asset has been retained by the seller or whether it has passed to the buyer. Control of an asset is defined by IFRS 15 as the ability to direct the use of and obtain substantially all of the remaining benefits from the asset. This includes the ability to prevent others from directing the use of and obtaining the benefits from the asset. The benefits related to the asset are the potential cash flows which may be obtained directly or indirectly.

Right-of-use asset

In this case, the lease term of ten years appears short compared to the asset's remaining life which is expected to exceed 50 years and given the demand for retail properties for rent in the area, it seems likely that Clive Co will direct the use of and obtain substantially all of the remaining benefits from the asset including the potential cash flows in the future. On the basis of the information available, therefore, the proposed derecognition of the property in Lifeson Co's financial statements and the recording of the transaction as a sale in accordance with IFRS 15 appears to be correct. Lifeson Co should therefore derecognise the property and recognise a right-of-use asset based on the proportion of the previous carrying amount of the asset effectively retained under the terms of the lease. In addition, it should recognise a financial liability based on the present value of the lease payments and any gain or loss arising on the transaction should be recognised in profit or loss for the year. In this case, therefore, the asset has been correctly derecognised but the auditor should investigate whether the company has recognised the right-of-use asset at the correct amount.

Evidence expected to be on file:

- A copy of the sale and leaseback agreement reviewed to confirm the key details including in particular the rights of the lessee and the lessor to control the asset.
- A working paper detailing all key aspects of the agreement required to identify the detailed accounting treatment including the sale proceeds, rental amounts and timings, the lease term and the interest rate implicit in the lease.
- Agreement of the sale proceeds as per the sale agreement to the cash book and/or bank statement to confirm the correct calculation of the gain or loss on disposal.
- Notes of discussions with management in relation to the transfer of control to confirm whether the correct treatment of the sale and leaseback arrangement has been determined.
- A copy of any client working papers in relation to the calculation of the right-of-use asset to identify whether the client has recognised the right-of-use asset at the correct amount.
- A review of the board minutes for evidence of management's discussion of the sale and leaseback transaction and any evidence in relation to the transfer of control.
- A review of the local property market including trade journals, press articles, official statistics to confirm high demand for retail leases.
- A review of surveyor reports on the property to confirm the expected remaining life of the property.

- A copy of the client’s working papers for the calculation of the present value of the lease payments and a recalculation of the present value of the lease payments by the auditor in order to form a basis for confirming the detailed accounting treatment of the lease.
- Agreement of the carrying amount of the property to the non-current asset register to determine whether the correct amount has been derecognised and whether the gain or loss on disposal has been recorded correctly.
- A schedule calculating any gain or loss on the transaction, recalculated by the audit team and confirming that it only represents the gain or loss on rights transferred to Clive Co.
- Review of the draft financial statements to confirm that details of the sale and leaseback transaction, such as the gain or loss arising on the transaction, have been disclosed in line with the requirements of IFRS 16.

(ii) Investment property

Matters

Materiality

The carrying amount of the investment property represents 2.6% (\$353,000/\$13.8 million) of Lifeson Co’s total assets at the reporting date and is material to the financial statements.

Classification as investment property

The auditor should consider whether the requirements of IAS 40 *Investment Property* have been satisfied and confirm if the warehouse held by Lifeson Co is actually an investment property. IAS 40 defines an investment property as land and/or buildings held to earn rentals or for capital appreciation, or both. Lifeson Co’s warehouse has been held to earn rentals and for capital appreciation from 1 April 20X4 and therefore qualifies as an investment property from this date. The fact that the property has not yet been let by the reporting date does not impact on this classification. The end of owner-occupation of the warehouse is evidence of the change in use to an investment property.

Fair value

The warehouse is recognised at fair value of \$353,000 and according to IAS 40, the fair value model is acceptable provided the treatment of any other investment property held by Lifeson Co is consistent. On transfer of an owner-occupied property recognised at depreciated historical cost, which has not been previously impaired, to investment property carried at fair value, IAS 40 requires that any resulting increase in the carrying amount should be recognised in other comprehensive income as a revaluation surplus within equity. Thereafter, any further increase in fair value is recognised in profit or loss for the year. In this case, Lifeson Co should recognise the initial increase of \$25,000 (\$348,000 – \$323,000) in other comprehensive income rather than in its profit for the year and the additional increase of \$5,000 (\$353,000 – \$348,000) which arises during the current year should be recognised in this year’s profit or loss. Lifeson Co’s recognition of the full \$30,000 gain in its profit before tax for the current year is incorrect and therefore results in an overstatement of profit by \$25,000.

Evidence expected to be on file:

- Notes of discussions with management to confirm its intention to hold the property to earn rentals and for capital appreciation.
- Inspection of title deeds held by Lifeson Co to confirm its ownership of the investment property.
- Board minutes for evidence of management discussion of the change of use and for confirmation of the date when owner-occupation ceased.
- Record of the physical inspection of the building by the auditor in order to confirm its general condition and that it is no longer occupied by Lifeson Co.
- Agreement of the accounting policy to the notes to the financial statements this year and in previous year, to confirm that the fair value model is to be adopted and is consistent with any other investment properties held.
- A market valuation of the building by an independent and external auditor’s expert at the date of the change of use and at the reporting date to determine the respective fair values and the resulting gains.
- Details of the external expert valuer and a working paper detailing the assessment of their professional qualifications, experience, reputation, independence and objectivity.
- Agreement of the carrying amount at the date of the change of use to the non-current asset register to confirm the correct amount of the fair value gain.
- Written representations from management confirming the change of use, the relevant date and future intentions.
- Notes of discussions with management in relation to the incorrect recording of the gain and the need to include the error in the auditor’s schedule of uncorrected misstatements.
- Review the disclosures made in the financial statements, such as details of the external valuation, to ensure they comply with the requirements of IAS 40.

(iii) Asset impairment

Matters

Materiality

The carrying amount of the shopping mall represents 64.1% (\$8.85 million/\$13.8 million) of Lifeson Co's total assets at the reporting date and is therefore highly material to the company's financial statements.

Value in use

The auditor should consider whether the client's calculation of the shopping mall's recoverable amount based on value in use is in line with the requirements of IAS 36 *Impairment of Assets*. This should include an assessment of whether the client has used an appropriate discount factor for calculating value in use based on the rate which reflects current market assessments of the time value of money and the risks specific to the asset. In line with IAS 36's definition of recoverable amount as the higher of its fair value less costs to sell and its value in use, the auditor should also consider whether the fair value less selling costs of the shopping mall exceeds its value in use.

Reversal of impairment loss

IAS 36 requires that the increased carrying amount of an asset, such as property, attributable to a reversal of an impairment loss should not exceed the carrying amount which would have been determined, net of depreciation, had no impairment loss been recognised for the asset in prior years. In this case, therefore, recognition of the reversal of the impairment loss should be calculated as follows:

	\$million	\$million
Carrying amount as at 31 March 20X5 prior to recognition of impairment reversal (\$8.25m x 18/19)		7.816
Recoverable amount based on impairment review as at 31 March 20X5	8.850	
Capped to \$9.5m x 18/20 =	8.550	<u>8.550</u>
Impairment reversal to be recognised		<u>0.734</u>

As a result of Lifeson Co's failure to limit the impairment reversal to \$0.734 million, profit and assets are overstated by \$300,000 (1.034m – 0.734m).

Evidence expected to be on file:

- Agreement of the opening balances for the property to the non-current asset register as at 1 April 20X4 to confirm the correct amount has been brought forward in the client's working papers.
- Physical inspection of the shopping mall property to confirm its condition, occupancy level and to assess the reasonableness of the depreciation policy and forecast cash flows for the value in use calculation.
- Copy of the client working papers for impairment review giving evidence of the client's basis for assessing the fair value less selling costs of the mall and detailed calculations of its value in use.
- Copy of the client's cash flow forecasts and budgets supporting the value in use calculations.
- Notes of discussions with management in relation to the bases for the calculation of recoverable amount including an assessment of the reasonableness of the assumptions used by management in its forecasts and calculations and the appropriateness of the discount factor used in the value in use calculations.
- Written representations attesting to the reasonableness of its assumptions and other related management judgements.
- A recalculation of the value in use of the shopping mall by the auditor in order to confirm the accuracy of the client's calculation.
- Sensitivity analyses on the forecasts and the value in use calculations in order to assess the impact of any changes in the key assumptions.
- External confirmation of the shopping mall's net realisable value by an appropriately qualified, independent expert in order to ensure the recoverable amount has been correctly determined.
- Notes of discussions with management in relation to the incorrect recording of the impairment reversal and the need to include the error in the auditor's schedule of uncorrected misstatements.

(b) Implications for the auditor's report

Based on the analysis and discussion above, there are two misstatements in the financial statements in relation to the investment property and shopping mall which may have implications for this year's auditor's report.

Investment property

Lifeson Co has recorded the increase in the carrying amount of \$30,000 on the warehouse in the statement of profit or loss for the year. The increase in fair value of \$25,000 on transfer of the property to investment property should have been recorded in other comprehensive income and profit is therefore overstated by \$25,000 in the year. This overstatement represents 1.2% of profit before tax and therefore is immaterial in isolation. As this misstatement is immaterial, the auditor's report would not need to be modified and it will be at the discretion of management to make the adjustment. If management intends to leave this as an uncorrected misstatement, written confirmation of its immaterial nature should be obtained via a written representation.

Shopping mall

Lifeson Co has incorrectly recognised the full impairment reversal of \$1·034 million in profit for the year. As per IAS 36, the reversal of an impairment loss should not exceed the carrying amount which would have been determined had no impairment loss been recognised. Based on depreciation over a 20-year useful life, the carrying amount of the asset should be capped at \$8·550 million and the reversal of the impairment to be recognised at \$0·734 million (\$8·550 million – \$7·816 million). Assets and profit are currently overstated by \$300,000 representing 2·2% of total assets and 14% of profit before tax which is material to both the statement of financial position and statement of profit or loss.

Overall impact on the auditor's report

The misstatement in relation to the shopping mall is individually material and if management fails to amend the financial statements, the auditor's opinion should be modified due to the material, but not pervasive, misstatement of the shopping mall in relation to both the statement of financial position and the statement of profit or loss for the year. A qualified 'except for' opinion should therefore be given.

The auditor's report should include a qualified opinion paragraph at the start of report. This paragraph should be followed immediately by a basis for qualified opinion paragraph which should explain the reasons for the qualified auditor's opinion and which should quantify the impact of the matters identified on the financial statements.

3 (a) Beyer Co

Scope of the investigation

Kaffe & Co should establish the specific work which Beyer Co expects them to perform. It is likely that the quantification of the loss represents an agreed upon procedures engagement and these would need to be confirmed with Beyer Co in advance.

The identification and recommendation on controls issues is more likely to be of a consulting nature and the process and outcomes agreed with the client. The assignment may require specific competencies, such as the use of specialists in the use of computer-assisted audit techniques and this should be identified prior to acceptance of the engagement.

Kaffe & Co would also need to establish the time period Beyer Co would like them to investigate. This will all have an impact on the total fee charged.

Establishing how Kaffe & Co's investigation relates to the criminal investigation

If the quantification of the loss were to become a criminal investigation, then the relevant authorities would take the lead. It is not clear whether the authorities would require additional, professional support in their investigation and, if so, what sort of assistance they would require. For example, it is possible that they would gather their own evidence, but they may require the use of an expert witness to verify their findings in court.

It is therefore vital that, before any terms are agreed or engagement contracts are signed, Kaffe & Co speaks to the authorities to ascertain whether there will be any criminal investigation and, if so, what their role might be in the investigation, and how they might interact with any other experts appointed by the authority to assist in the investigation.

Confidentiality

Firms providing professional services must always ensure that information relating to clients is not given to third parties without the permission of the client. In preparing the report for the insurance company, Kaffe & Co will need permission from Beyer Co to disclose the information to the insurance company. In an investigation such as this, it is highly likely that all of the evidence collected will have to be submitted to the authorities to assist with their criminal investigation. It is therefore vital that before Kaffe & Co accepts the assignment, they obtain permission to do so from the board of Beyer Co.

The types of reports and prospective users

The firm must confirm with Beyer Co what types of report they would expect as a result of the engagement and whom the reports would be distributed to. In forensic engagements, the procedures to be performed would normally be agreed and then the results of those procedures would be reported. It may be that the insurance company expects an opinion to be given on the results of the investigation and if this is the case, then the assurance issued would be limited to negative assurance. Kaffe & Co would usually expressly state that the report is not intended for use by third parties.

In this investigation, it is possible that the relevant authorities would want to use the results of the procedures to compile evidence for their case. It would, if this were the case, be important to establish if additional reports would be required for this.

Management also wants additional reports relating to the deficiencies identified in the control environment and systems recommendations on how to strengthen controls in this area. The form and content of such a report must be agreed upon in advance of accepting the assignment.

Professional competence

Before they can accept the role, Kaffe & Co must be certain that they have staff with the requisite competencies to be able to conduct the investigation effectively.

If this were conducted as a criminal investigation, it is also vital that the staff used have sufficient experience in relation to the gathering and safeguarding of evidence. Any failure to follow the relevant protocol may render the evidence useless to the legal case.

Time pressure, deadlines and resource availability

As well as having staff with the requisite competencies to conduct the engagement, it is also vital that those staff are available to be able to conduct the investigation in the time frame suggested. The insurance company is likely to set the time frame for any initial investigation. If the relevant authorities conduct an additional criminal investigation, Kaffe & Co must consider the extent of the possible investigation and whether they are able to commit the necessary resources without adversely affecting their other client commitments.

Client due diligence

As Beyer Co is a new client, Kaffe & Co may be required to perform client identification procedures as part of local anti-money laundering regulations. If this is the case, the firm must explain the need to obtain information about the company and its directors before Beyer Co can be accepted as a client. If Beyer Co is unable, or refuses, to do this, then Kaffe & Co would not be able to take on Beyer Co as a client or proceed with the engagement.

(b) (i) Procedures to be performed to quantify the inventory loss

- Meet with the audit committee and members of management to understand and document what they know about the fraud and who might be involved.
- Discuss with the company's legal team what is known about the fraud at present and the source of the information.
- If possible, interview the whistle-blower to identify the potential staff involved and the timescales over which the fraud has been perpetrated.
- Obtain the prior year report to management from the auditor and inspect auditor's reports to identify any deficiencies or discrepancies in inventories identified by the auditors.
- Obtain/prepare a reconciliation of all orders placed including cancelled orders to all invoices raised to identify the total of all orders placed but not invoiced to establish the maximum potential value of the theft.
- Arrange to conduct a full inventory count to identify discrepancies between the inventory records and physical inventory.
- Investigate records of inventory written off to identify possible attempts to disguise the missing items.
- Interview sales, warehouse and accounting staff to identify the system in place for creating a sales order and for setting up customers within the sales and inventory systems.
- Use CAATs or other data analytics tools to identify the total of cancelled orders within the inventory records system and any addresses which are associated with large volumes of cancellations.
- Identify which cancelled orders are assigned to the sales representative identified by the whistle-blower.
- Identify which customers those orders are assigned to and verify their existence within the invoicing system and, where possible, their registered business address to ensure they are genuine customers.
- From this, identify fictitious customers and reconcile their cancelled orders to the inventory discrepancies identified.
- Assess if the amounts ordered by the fictitious customers agree to the total discrepancies or if there is a further difference to be investigated.
- Obtain inventory listing to identify the cost of the parts stolen and calculate the cost of the inventory identified as relating to the fictitious customer orders.
- Using CAATs or other data analytics tools, identify any other sales staff with unusual levels of cancelled sales dispatches to see if this is a wider issue.

(ii) Control deficiencies and recommendations

Lack of segregation of duties and monitoring of order cancellations

There is a lack of internal control over the warehouse team, particularly in relation to authorisation and approval of transactions. The warehouse manager having the ability to create new customers on the system without authorisation has allowed fictitious customers to be created.

The ability of the sales representative to cancel orders and the ability of the warehouse manager to reverse dispatches without authorisation gives rise to a lack of segregation of duties. These processes should require authorisation from a senior member of staff, for instance, sales cancellations should be approved by the sales manager and reversed goods dispatches by the operations manager.

Additionally, the lack of reconciliation of the sales orders to the amounts invoiced allowed the cancellation of deliveries to avoid detection from any invoicing process. The consistent cancellation of dispatches relating to one customer from one sales representative may have drawn attention within the sales system had the transaction made it that far.

The existence of the inventory system in isolation from the invoicing and accounting system allowed for incomplete information to be relayed further up within the business. While this in itself is not an issue, it did mean that any management review of accounting and invoicing reports does not act as a means of review of the inventory management and dispatch system. In many businesses, a system which linked the inventory movements with the accounting and

management information system would allow reports to be generated to monitor for unusual levels of returns and cancellations. In the absence of the ability to merge the two systems, it may be possible for additional reporting functions to be added to the inventory system to allow reports of returns and cancellations to be generated for review at a higher level than the warehouse manager to provide oversight of this area.

A proper monitoring system would have flagged that one sales representative in particular had higher than usual cancellation levels which could have been investigated and monitored by management.

It would also be possible to implement a system where all cancelled orders and reversed dispatches are processed outside of the sales and warehouse team, for example, by the accounts department.

Lack of segregation of duties in the warehouse counts

The lack of segregation of duties between warehouse staff and inventory count staff allowed the fictitious sales orders to pass unnoticed as the inventory discrepancy which would have flagged the issue was ineffective. An independent inventory count process using an external company or using staff from outside the warehouse to perform counts and reconcile the inventory amounts to inventory records would have identified missing inventory sooner.

Additional implications of the fraud

In addition to the value of the inventory stolen by the warehouse manager and sales representative, the business is not holding accurate records of its inventory, meaning that it may be in breach of the requirement to keep proper records of assets and liabilities and its assets are overstated. This may or may not be a material amount.

There is also a business risk arising from inaccurate inventory in that inventory believed to be on hand to satisfy genuine orders may not exist, causing delays and disruption to the ability of Beyer Co to satisfy customer orders in a timely manner causing customer satisfaction issues and potential loss of customers if the delays become unacceptable.

Recommendations

- Integration of the sales order and invoicing systems into the management information system.
- New customers should be created by the accounts department not the sales/dispatch teams.
- Authorisation process for cancelled orders/returns.
- Creation and regular review of exception reports and unusual trends including cancellation reports by higher level management to identify irregular or suspicious patterns.
- Regular inventory counts to be performed by staff independent of the warehouse and sales staff.

(c) Difficulty identifying fraud

According to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, management of the company and those charged with governance are responsible for the prevention and detection of fraud and error within the company through the provision of a sound system of internal controls and a strong control environment. However, even when controls are in place, fraud can be difficult to detect. By its nature, fraud is hidden, and controls intended to reduce the risk of fraud may be insufficient to prevent or detect fraud.

In many cases, the detection of fraud is made difficult because the perpetrator will deliberately conceal their activity. In the case of Beyer Co, the missing inventory was concealed by the falsifying of inventory count records. This meant that the amounts stolen were not apparent from the control in place to detect inventory anomalies.

Frauds such as this one are made harder to detect by the collusion of more than one person. This can mean that segregation of duties controls which are in place to prevent or detect fraud can be circumvented.

Frauds are also often performed in small enough amounts that the losses are immaterial in comparison to the size of the company which means that high level controls such as monitoring of KPIs related to profit margins may not detect the fraud until the fraud reaches a scale which affects the business significantly.

Given the difficulties faced by companies in identifying fraud, it is often the case that fraud is discovered by accident or through whistle-blowers and when this happens, it is common for companies to ask why auditors did not discover the fraud during their audit. ISA 240 states that when the auditor is conducting an audit in accordance with ISAs they are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements of the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs. The auditor's responsibility for detection of fraud is therefore a secondary one to that of management and auditors face the same issues as management when it comes to detecting fraud through the concealment, controls override and often immaterial nature of fraud.

In addition to the challenges shared with management, the audit process is limited by the focus on material misstatements and by the nature of sampling whereby not every transaction will be examined. Auditors should, however, consider the risks of fraud when planning their audit and the control weaknesses which would increase the risk of fraud occurring. Auditors should conduct their audit with professional scepticism having awareness that override of controls may exist and that representations made to them may be false.

Overall, for both management and for auditors, fraud is hard to detect especially when collusion exists to enable override of controls and concealment of the fraud.

Marks

1 (a) Evaluation of 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.

In addition, ½ mark for each relevant trend or calculation which forms part of the audit risk evaluation (max 3 marks).

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

- Disclosure of events after the reporting period in respect of Group restructuring – risk of inadequate disclosure
- Assets held for sale in respect of planned disposal of Primal Burgers Co – risk assets not measured or recognised appropriately as assets held for sale (up to 4 marks)
- Discontinued operation – risk that Group statement of profit or loss does not reflect results of Primal Burgers Co as a discontinued operation
- Disposal of Primal Burgers Co – incentive for manipulation (2 marks)
- Joint arrangement in Peppers Co – risk that the investment is not equity accounted
- Misclassification of operating licence in respect of Mondays Coffee Co drive-throughs as PPE, impact on measurement of PPE and intangible assets and associated expenses
- Mondays Coffee Co drive-throughs likely to be a reportable segment – risk of incomplete disclosure of operating segments
- Government grant – risk that conditions will not be met and a liability should be recognised for repayment of the grant
- Audit committee – lack of financial reporting expert creates control risk (2 marks)

Maximum marks

24

(b) Additional information required to plan the audit of the planned disposal of Primal Burgers Co

Up to 1 mark for each piece of additional information recommended:

- The financial statements of Primal Burgers Co, to ascertain the detail of the amounts recognised
- A copy of the vendor's due diligence report to ascertain key findings, e.g. valuations of assets and liabilities
- Information surrounding the reasons for disposal, from the Group board minutes at which approval was given for the disposal
- Information regarding the potential acquirers of Primal Burgers Co and the stage of negotiations
- Any preliminary determination by management of the anticipated profit or loss on disposal and expectation of any impairment to the value of assets held in the disposal group
- Obtain a copy of management's assessment/workings of the impact on the Group's financial position on the sale of Primal Burgers Co and the overall impact of the restructure of the Group

Maximum marks

4

(c) Principal audit procedures

Up to 1 mark for each well designed audit procedure.

(i) The 50% investment in Peppers Co

- Obtain the legal documentation supporting the investment and agree the details of the investment including (max 2 marks):
 - o The date of the investment
 - o Amount paid
 - o Number of shares purchased
 - o The voting rights attached to the shares
 - o The nature of the profit sharing arrangement between the Group and Smiths Co
 - o The nature of access to Peppers Co's assets under the terms of the agreement
 - o Confirmation that there is no restriction of the Group's shared control of Peppers Co
- Review board minutes to confirm the approval of the investment and to understand the business rationale for the investment
- Review minutes of relevant meetings between the Group and Smiths Co to confirm that control is shared between the two investors and to understand the nature of the relationship and the decision-making process
- Obtain documentation such as Peppers Co's organisational structure to confirm that the Group has successfully appointed members to the board of the company and that those members have equal power to the members appointed by Smiths Co

(ii) The government grant

- Obtain the documentation relating to the grant and review to obtain understanding of:
 - o The terms of the grant, in particular requirements relating to the specific use of the funds
 - o The date by which the funds must be used
 - o Any clauses relating to repayment of some or all of the grant should certain conditions arise
- Agree the amount received to bank statement and cash book of Ryder Co
- Obtain and review the Group's capital expenditure forecast to confirm the amount planned to be spent on capital expenditure relating to environmental matters
- Discuss the use of the grant to fund an advertising campaign with an appropriate person, e.g. Group marketing director, and review any plans to use the funds for promotional purposes to confirm that recycling features in the campaign, as intended by the government
- Confirm, through agreement to marketing plans, whether any funds will be spent during this financial year
- Obtain a written representation from management that the grant received will be used for the specific purposes required by the government

Maximum marks

8

(d) Ethical issues

Up to 1 mark for each point explained:

- Audit firm partner serving on Group audit committee – self-review threat explained
- Audit firm partner serving on Group audit committee – self-interest threat explained
- Safeguards cannot reduce to an acceptable level so cannot provide partner to serve on audit committee
- Referral fee – self-interest threat to objectivity and professional competence explained
- Can earn referral fee as long as safeguards used – disclose to client and obtain agreement (up to 2 marks)
- Internal audit assistance – self-review threat explained
- Internal audit assistance – management responsibility threat explained
- No safeguards can reduce threat relating to management responsibility
- For PIE client cannot provide internal audit assistance in relation to material/significant matter
- Audit firm therefore cannot provide internal audit assistance

Maximum marks

10

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

2 (a) Matters and evidence

Generally up to 1 mark for each matter explained and each piece of evidence recommended (unless otherwise stated).

(i) Sale and leaseback transaction

Matters

- Consider treatment of sale and leaseback transaction as required by IFRS 16
- Assess whether control of asset has transferred to buyer
- Whether asset transfer is sale in line with IFRS 15
- IFRS 15 criteria based on transfer of control; ability to direct, use and obtain substantially all remaining benefits of asset
- Derecognise property and recognise right-of-use asset based on proportion of asset retained
- Recognise financial liability based on PV of lease payments
- Recognise gain/loss on transaction in P/L for year
- Reasoned conclusion that treatment appears to be correct on basis of information available

Evidence

- Copy of sale and leaseback agreement to confirm key details, e.g. rights of lessee and lessor to control asset; also: proceeds, rental amounts and timings, lease term, interest rate implicit in lease
- Discussions with management about transfer of control and correct treatment of sale and leaseback arrangement
- Board minutes for evidence of discussion of sale and leaseback transaction
- Review of local property market including trade journals, press articles, official statistics to confirm high demand for retail leases
- Review of surveyor reports on building to confirm expected life
- Agreement of carrying amount of property to non-current asset register
- Agreement of sale proceeds to cash book/bank statement
- Copy of client working papers for present value of lease payments
- Recalculation of PV of lease payments by auditor
- Review of financial statements to confirm that details of sale and leaseback transaction disclosed in line with IFRS 16 requirements

Maximum marks

8

(ii) Investment property**Matters**

- Materiality
- Discussion of whether it meets classification requirements from 1 April 20X4
- Property not let by 31 March 20X5 does not impact on this classification
- End of owner-occupation is evidence of change in use
- Fair value model is acceptable provided consistent treatment
- On transfer to investment property carried at fair value
- Increase of \$25,000 should be recognised in other comprehensive income
- Resulting error: overstatement of profit by \$25,000

Evidence

- Notes of discussions with management to confirm intention to hold property to earn rentals and for capital appreciation
- Inspection of title deeds to confirm ownership of investment property
- A copy of any client working papers in relation to the calculation of the right-of-use asset
- Accounting policy agreed to financial statements to confirm that fair value model is to be adopted and consistent
- Board minutes for evidence of management discussion of change of use and for confirmation of date when owner-occupation ceased
- Written representations from management confirming change of use, relevant date and future intentions
- Record of physical inspection of building in order to confirm its general condition and that it is no longer occupied by Lifeson Co
- Market valuation of building by independent and external auditor's expert at date of transfer and at reporting date to determine respective fair values and resulting gains
- Details of external expert valuer including an assessment of professional qualifications, experience, reputation, independence and objectivity
- Agreement of carrying amount on transfer to non-current asset register
- Notes of discussions with management in relation to incorrect recording of the gain and need to include error in auditor's schedule of uncorrected misstatements
- Review disclosures made in the financial statements to ensure they comply with the requirements of IAS 40

Maximum marks

6

(iii) Shopping mall – asset impairment**Matters**

- Materiality
- Whether client's calculation of recoverable amount based on value in use is in line with requirements of IAS 36
- Discussion of whether client has used appropriate discount factor for calculating value in use
- Whether NRV of shopping mall exceeds its value in use (at both dates)
- Reversal of impairment loss should be capped to depreciated historic cost had no impairment loss been recognised
- Resulting error: overstatement of profit and assets by \$300,000

Evidence

- Agreement of opening balances for property to non-current asset register
- Physical inspection of shopping mall to confirm condition, occupancy level and reasonableness of depreciation policy and of management's cash flow forecasts
- Copy of client working papers for impairment review giving details of NRV of mall and value in use calculations
- Copy of client cash flow forecasts and budgets supporting value in use calculations
- Notes of discussions with management and assessment of reasonableness of assumptions used in forecasts and appropriateness of discount factor used in value in use calculations
- Management representations attesting to the reasonableness of assumptions and other related management judgements
- Recalculation of value in use by auditor
- Sensitivity analyses on forecasts and value in use calculations
- External confirmation of the shopping mall's net realisable value by an appropriately qualified, independent expert
- Notes of discussions with management in relation to incorrect recording of impairment reversal and need to include error in auditor's schedule of uncorrected misstatements

Maximum marks

6

(b) Auditor's report

Investment property

- Misstatement is immaterial
- No modification needed
- Written representation if not amended

Shopping mall

- Material misstatement due to inappropriate application of IAS 36
- Matter is not pervasive
- Qualified audit opinion
- Basis of qualified opinion paragraph

Maximum marks

5

Maximum

25

3 (a) Acceptance considerations

Up to 2 marks for each issue explained.

- Scope of assignment
- Interaction with criminal investigation
- Form and contents of reports/audience
- Confidentiality (max 1 mark)
- Competence
- Resource availability (including ability to make deadlines)
- Customer due diligence requirements/reputational risks (award up to 1 additional mark for specific examples of information required as part of the customer due diligence)

Maximum marks

8

(b) (i) Procedures to quantify the loss

1 mark for each relevant procedure described.

- Meet with audit committee/management to understand and document what they know about the fraud and who might be involved
- Discuss with the company's legal team what is known about the fraud at present and the source of the information
- If possible, interview the whistle-blower to identify the potential staff involved and the timescales over which the fraud has been perpetrated
- Obtain the prior year report to management from the auditor and inspect auditor's reports to identify any deficiencies or discrepancies in inventories identified by the auditors
- Obtain/prepare a reconciliation of all orders placed including cancelled orders to all invoices raised to identify the total of all orders placed but not invoiced to establish the maximum potential value of the theft
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- From this, identify fictitious customers and reconcile their cancelled orders to the inventory discrepancies identified
- Assess if the amounts ordered by the fictitious customers agree to the total discrepancies or if there is a further difference to be investigated
- Obtain inventory listing to identify the cost of the parts stolen and calculate the cost of the inventory identified as relating to the fictitious customer orders
- Using CAATs/data analytics identify any other sales staff with unusual levels of cancelled sales dispatches to see if this is a wider issue

Maximum marks

6

(ii) Control deficiencies and contribution to fraud

Up to 2 marks for each point explained with up to 1 mark per recommendation.

- Lack of segregation of duties and monitoring
 - o lack of integration of systems
 - o lack of monitoring of order cancellations
- Lack of segregation of duties in warehouse counts
- Additional implications
- Recommendations

Maximum marks

6

(c) Difficulty in identifying fraud

Generally, 1 mark per point explained.

- Management's responsibility
- Concealment
- Collusion
- Size of fraud relative to the business
- Auditor's responsibility
- Materiality
- Sampling risk
- Risk assessment and scepticism

Maximum marks

5

Maximum

25