ACCA

Advanced Audit and Assurance

Paper P7 (Global)

Course Notes

ACP7CN07

BPP LEARNING MEDIA

P7 *Advanced Audit and Assurance (Global)* Study Programme

		Page
Introduction to the paper and the course		(ii)
1	International regulatory environments for audit and assurance services	1.1
2	Code of ethics and conduct	2.1
3	Professional liability	3.1
4	Quality control	4.1
5	Obtaining and accepting professional appointments	5.1

End of Day 1 – refer to Course Companion for Home Study ❑ Progress test 1 ❑

6	Planning and risk assessment	6.1
7	Evidence	7.1
8	Evaluation and review	8.1
9	Evaluation & review (ii) matters relating to specific accounting issues	9.1
10	Evaluation & review (iii) matters relating to specific accounting issues	10.1
11	Group audits and transnational audits	11.1

End of Day 2 – refer to Course Companion for Home Study ❑ Progress test 2 ❑

Course exam 1 ❑

12	Audit related services and other assurance services	12.1
13	Prospective financial information (PFI)	13.1
14	Forensic audits	14.1
15	Social and environmental auditing	15.1
16	Internal audit and outsourcing	16.1
17	Reporting	17.1
18	*Homestudy chapter* – Current issues	18.1

End of Day 3 – refer to Course Companion for Home Study ❑ Progress test 3 ❑

Course exam 2 ❑

19	Answers to Lecture Examples	19.1
20	Question and Answer bank	20.1
21	Appendix A: Pilot Paper questions	21.1

Don't forget to plan your revision phase!

- Revision of syllabus
- Testing of knowledge
- Question practice
- Exam technique practice

BPP provides revision courses, question days, mock days and specific material to assist you in this important phase of your studies.

Introduction to Paper P7 *Advanced Audit and Assurance (Global)*

Overall aim of the syllabus

To develop knowledge and skills in understanding and applying accounting standards and the theoretical framework in the preparation of financial statements of entities, including groups and how to analyse and interpret those financial statements.

The syllabus

The broad syllabus headings are:

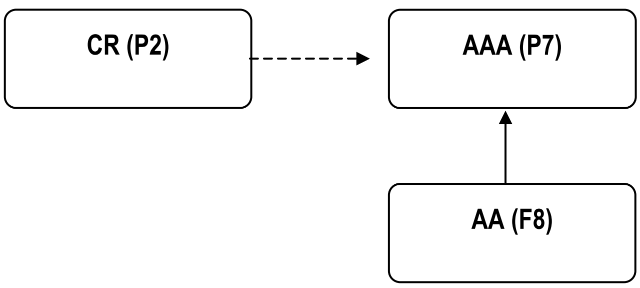
A	Regulatory environment
B	Professional and ethical considerations
C	Practice management
D	Assignments
E	Reporting
F	Current issues and development

Main capabilities

On successful completion of this paper, candidates should be able to:

- Recognise the legal and regulatory environment and its impact on audit and assurance practice
- Demonstrate the ability to work effectively on an assurance or other service engagement within a professional and ethical framework
- Assess and recommend appropriate quality control policies and procedures in practice management and recognising the auditor's position in relation to the acceptance and retention of professional appointments
- Identify and formulate the work required to meet the objectives of audit and non-audit assignments and the application of the International Standards on Auditing
- Evaluate findings and the results of work performed and drafting suitable reports on assignments
- Understand the current issues and developments relating to the provision of audit-related and assurance service

Links with other papers



This diagram shows where direct (solid line arrows) and indirect (dashed line arrows) links exist between this paper and other papers that may precede or follow it.

The advanced audit and assurance syllabus assumes knowledge acquired in Paper F8 Audit and Assurance and develops and applies this further in greater depth.

Assessment methods and format of the exam

Examiner: Lisa Weaver

The examination is a three hour paper consisting of two sections. The paper will have a global focus; no numerical questions will be set.

Format of the Exam		**Marks**
Section A	Will consist of two compulsory questions which must be attempted. These questions will be based on case study type scenarios. They will cover topics from across the syllabus,	50 – 70
Section B	Will consist of three questions, of which two must be answered. These questions will tend to be more focused on specific topics, such as audit reports and quality control for example.	30 - 50
		100

Course Aims

Achieving ACCA's Study Guide Outcomes

A A Regulatory environment

A1	International regulatory frameworks for audit and assurance services	**Chapter 1**
A2	Money laundering	**Chapter 1**
A3	Laws and regulations	**Chapter 1**

B Professional and ethical considerations

B1	Code Of Ethics	**Chapter 2**
B2	Fraud and error	**Chapter 3**
B3	Professional liability	**Chapter 3**

C Practice management

C1	Quality control	**Chapter 4**
C2	Advertising, publicity, obtaining professional work and fees	**Chapter 5**
C3	Tendering	**Chapter 5**
C4	Professional appointments	**Chapter 5**

D Assignments

D1	The audit of historical financial information including: (i) Planning, materiality and assessing the risk of statement (ii) Evidence (iii) Evaluation and review	 **Chapter 6** **Chapter 7** **Chapters 8-10**
D2	Group audits	**Chapter 11**
D3	Audit-related services	**Chapter 12**
D4	Assurance services	**Chapter 12**
D5	Prospective financial information	**Chapter 13**
D6	Forensic audits	**Chapter 14**
D7	Internal audit	**Chapter 16**
D8	Outsourcing	**Chapter 16**

E Reporting

E1	Auditor's report	**Chapter 17**
E2	Reports to management	**Chapter 17**
E3	Other reports	**Chapter 12**

F Current issues and developments

F1	Professional, ethical and corporate governance	**Chapters 1-3**
F2	Information technology	**Chapter 12**
F3	Transnational audits	**Chapter 11**
F4	Social and environmental auditing	**Chapter 15**
F5	Other current issues	**Chapters 1, 6 & 11**

Classroom tuition and Home study

Your studies for BPP consist of two elements, classroom tuition and home study.

Classroom tuition

In class we aim to cover the key areas of the syllabus. To ensure examination success you will need to spend private study time reinforcing your classroom course with question practice and reviewing areas of the Course Notes and Study Text.

Home study

To support you with your private study BPP provides you with a Course Companion which helps you to work at home and aims to ensure your private study time is effectively used. The Course Companion includes a Home Study section which breaks down your home study by days, one to be covered at the end of each day of the course. You will find clear guidance as to the time to spend on various activities and their importance.

You are also provided with progress tests and two course exams which should be submitted for marking as they become due.

These may include questions on topics covered in class and home study.

BPP Learn Online

Come and visit the BPP Learn Online free at **www.bpp.com/acca/learnonline** for exam tips, FAQs and syllabus health check.

ACCA Forum

We have thriving ACCA bulletin boards at **www.bpp.com/accaforum**. Register and discuss your studies with tutors and students.

Helpline

If you have any queries during your private study simply contact your class tutor on the telephone number or e-mail address that they will supply. Alternatively, call +44 (0)20 8740 2222 (or your local training centre if outside the London area) and ask for a tutor for this paper to speak to you or to call you back within 24 hours.

Feedback

The success of BPP's courses has been built on what **you**, the students tell us. At the end of the course for each subject, you will be given a feedback form to complete and return.

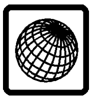
If you have any issues or ideas before you are given the form to complete, please raise them with the course tutor or relevant head of centre.

If this is not possible, please email **ACCAcoursesfeedback@bpp.com**.

Key to icons

Question practice from the Study Text

This is a question we recommend you attempt for home study.



Real world examples

These can be found in the Course Companion.

Section reference in the Study Text

Further reading is needed on this area to consolidate your knowledge.

Formula to learn

Formula given in exam

International regulatory environments for audit and assurance services

1

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the need for laws, regulations, standards and other guidance relating to audit, assurance and related services.
- Outline and explain the legal and professional framework.
- Discuss the effectiveness of the different ways in which the audit profession and audit markets are regulated.
- Define money laundering and explain how international efforts seek to combat money laundering.
- Explain the scope of criminal offences of money laundering and how professional accountants may be protected from criminal and civil liability.
- Explain the need for ethical guidance in this area.
- Describe how accountants meet their obligations to help prevent and detect money laundering and explain the importance of customer due diligence (Know your customer (KYC) information).
- Recognise potentially suspicious transactions and assess their impact on reporting duties.
- Describe with reasons the basic elements of an anti-money laundering programme.
- Compare and contrast the respective responsibilities of management and auditors concerning compliance with laws and regulations in an audit of financial statements.
- Describe the auditor's considerations of compliance with laws and regulations and plan audit procedures when possible non-compliance is discovered.
- Discuss how and to whom non-compliance should be reported and recognise when withdrawal from an engagement is necessary.
- Discuss IFAC developments including: the implementation and adoption of international standards on auditing and significant current assurance issues being dealt with by APB/IAASB.
- Explain how International Standards on Auditing affect smaller firms.

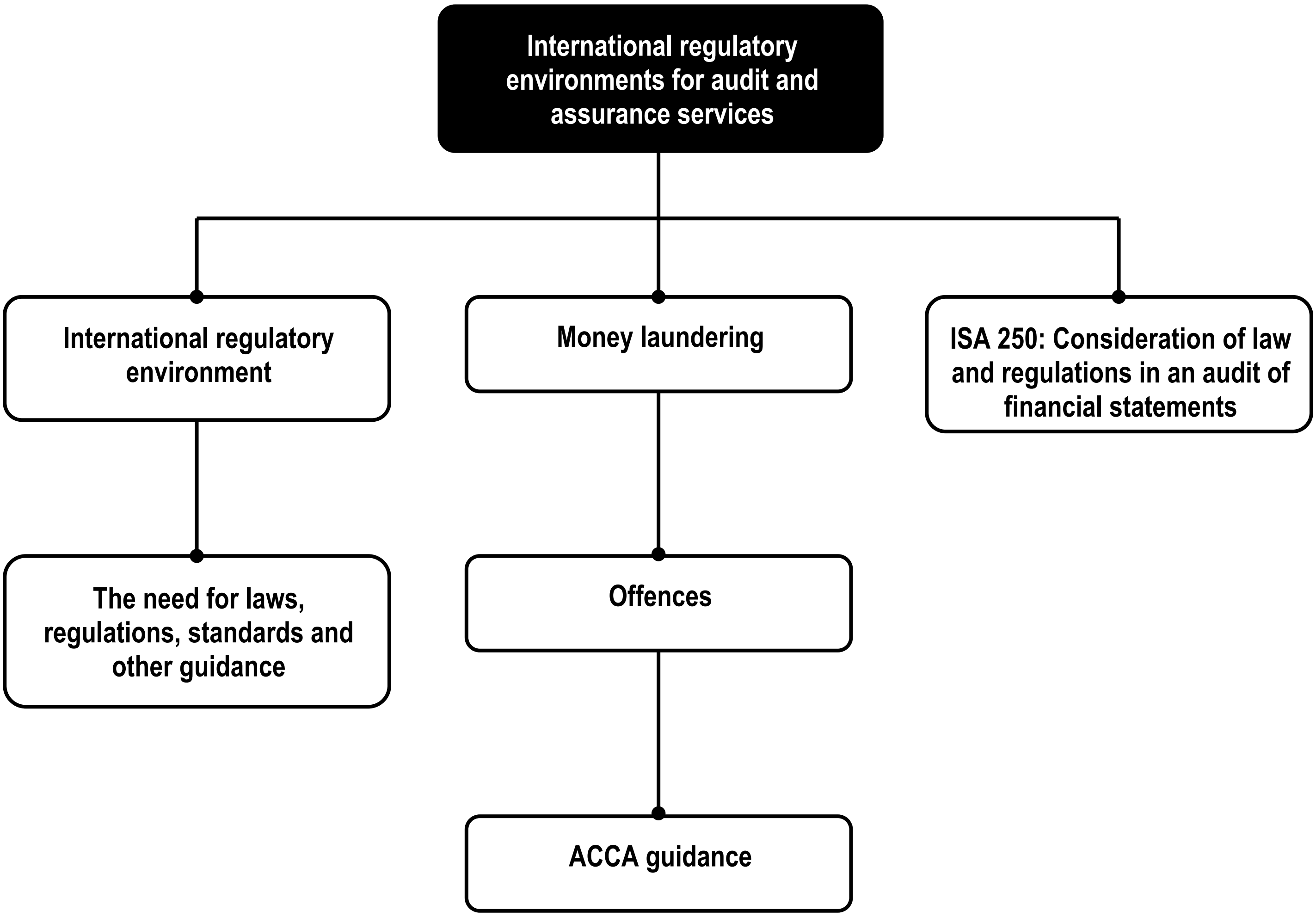
Exam Context

This chapter is likely to be important in the exam, particularly money laundering which was covered in the pilot paper from both a discussion and practical context.

Business Context

An understanding of the regulatory environment and legal issues is essential for any auditor as it provides a context for the performance of professional engagements.

Overview


International regulatory environments for audit and assurance services
International regulatory environment
Money laundering
ISA 250: Consideration of law and regulations in an audit of financial statements
The need for laws, regulations, standards and other guidance
Offences
ACCA guidance

1 International regulatory environment

1.1

International Federation of Accountants (IFAC) — International organisation representing national accountancy bodies

International Auditing and Assurance Standards Board (IAASB) — Standing technical committee of IFAC

issues

ASSURANCE

RELATED SERVICES

International Standards on Auditing (ISAs)

Contain
- basic principles and essential procedures; and
- related guidance
  - explanatory notes
  - other material.

Basic principles/ essential procedures must be applied in context of related guidance.

International Auditing Practice Statements (IAPSs)

- Practical assistance in implementing standards; and
- Promote good practice

International Standards on Review Engagements (ISREs)

- ISRE 2400 *Engagements to Review Financial Information*

International Standards on Assurance Engagements (ISAEs)

- ISAE 3000 *Assurance Engagements*
- ISAE 3400 *Prospective Financial Information*

International Standards on Related Services (ISRSs)

- ISRS 4400 *Agreed-upon Procedures*
- ISRS 4410 *Engagements to Compile Financial Information*

ISAs (UK and Ireland) and are issued by the UK Auditing Practices Board, part of the Financial Reporting Council, based on the international ones with additional UK-specific guidance where desirable.

The APB has not yet adopted the IAASB's IAPSs, ISREs, ISAEs or ISRSs.

1.2 The need for laws, regulations, standards and other guidance

Lecture example 1

Idea generation

Required

What factors have led to the growth in regulation of the audit profession?

Solution

2 Money laundering

Definition

2.1 Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a cover for their sources of income.

International efforts to combat money laundering

2.2 An intergovernmental body, the **Financial Action Task Force (FATF)** was established in 1990 to set standards and develop policies to combat money laundering and terrorist financing.

2.3 FATF has made 40 recommendations designed to combat money laundering and these have been adopted by more than 130 countries.

Money laundering offences

2.4 FATF has clarified a number of criminal offences relating to money laundering. Many of these have significant impact on the auditor and it is imperative that firms are aware of them and consider the risk that they may be committing an offence. The key offences are as follows:

- Possessing, dealing with or concealing **criminal property**.
- **Failure to report** knowledge or suspicion of money laundering to the appropriate authority (in the UK this would be the Serious Organised Crime Agency).
- **Tipping off** a client of suspicions relating to money laundering or disclosing any information that may prejudice an investigation.

ACCA guidance

2.5 In order to assist members in fulfilling their obligations the ACCA has issued two technical factsheets (94 and 131) on money laundering. The factsheets have been summarised into a section of the ACCA's ethical guidance which is a useful summary of members' responsibilities. The key elements of the guidance are as follows.

Internal controls and policies	Members should ensure their staff receive regular training to ensure that client identification procedures are carried out correctly and that knowledge and suspicions of money laundering or terrorist financing are reported. Firms should identify to their staff a clear procedure for reporting suspected money laundering and an individual; through whom reports of suspicions can be channelled to the relevant authority.
Client identification	Before any work is undertaken, members should verify the identity of the potential client.
Record keeping	Members should retain all client identification records for at least five years after the end of the client relationship. Records of all transactions and other work carried out, in a full audit trail form, should be retained for at least five years after the conclusion of the transaction.
Recognition of suspicion	Suspicion can be described as being more than speculation but falling short of proof based on firm evidence. The key to recognising a suspicious transaction or situation is for members to have sufficient understanding of clients and their activities.
Reporting suspicious transactions	Where members know or suspect that funds are the proceeds of crime or relate to terrorist financing, they should promptly report their suspicions to the relevant authority.
Tipping off	Members should not "tip off" a client that a report has been made. If a suspicion has arisen during the course of client identification procedures, members should take extra care that carrying out those procedures will not tip off the client.

Lecture example 2

Exam standard for 4 marks

Required

Why is there a need for ethical guidance in respect of money laundering?

Solution

3 ISA 250: Consideration of law and regulations in an audit of financial statements

3.1 When designing and performing audit procedures and in evaluating and reporting the results thereof, the auditor should recognise that non-compliance by the entity with law or regulations may materially affect the financial statements.

Responsibility of management

3.2 It is management's responsibility to ensure that the entity's operations are conducted in accordance with laws and regulations.

The responsibility for the prevention and detection of non-compliance also rests with management.

3.3 The following policies and procedures, among others, may assist management in discharging its responsibilities for the prevention and detection of non-compliance:

- Monitoring legal requirements and any changes therein and ensuring that operating procedures are designed to meet these requirements.
- Instituting and operating appropriate internal control.
- Developing, publicising and following a Code of Conduct.
- Ensuring employees are properly trained and understand the Code of Conduct.
- Monitoring compliance with the Code of Conduct and acting appropriately to discipline employees who fail to comply with it.
- Engaging legal advisers to assist in monitoring legal requirements.
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints.

- In larger entities, these policies and procedures may be supplemented by assigning appropriate responsibilities to:
  - An internal audit function
  - An audit committee.

The auditor's consideration of compliance with laws and regulations

3.4 The auditor is not, and cannot be held responsible for preventing non-compliance. The fact than an audit is carried out may, however, act as a deterrent.

3.5 In order to plan the audit, the auditor should obtain a general understanding of the legal and regulatory framework applicable to the entity and the industry and how the entity is complying with that framework.

Audit procedures when possible noncompliance is discovered

3.6 When the auditor becomes aware of information concerning a possible instance of non-compliance, the auditor should obtain an understanding of the nature of the act and the circumstances in which it has occurred, and sufficient other information to evaluate the possible effect on the financial statements.

3.7 Any non-compliance with law or regulations should be documented and discussed with the appropriate level of management. The auditor should consider the implications in relation to other aspects of the audit, particularly the reliability of management representations.

The auditor's report

3.8 *Disagreement*

Where the auditor concludes that the non-compliance has a material effect on the financial statements, which has not been amended, he should express a qualified or adverse opinion.

3.9 *Limitation on scope*

Where adequate information about compliance or suspected noncompliance cannot be obtained, the auditor may need to express a qualified opinion or disclaimer of opinion due to limitation on the scope of the audit.

Withdrawal from the engagement

3.10 The auditor may conclude that withdrawal from the engagement is necessary when the entity does not take the remedial action that the auditor considers necessary in the circumstances, even when the non-compliance is not material to the financial statements.

4 Chapter summary

- The existence of **laws and regulations** are very important to protect and enhance the **reputation** of the audit profession.
- A key area where guidance and regulations exist is **money laundering**.
- Auditors are at risk of committing various **criminal offences** regarding money laundering, for example **not reporting** suspicious transactions and/or **tipping off** the client that suspicion has arisen.
- Auditors should ensure they are familiar with the **laws and regulations** that the client has to comply with and have considered the risk of non-compliance at all stages of the audit (ISA 250).

END OF CHAPTER

Code of ethics and conduct

2

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the fundamental principles and the conceptual framework approach.
- Identify, evaluate and respond to threats to compliance with the fundamental principles.
- Discuss and evaluate the effectiveness of available safeguards.
- Recognise and advise on the conflicts in the application of fundamental principles.
- Discuss the relative advantages of an ethical framework and a rulebook.
- Evaluate the adequacy of existing ways in which objectivity may be safeguarded and suggest additional measures to improve independence.
- Identify and assess relevant emerging ethical issues and evaluate the safeguards available

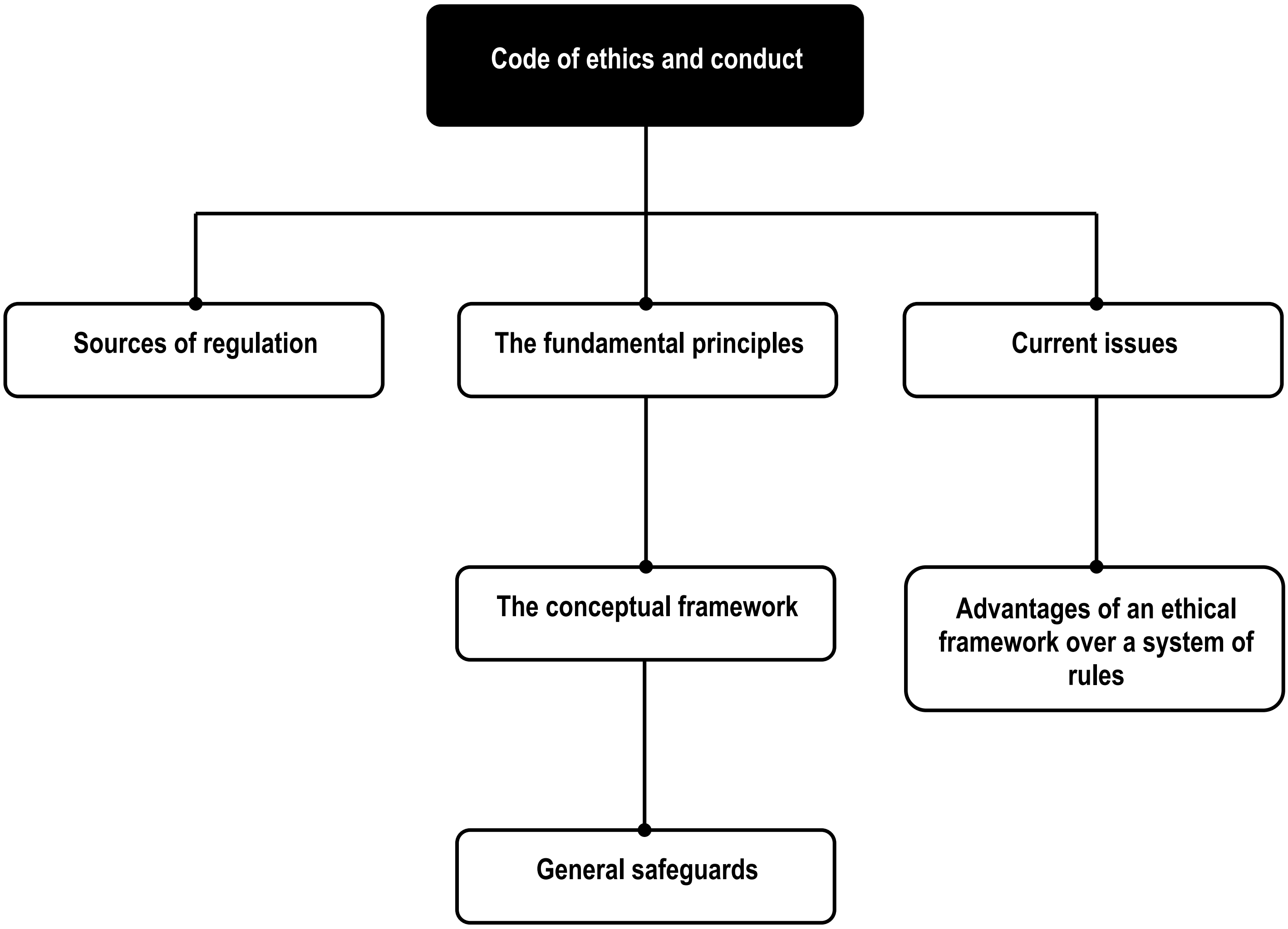
Exam Context

Professional ethics is a key area of the syllabus and is likely to be examined regularly in a practical context. A practical question on ethics came up in the pilot paper for 15 marks in the optional section.

Business Context

The ethical rules and principles covered in this chapter apply to all ACCA accountants and trainees. You are therefore required to adhere to these in both your professional and personal life.

Overview


Code of ethics and conduct
Sources of regulation
The fundamental principles
Current issues
The conceptual framework
Advantages of an ethical framework over a system of rules
General safeguards

1 Sources of regulation

1.1 As a member of IFAC (the International Federation of Accountants) the ACCA is required to enforce ethical standards no less stringent than those of the global body.

The ACCA rules are now fundamentally the same as those of IFAC. They give fundamental principles and specific guidance statements.

The Code of ethics and conduct applies to members, affiliates and students of the ACCA.

2 The fundamental principles

2.1	**Integrity**:	– Members should be straightforward and honest in all professional and business relationships.
	Objectivity:	– Members should not allow bias, conflicts of interest or undue influence of others to override professional or business judgement.
	Professional competence & due care	– Members have a continuing duty to maintain professional knowledge and skill at a level required to ensure that a client or employer receives competent professional service based on current developments in practice, legislation and techniques. Members should act diligently and in accordance with applicable technical and professional standards when providing professional services.
	Confidentiality:	– Members should respect the confidentiality of information acquired as a result of professional and business relationships and should not disclose any such information to third parties without proper and specific authority or unless there is a legal or professional right or duty to disclose. Confidential information acquired as a result of professional and business relationships should not be used for the personal advantage of members or third parties.
	Professional behaviour:	– Members should comply with relevant laws and regulations and should avoid any action that discredits the profession.

Question 1

3 The conceptual framework

Lecture example 1

Idea generation

The ACCA guidance identifies five circumstances which have the potential to threaten compliance with the fundamental principles. These are:

- The Self interest threat
- The Self review threat
- The Advocacy threat
- The Familiarity threat
- The Intimidation threat

Required

What real world situations could lead to the above threats to compliance with the fundamental principles?

Solution

General safeguards

3.1 The conceptual framework, having identified the threats discussed in Lecture example 1, goes on to give guidance as to appropriate safeguards where threats are identified. These safeguards fall into three broad categories.

3.2 Safeguards created by the **profession**, legislation or regulation. For example:

- Education and training requirements for members
- Continuing professional development requirements
- Professional standards (eg. the specific guidance statements)
- Professional or regulatory monitoring and disciplinary procedures
- Corporate governance requirements

Safeguards in the **work environment.** For example:

- Quality control over assurance engagements (Chapter 4)
- Using different partners and engagement terms with separate reporting lines for the provision of non-assurance services to clients

- The employing organisation's ethics and conduct requirements
- Strong internal controls
- Appropriate disciplinary processes

Safeguards created by the **individual**.

- Continuing professional development.
- Keeping records of contentious issues and approach to decision making

Lecture example 2

Preparation question

Required

Discuss the ethical issues raised by the following scenarios and suggest actions that the auditor may take in relation to these matters.

(1) An audit manager has inherited 7,500 ordinary shares in one of his client's companies. He does not want to sell them as they are currently trading at a very low market price.

(2) The audit partner of a company (a long standing audit client) has recently been asked to be the godfather of the finance director's son.

Solution

4 Current issues

Lecture example 3

Exam standard for 5 marks

Required

Discuss the advantages of an ethical framework over a system of ethical rules.

Solution

5 Chapter summary

Chapter 2

- The **Code of ethics and conduct** is a crucial document and should be observed by all ACCA members and trainees.
- The Code is based on **five fundamental principles** which govern the general behaviour and characteristics of members.
- The fundamental principles are themselves underpinned by a **conceptual framework** which identifies **threats** to compliance with the fundamental principles and recommends **safeguards** to protect against the threats.
- These safeguards fall into three categories; those created by the **profession**, safeguards in the **work environment** and safeguards created by the **individual**.

END OF CHAPTER

3

Professional liability

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define and clearly distinguish between the terms 'error', 'irregularity', 'fraud' and 'misstatement'.
- Compare and contrast the respective responsibilities of management and auditors for fraud and error.
- Describe the matters to be considered and procedures to be carried out to investigate actual and/or potential misstatements in a given situation.
- Explain how, why, when and to whom fraud and error should be reported and the circumstances in which an auditor should withdraw from an engagement.
- Recognise circumstances in which professional accountants may have legal liability.
- Describe the factors to determine whether or not an auditor is negligent in given situations.
- Explain the other criteria for legal liability to be recognised (including 'due care' and 'proximity') and apply them to given situations.
- Compare and contrast liability to client with liability to third parties and comment on precedents of case law.
- Evaluate the practicability and effectiveness of ways in which liability may be restricted, including professional indemnity insurance (PII).
- Discuss how audit and other opinions may be affected by limiting auditors' liability.
- Discuss the advantages and disadvantages of claims against auditors being settled out of court.
- Discuss and appraise the principal causes of audit failure and other factors that contribute to the 'expectation gap' (e.g. responsibilities for fraud and error).
- Recommend ways in which the expectation gap can be bridged.
- Assess the relative advantages and disadvantages of partnership status, limited liability partnerships and incorporation of audit firms.
- Discuss current developments in the limitation of auditors' liability and the practical ways in which the risk of litigation and liability can be reduced in a given situation.

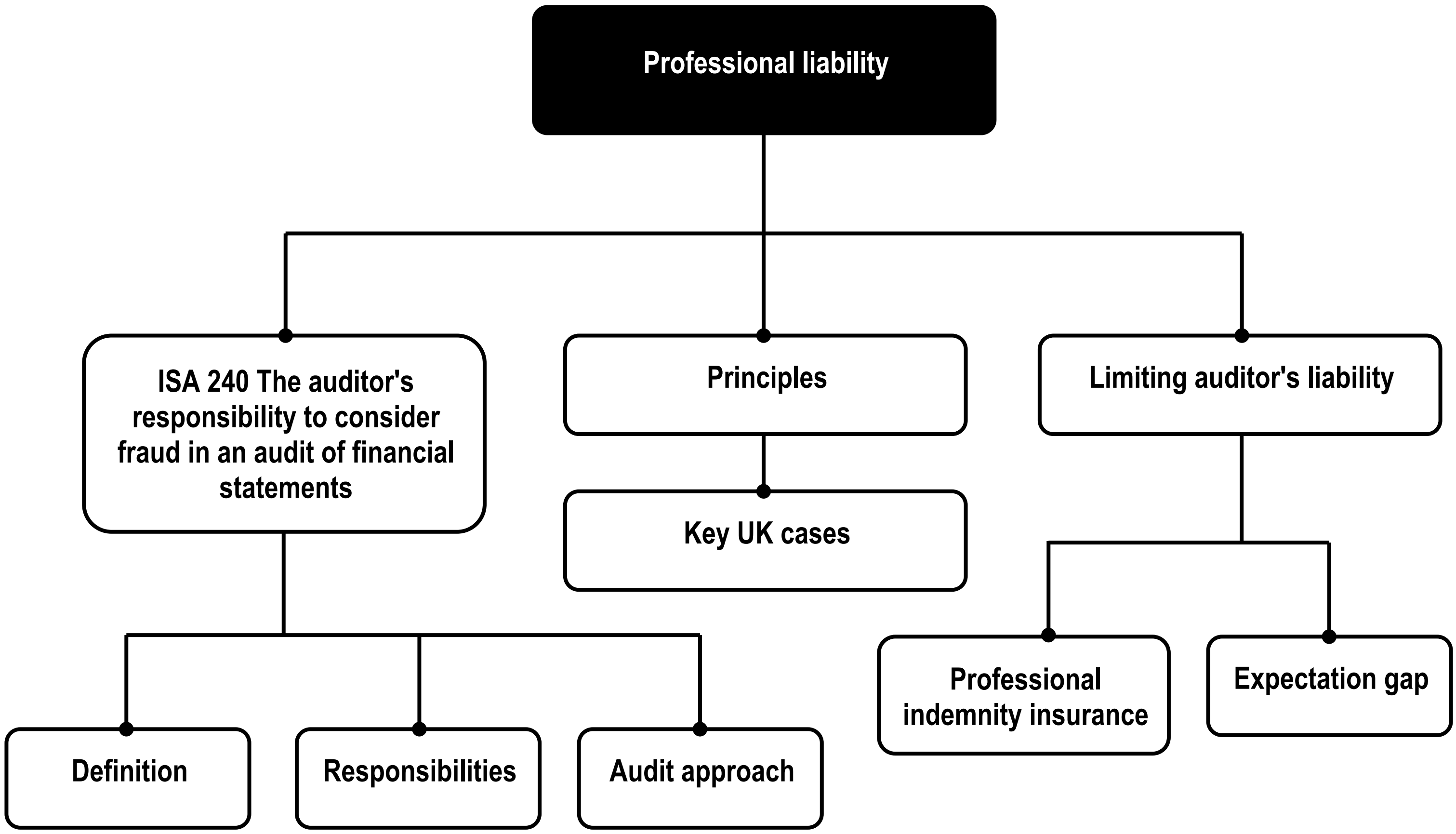
Exam Context

The areas covered in this chapter are likely to be important in the exam; you are likely to see professional liability tested in a very practical context.

Business Context

Issues relating to liability are a significant issue for all audit firms, recent, high-profile audit failures, such as Enron have lead to significant changes in the audit industry, particularly with respect to the legal structure of firms.

Overview


Professional liability
ISA 240 The auditor's responsibility to consider fraud in an audit of financial statements
Principles
Limiting auditor's liability
Key UK cases
Definition
Responsibilities
Audit approach
Professional indemnity insurance
Expectation gap

1 ISA 240: The auditor's responsibility to consider fraud in an audit of financial statements

Definition

1.1 **Fraud** refers to an intentional act by one or more individuals among management, those charged with governance, employees, or third parties, involving the use of deception to obtain an unjust or illegal advantage.

1.2 Two types of intentional misstatements caused by fraud are relevant to the auditor:

– misstatements resulting from **fraudulent financial reporting**; and
– misstatements resulting from **misappropriation of assets**.

Responsibilities

Question 4

1.3 The primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and with management.

The auditor should obtain reasonable assurance that the financial statements as a whole are free from material misstatement, whether caused by fraud or error.

Audit approach

1.4 Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatement due to fraud.

The auditor should make enquiries of management regarding management's assessment of the risk that the financial statements may be materially misstated due to fraud and management's process for identifying and responding to the risks of fraud in the entity.

The auditor should also enquire about any actual, suspected or alleged fraud affecting the entity.

The auditor should obtain an understanding of how those charged with governance exercise oversight of management's processes for identifying and responding to the risks of fraud and the internal control that management has established to mitigate these risks.

1.5 Having obtained an understanding of the entity's environment and internal control with respect to fraud, the auditor should:

- assess the risk of material misstatement due to fraud at both the **financial statement** and **assertion** levels; and
- determine overall responses to address the assessed risks. This could include:
  – appropriate assignment and supervision of audit personnel
  – consideration of accounting policies used by the entity
  – incorporating unpredictability in the nature, timing and extent of audit procedures

- changing nature of audit procedures, e.g. more physical observation and inspection
- changing the timing of audit procedures away from the period end to interim figures
- changing the extent of procedures applied, e.g. larger sample sizes.

Procedures when misstatements are discovered

1.6 When there is a misstatement indicative of fraud, the auditor should consider its implications in relation to other aspects of the audit, particularly the reliability of management representations.

Auditor's report

1.7 When the auditor confirms that, or is unable to conclude whether, the financial statements are materially misstated as a result of fraud, the auditor should consider the implications for the auditor's report:

Insufficient evidence → Limitation on scope

Uncorrected fraud/error → Disagreement

Communication

1.8 When the auditor identifies fraud or suspected fraud, he should communicate it to the **appropriate level of management** as soon as practicable.

1.9 Fraud should be communicated to **those charged with governance** where it involves:

(a) Management;
(b) Employees who have significant roles in internal control; and
(c) Others where the fraud results in a material misstatement in the financial statements.

1.10 The auditor should communicate to management and those charged with governance any material weaknesses in the design or implementation of internal control to the prevent and detect fraud which have come to the auditor's attention.

1.11 The auditor may have a legal duty under national law to report fraud to **regulatory and enforcement authorities**. In such case, the auditor's duty of confidentiality is overridden by the law.

Withdrawal from an engagement

1.12 If, as a result of a misstatement resulting from fraud or suspected fraud, the auditor encounters exceptional circumstances that bring into question the auditor's ability to continue performing the audit the auditor should consider the possibility of withdrawing from the engagement.

1.13 Such exceptional circumstances can arise, for example, when:

- The entity does not take the appropriate action regarding fraud that the auditor considers necessary in the circumstances;

- The auditors consideration of the risks of material misstatement due to fraud and the results of audit tests indicate a significant risk of material and pervasive fraud; or
- The auditor has significant concern about the competence or integrity of management or those charged with governance.

2 Professional liability

Principles

Chapter 3 Section 2.2.1

2.1 Negligence is a common law concept under English law. It seeks to provide compensation to a person who has suffered loss due to another person's wrongful neglect. To succeed in an action for negligence, an injured party must prove three things:

(a) A **duty of care** which is enforceable at law existed.

(b) This duty of care was **breached**.

(c) The breach caused the injured party **loss**. In the case of negligence in relation to financial advisers/auditors, this loss must be pecuniary (i.e. financial) loss.

The client

2.2 The **company** has a **contract** with the audit firm. In English law, a contract for the supply of a service such as an audit has a duty of reasonable care implied into it by statute.

Client	
Duty of care exists?	Automatic
Breached?	Must be proved
Loss arising?	Must be proved

In order to prove whether a duty of care has been breached, the court has to give further consideration to what the duty of 'reasonable' care means in practice. This will be decided with reference to past cases.

Third parties

2.3 'Third parties' in this context means anyone other than the company (audit client) who wished to make a claim for negligence.

The key difference between third parties and the company is that third parties have no contract with the audit firm. There is therefore no implied duty of care. The situation is therefore as follows.

Third parties	
Duty of care exists?	Must be proved
Breached?	Must be proved
Loss arising?	Must be proved

Summary of the key UK cases

2.4 The most important case in deciding if a duty of care is owed to third parties is the *Caparo case*, which is described here.

(a) **Caparo Industries plc v Dickman and Others (1990)**

During 1984, Caparo Industries plc invested in and eventually acquired control of Fidelity plc.

Having bought Fidelity, Caparo brought an action against two of the directors of Fidelity plc and their auditors, Touche Ross.

They alleged that the accounts they had relied upon overstated the profits and that reported pre-tax profits of £1.3m were, in reality, losses of £400,000.

Two relationships were advanced by Caparo:

(i) At the year end and on the day Touche Ross signed the audit report Caparo held a small shareholding in Fidelity.

(ii) Subsequently Caparo made a full bid relying on the audited accounts in their investment decision-making.

The case went to the House of Lords (the highest UK Court).

They concluded that the auditor owes a responsibility to the company/shareholders as a whole, not to individual shareholders.

Further, it was decided that sufficient proximity between the auditors and Caparo as investors did not exist.

The Law Lords said that the auditor owed no duty of care to members of the public at large who relied on the accounts in making investment decisions, and that as a shareholder, Caparo stood in the same position as any other investing member of the public.

They stated that an essential element of proximity is that "the defendant knew that his statement would be communicated to the plaintiff, either as an individual or a member of an identifiable class, specifically in connection with a particular transaction or transactions of a particular kind and that the plaintiff would be very likely to rely on it for the purpose of deciding whether or not to enter upon that transaction".

(b) **The ADT case (1996)**

ADT acquired control of Britannia Securities Group who were audited by Binder Hamlyn. Before ADT made a bid, they had a meeting with one of the partners from Binder Hamlyn. At this meeting, the partner was asked if he stood by the results of the 1989 audit and he confirmed that he did.

After the take-over, ADT alleged that these accounts were misstated and sued Binder Hamlyn for £65 million. They believed that the meeting between themselves and the partner created proximity.

The judge agreed and Binder Hamlyn were ordered to pay the £65 million in damages together with £40 million in interest.

(c) **Littlejohn Case (1985)**

The plaintiff alleged the auditors of a trailer rental business had been negligent, claiming that they had failed to consider that the tyre replacement policy was cash rather than accruals based.

The audit client had gone into receivership a few months after plaintiff bought controlling interest.

The auditor's defence was that they had fully considered and documented the tyre policy, including raising it in the Management Letter. Also, they had issued a going concern modification and generally carried out a thorough audit.

The judge concluded that a thorough audit (in accordance with auditing standards) is a good defence against claims of negligence and the plaintiff lost the case.

(d) **Royal Bank of Scotland v Bannerman Johnstone Maclay and others (2002)**

The Royal Bank of Scotland (RBS) provided an overdraft facility to APC Limited, a company audited by Bannerman Johnstone Maclay ('Bannerman'). The facility letter between RBS and APC contained a clause requiring APC to send RBS a copy of the annual audited financial statements each year.

In 1998 APC went into receivership with approximately £13,250,000 owing to RBS. RBS claimed that, due to fraud, the accounts for the previous year had materially misstated the financial position of the company and the auditor had been negligent in not detecting the fraud. RBS contended that it had continued to provide the overdraft facility to the company by relying on the auditor's unqualified opinion.

Bannerman claimed in court that it did not owe a duty of care to RBS.

The judge held that the knowledge gained during the course of the audit was sufficient, in the absence of any disclaimer, to create a duty of care between Bannerman and RBS: in order to consider the going concern issues the auditor would have had to review the facility letter, so would have become aware that the audited accounts would be provided to RBS for the purpose of making a lending decision. Having acquired this knowledge, the auditor could have disclaimed liability to RBS but did not do so. The lack of any disclaimer was an important fact in the circumstances surrounding the creation of a duty of care to RBS.

Disclaimers to third parties in auditor's reports are now recommended by some UK accounting bodies as a result of this case. However, ACCA disagrees as it feels the response is disproportionate (Technical Factsheet 84) and discourages their use.

Lecture example 1

Exam standard for 10 marks

Your firm of Certified Accountants, in common with many of the firms of accountants and auditors, issues to its staff an audit manual which contains, amongst other matters, recommended procedures to be adopted in carrying out audits. A number of these recommended procedures relate to physical observation of inventory counts and review of inventory counting instructions. Owing to pressure of work, you neglected to arrange for the physical observation of inventories at the premises of Moorland, a limited liability company audit client, at 31 March 20X3, but your review of inventory counting instructions indicated that company procedures appeared to be in order. You decided to accept the amount at which inventories were stated in the financial statements at 31 March 20X3 on the grounds that:

(i) the inventory counting instructions appeared to be satisfactory;
(ii) no problems had arisen in determining physical inventory quantities in previous years; and
(iii) the figures in the financial statements generally 'made sense'.

You issued your unqualified auditor's report on 28 May 20X3 and unbeknown to you Moorland used the financial statements and the auditor's report for the purpose of obtaining material additional finance from a third party in the form of an unsecured long-term loan. Unfortunately, in October 20X3 the company ran into financial difficulties and was forced into liquidation as a result of which the long-term loan holder lost the amount of his loan. During the liquidation proceedings it became clear that inventory quantities at 31 March 20X3 had been considerably overstated.

Required

(a) Explain the probable legal position (under English law) of your firm in respect of the above matter commenting specifically on the following:

   (i) The possibility of demonstrating your firm was negligent

   (ii) The fact that the inventories figure in the financial statements apparently 'made sense'

   (iii) The fact that you were not informed that the financial statements and your auditor's report were to be used to obtain additional finance.

(b) Describe the reasonable steps your firm should take to avoid a recurrence of a matter such as that described above.

Solution

3 Limiting auditors' liability

3.1 The auditing profession is concerned about the extent of their liability to third parties. They argue that they are unable to get sufficient insurance cover to meet the level of claims. Also, as firms are required to have Professional Indemnity Insurance (see Section 4), even if other parties (i.e. directors) share an element of responsibility for misleading financial statements, audit firms argue that they bear the burden of giving financial compensation.

3.2 **Avoiding litigation**

Auditors may reduce the chances of litigation by ensuring they have good procedures over:

- client acceptance
- performance of audit work, compliance with standards
- quality control/quality audits.

3.3 The following suggestions have been put forward as possible methods of reducing liability:

- Incorporation
- Limited Liability Partnership
- Capping Liability
- Professional Indemnity Insurance.

3.4 **Incorporation** would protect the partners from personal bankruptcy. However, the firm itself could be forced into liquidation. Further, there could be adverse tax implications and the firm would need to publish accounts and be subject to an audit.

3.5 **Limited Liability Partnerships (LLPs)** would permit the partners not to be personally liable for the liabilities of the firm. Legislation was enacted in the UK in April 2001 allowing LLPs to be set up. Ernst & Young were the first firm to avail of the legislation.

3.6 **Capping liability** would allow auditors to limit the amount of their liability for an individual audit. The maximum amount could be based on some multiple of the audit fee. This is not currently permitted for audit work in the UK although there are government proposals to introduce a cap. This would be a similar system to Germany where a cap is permitted and auditors' liability cannot exceed £1,022,500 for audits of non-quoted companies and £4,090,000 for audits of quoted companies.

Settlements out of court

3.7 Many liability claims are settled out of court.

Lecture example 2

Idea generation

Required

What are the advantages and disadvantages of settling audit liability cases out of court?

Solution

4 Professional indemnity insurance (PII)

4.1 Members or firms who wish to hold an ACCA practising certificate must hold PII and fidelity guarantee insurance (FGI) in respect of all partners, directors and employees.

4.2 PII must provide cover in respect of all civil liability incurred in connection with the conduct of the firm's business. FGI must include cover against any acts of fraud or dishonesty by any partner, director or employee in respect of money or goods held in trust by the firm.

5 Expectation gap

5.1 This term is used to describe the difference between the expectations of those who rely upon audit reports concerning audit work performed and actual work performed.

Contributing factors

5.2 The expectation gap arises due to a general misunderstanding of the respective responsibilities of management and the auditor and a misunderstanding of the scope of an audit.

Specific issues may include:

- perception that it is the auditor's duty to prevent and detect fraud
- perception that the auditor is liable for any errors in the financial statements.

5.3 In an attempt to narrow the expectation gap, the auditor's report covers:

- the respective responsibilities of management and the auditor;
- an explanation of the nature of an audit, i.e. test basis only and includes an assessment of the accounting principles used and significant estimates made; and
- a statement that the opinion gives *reasonable* rather than absolute assurance that financial statements are free from material misstatement.

5.4 Additionally, the audit firm will reiterate the respective responsibilities of management and the auditor, and the nature, scope and purpose of an audit, in the engagement letter.

6 Chapter summary

- **Fraud** is a risk that auditors must be aware of however the primary **responsibility** for prevention and detection lies with the **directors** of the entity.
- Auditors take a considerable risk when signing the audit report since many third parties rely on the opinion given. If the opinion is proven to have been negligently provided the **auditor** may be **liable** for financial losses suffered.
- This leads to the risk of **litigation**; case history has determined that auditors are currently only likely to be **liable** to the **client** itself and the **shareholders as a body**.
- Any other third party would have to demonstrate sufficient **proximity** and therefore a **duty of care** to be successful in a claim of negligence.
- The profession has taken many steps recently to try to **limit liability** to third parties; many major firms have changed their **legal structure** as a result.

END OF CHAPTER

4

Quality control

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the principles and purpose of quality control of audit and other assurance engagements.
- Describe the elements of a system of quality control relevant to a given firm.
- Select and justify quality control procedures that are applicable to a given audit engagement.
- Assess whether an engagement has been performed in accordance with professional standards and whether reports issued are appropriate in the circumstances.

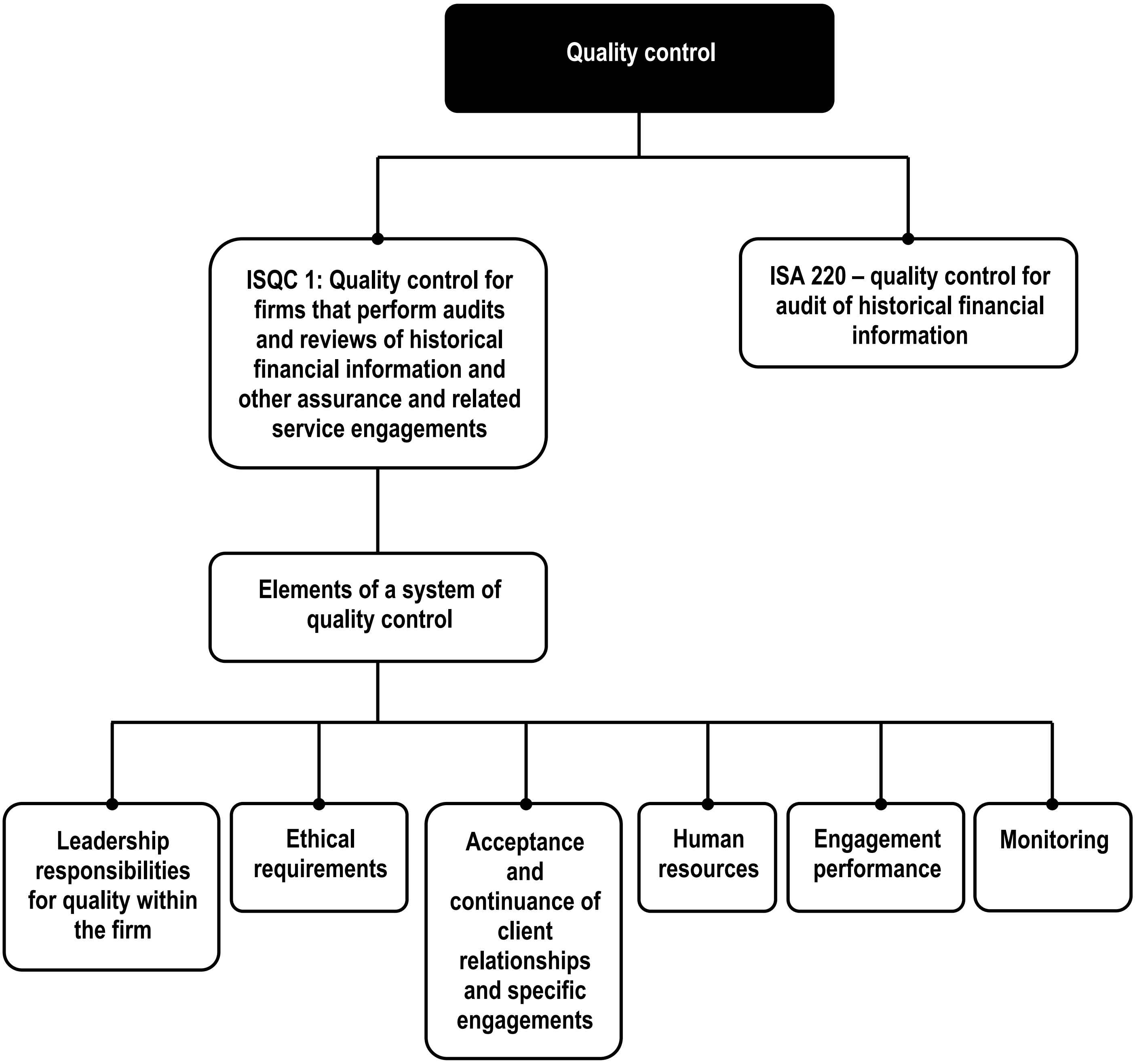
Exam Context

Quality control is an important area of the syllabus and appeared in the optional section of the pilot paper for 20 marks in a scenario based question.

Business Context

Quality control is a very important issue for all audit firms; everything a firm does, can, in some way be brought back to the issue of quality control.

Overview


Quality control
ISQC 1: Quality control for firms that perform audits and reviews of historical financial information and other assurance and related service engagements
ISA 220 – quality control for audit of historical financial information
Elements of a system of quality control
Leadership responsibilities for quality within the firm
Ethical requirements
Acceptance and continuance of client relationships and specific engagements
Human resources
Engagement performance
Monitoring

1 ISQC 1 Quality control for firms that perform audits and reviews of historical financial information, and other assurance and related services engagements

Lecture example 1 **Idea generation**

Required

Quality control is a key issue for all audit firms, can you think of why a firm would want or need a strong system of quality control?

Solution

2 Elements of a system of quality control

2.1 The firm's system of quality control should include policies and procedures addressing each of the following elements:

(a) Leadership responsibilities for quality within the firm
(b) Ethical requirements
(c) Acceptance and continuance of client relationships and specific engagements
(d) Human resources
(e) Engagement performance
(f) Monitoring.

Leadership responsibilities for quality within the firm

2.2 *The firm should establish policies and procedures designed to promote an internal culture based on the recognition that quality is essential in performing engagements.*

2.3 This is achieved in the following ways:

(a) The firm assigns its management responsibilities so that commercial considerations do not override the quality of work performed;

(b) The firm's policies and procedures addressing performance evaluation, compensation, and promotion are designed to demonstrate the firm's overriding commitment to quality; and

(c) The firm devotes sufficient resources for the development, documentation and support of its quality control policies and procedures.

Ethical requirements

2.4 *The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm and its personnel comply with relevant ethical requirements.*

2.5 The firm's policies and procedures should emphasise the fundamental principles of the IFAC Code of Ethics and reinforce them through:

(a) the leadership of the firm
(b) education and training
(c) monitoring
(d) a process for dealing with non-compliance.

Independence

2.6 *The firm should establish policies and procedures designed to provide it with reasonable assurance that the firm, its personnel and, where applicable, others subject to independence requirements (including experts contracted by the firm and network firm personnel), maintain independence where required by the IFAC Code and national ethical requirements.*

2.7 At least annually, the firm should obtain written confirmation of compliance with its policies and procedures on independence from all firm personnel required to be independent by the IFAC Code and national ethical requirements.

Acceptance and continuance of client relationships and specific engagements

2.8 *The firm should establish policies and procedures for the acceptance and continuance of client relationships and specific engagements, designed to provide it with reasonable assurance that it will only undertake or continue relationships and engagements where it:*

(a) *has considered the integrity of the client and does not have information that would lead it to conclude that the client lacks integrity;*

(b) *is competent to perform the engagement and has the capabilities, time and resources to do so; and*

(c) *can comply with ethical requirements.*

Human resources

2.9 *The firm should establish policies and procedures designed to provide it with reasonable assurance that it has sufficient personnel with the capabilities, competence, and commitment to ethical principles necessary to perform its engagements in accordance with professional standards and regulatory and legal requirements, and to enable the firm or engagement partners to issue reports that are appropriate in the circumstances.*

2.10 Such policies and procedures address the following personnel issues:

- Recruitment;
- Performance evaluation;
- Capabilities;
- Competence;
- Career development;
- Promotion;
- Compensation; and
- The estimation of personnel needs.

Lecture example 2

Idea generation

Required

List examples of appropriate control procedures to ensure the firm's staff have the necessary capabilities and competence.

Solution

Assignment of personnel to engagements

2.11 *Audit work is to be assigned to personnel who have the degree of technical training and proficiency required in the circumstances*.

Lecture example 3

Idea generation

Required

What matters would you consider when assigning personnel to a particular audit?

Solution

Engagement performance

2.12 *The firm should establish policies and procedures designed to provide it with reasonable assurance that engagements are performed in accordance with professional standards and regulatory and legal requirements, and that the firm or the engagement partner issue reports that are appropriate in the circumstances.*

2.13 Matters to be addressed in the firm's guidance materials include the following.

- How engagement teams are briefed on the engagement to obtain an understanding of the objectives of their work.
- Processes for complying with applicable engagement standards.
- Processes of engagement supervision, staff training and coaching.
- Methods of reviewing the work performed, the significant judgments made and the form of report being issued.
- Appropriate documentation of the work performed and of the timing and extent of the review.
- Processes to keep all policies and procedures current.

2.14 The engagement process should include both:

- **supervision** of the work as it is undertaken; and
- **review** that it has been performed in accordance with professional and legal requirements and that the evidence obtained is sufficient and appropriate to support the conclusions drawn.

Consultation

2.15 *The firm should establish policies and procedures designed to provide it with reasonable assurance that:*

(a) *appropriate consultation takes place on difficult or contentious matters;*
(b) *sufficient resources are available to enable appropriate consultation to take place;*
(c) *the nature and scope of such consultations are documented; and*
(d) *conclusions resulting from consultations are documented and implemented.*

2.16 Consultation includes discussion, at the appropriate professional level, with individuals within or outside the firm who have specialised expertise, to resolve a difficult or contentious matter.

2.17 Effective consultation with other professionals requires that those consulted be given all the relevant facts that will enable them to provide informed advice on technical, ethical or other matters.

Engagement quality control reviews

2.18 An engagement quality control review is an objective evaluation of the significant judgments made by the engagement team and the conclusions reached in formulating the report.

Engagement quality control reviews are *required* for:

- all audits of financial statements of listed entities
- other audit, assurance and related services engagements meeting appropriate criteria set by the firm, e.g. nature, unusual circumstances or risks, laws and regulations requiring a review.

This review is performed *prior* to signing the opinion and is often referred to as a '*hot*' review.

Monitoring

2.19 *The firm should establish policies and procedures designed to provide it with reasonable assurance that the policies and procedures relating to the system of quality control are relevant, adequate, operating effectively and complied with in practice. Such policies and procedures should include an ongoing consideration and evaluation of the firm's system of quality control, including a periodic inspection of a selection of completed engagements.*

2.20 The purpose of monitoring compliance with quality control policies and procedures is to provide an evaluation of:

(a) adherence to professional standards and regulatory and legal requirements;

(b) whether the quality control system has been appropriately designed and effectively implemented; and

(c) whether the firm's quality control policies and procedures have been appropriately applied, so that reports that are issued by the firm or engagement partners are appropriate in the circumstances.

2.21 The firm entrusts responsibility for the monitoring process to a partner or partners or other persons with sufficient and appropriate experience and authority in the firm to assume that responsibility.

The monitoring process is focused on completed engagements where the audit report has *already been signed* and is often referred to as a '*cold*' review.

3 ISA 220: Quality control for audits of historical financial information

3.1 ISA 220 applies the firm-wide quality control principles in ISQC 1 specifically to individual audits of historical financial information.

Role of the engagement partner

3.2 Under the standard the engagement partner is responsible for:

- overall quality control of the audit engagement;
- evaluation of compliance with ethical requirements and independence;
- acceptance and continuance of client relationships and specific audit engagements;
- assignment of an engagement team with the appropriate capabilities, competence and time;
- direction, supervision and performance of the audit engagement in compliance with professional standards and regulatory and legal requirements;
- ensuring appropriate consultation is undertaken on difficult or contentious matters; and
- ensuring that an engagement quality control review is undertaken for audits of financial statements of listed entities and resulting issues discussed *before* the auditor's report is issued.

Lecture example 4 **Exam standard for 20 marks**

Crossman, Wheaton, Massie and Mahoney (CWMM) is a small four partner independent audit firm with a single office in a regional location. Clients include businesses and companies mainly in the retail and financial services industries. Two of the firm's biggest clients are listed. CWMM operates in a regime which has adopted IAASB audit, assurance, quality control and ethical standards as its national standards.

The firm considers quality control very important and endeavours to comply with International guidance. Steve Crossman is partner in charge of quality. He is also Marketing Partner of the firm due to his 'gift of the gab'.

There is no specific quality control department, but Steve gives an annual update on the firm's quality control procedures in August when he is not busy.

Annual quality control reviews of audits are not undertaken due to the firm's size: the partners are in daily contact and discuss quality at their monthly meetings.

However, as part of Steve's annual marketing review of clients, he identifies any clients perceived as risky due to their size or the firm's dependence on them.

Human resources

New joiners to the firm are generally accounting graduates from the local economics university to minimise training costs. They all attend final interviews with the Senior Partner, Paul Mahoney. Selection is based on their exam marks, ability to speak fluent English (a lot of the firm's clients are international), presentation and confidence.

Annual appraisals of all professional staff are conducted by the Senior Partner. He feels that the firm, which although growing, is still small enough to appraise staff personally.

Promotion is based on a 'balanced scorecard' of four criteria:

- Marketing events attended
- Completion of audit work on time
- Feedback from clients (based on an assessment after each audit)
- Punctuality of arrival in the mornings (staff should arrive by 8am, but can leave once their work is complete)

Audit process

All audit work is reviewed by the auditor in charge (AIC) before presentation of the files to the engagement partner. The AIC highlights the key risk areas for the partner to perform a second review on.

Files are created and delivered for review entirely electronically. Due to the firm's scanning facility being oversubscribed, less important physical evidence is discarded at the end of the audit.

The firm is too small to have industry units so clients are spread across the four partners based on their location.

Technical matters

An Ethical helpdesk is staffed by one of the partners, Ben Wheaton (when in the office), respected in the firm for his technical knowledge. Staff are encouraged to seek help where they consider it appropriate.

All audit staff are provided annually with a CD-Rom containing PDFs of the latest IFAC Pronouncements for reference while conducting audits.

Any necessary 'library' data – exchange rates, share prices etc are obtained directly by audit staff from the Internet.

Technical issues are resolved by the engagement partner on the relevant audit.

Solution

4 Chapter summary

- Quality control is a fundamental issue for all audit firms.
- The main source of guidance for firms in relation to quality control comes from ISQC 1 which details the specific elements of a system of quality control.
- ISA 220 provides additional guidance by applying ISQC 1 to specific engagements.

END OF CHAPTER

Obtaining and accepting professional appointments

5

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain the need for guidance in these areas.
- Recognise situations in which specified advertisements are acceptable.
- Discuss the restrictions on practice descriptions, the use of the ACCA logo and names of practicing firms.
- Discuss the extent to which reference to fees may be made in promotional material.
- Outline the determinants of fee-setting and justify the bases on which fees and commissions may and may not be charged for services.
- Discuss the ethical and other professional problems involved in establishing and negotiating fees for a specified assignment.
- Discuss the reasons why entities change their auditors/professional accountants.
- Recognise and explain the matters to be considered when a firm is invited to submit a proposal or fee quote for an audit or other professional engagement.
- Identify the information required for a proposal.
- Prepare the content of an engagement proposal document.
- Discuss and appraise the criteria that might be used to evaluate tenders received from audit firms in a given situation.
- Discuss reasons why audit fees may be lowered from the previous year's fees.
- Explain lowballing and discuss whether or not it impairs independence.
- Explain the matters to be considered and the procedures that an audit firm/professional accountant should carry out before accepting a specified new client /engagement including: client acceptance, engagement acceptance and agreeing the terms of engagement.
- Recognise the key issues that underlie the agreement of the scope and terms of an engagement with a client.
- Outline the procedures for the transfer of books, papers and information following a new appointment.

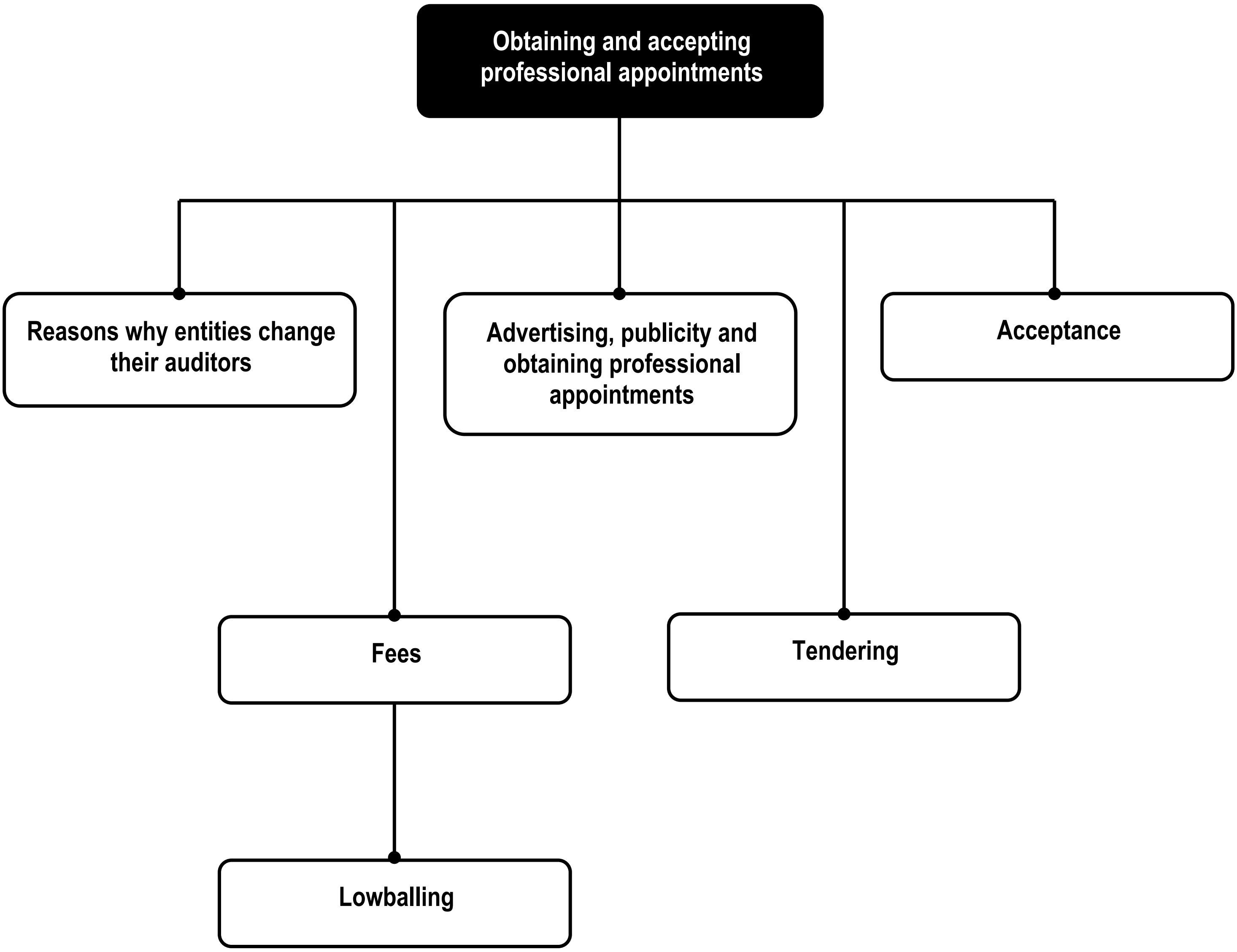
Exam Context

Tendering is potentially an important area for the exam; under the old syllabus it was examined from a very practical context in the compulsory section of the exam on two occasions.

Business Context

You mustn't forget that audit firms exist to make a profit, therefore winning clients and the fees they bring them is a key real world issue. Due to the sensitive nature of the work performed by auditors it is important that there is guidance as to how firms should behave in this respect.

Overview


Obtaining and accepting professional appointments
Reasons why entities change their auditors
Advertising, publicity and obtaining professional appointments
Acceptance
Fees
Tendering
Lowballing

1 Reasons why entities change their auditors

Real world example in Course Companion

1.1 The focus of this chapter is on issues surrounding the change of auditors/accountants by an entity. It is important that you are aware of the circumstances that may lead to a need for the auditors to be replaced.

Lecture example 1 — **Idea generation**

Required

Can you think of reasons why an entity may need to replace its auditors?

Solution

2 Fees

2.1 The ACCA Code of Ethics and Conduct state that fees should be fair and reasonable.

They recommend that the basis of charging fees should be mentioned in the engagement letter.

2.2 Fees should not be charged on a contingency, percentage or similar basis save where that course of action is generally accepted practice for certain specialised work.

2.3 Fee disputes may arise when the client believes that the fee charged is excessive. If a firm is about to issue a fee note, which is higher than previous fees, it is good practice to explain the reasons for the variation to the client concerned.

2.4 Assuming there are no dramatic changes in the size or complexity of an audit client it is reasonable to expect that the audit fee should fall over time, some reasons why this would be the case are as follows:

(a) Time spent on the audit should reduce as the auditors' knowledge of the business improves over time allowing the work to be completed more efficiently.

(b) The client's systems and procedures should be fully documented in the first year, this is very time consuming; in subsequent years this information only needs updating if there has been any major changes.

(c) The first year of an audit is generally high risk due to a lack of knowledge of the business; the firm is likely to respond to this risk by assigning more senior staff to the audit, which will drive the fee up. In subsequent years this risk will fall and more junior, and therefore, cheaper staff can be assigned to the audit.

Lowballing

2.5 This refers to the practice of setting the initial audit fee low in order to win the client.

The ethical implications of this practice are:

– Because the fee is set low the audit firm needs to retain the client for a number of years in order to recover its initial losses; therefore, independence will be impaired as the audit firm will not wish to lose the client in the short term;

– This can be seen as unprofessional because it means that smaller practices cannot compete.

3 Advertising, publicity and obtaining professional appointments

Real World example in Course Companion

3.1 The ACCA Code of ethics and conduct give guidance in relation to the above.

3.2 Audit firms are allowed to advertise. The following considerations should be borne in mind when preparing advertisements or promotional material.

1 They should not bring ACCA into disrepute or bring discredit to the member, firm or the accountancy profession.

2 They should not discredit the service offered by other firms.

3 Care should be taken to ensure that any reference to fees does not mislead the reader as to the precise range of services and time commitment that the reference is intended to cover.

4 The material should comply with local regulatory or legislative requirements, e.g. UK Advertising Standards Authority's Code of Advertising and Sales Promotion, notably as to legality, decency, clarity, honesty, and truthfulness.

4 Tendering

Introduction

4.1 When an audit firm is approached by a prospective client, they are faced with two initial questions:

– Do they want the work?
– Do they think they will get a reasonable fee for a quality job?

Do they want the work?

4.2 The risk attaching to the client must be considered. The audit firm would wish to consider the following:

(1) How has the approach arisen?

(2) Why has the firm been asked? Is it due to their reputation, a recommendation from a mutual contact or is the company unhappy with the current fees?

(3) What it is being asked to do?

(4) What is the risk in getting involved?

(5) Can the firm afford to spend time on the proposal?

Lecture example 2

Idea generation

Required

What work would you perform in order to assess the risk attaching to a prospective client?

Solution

Can the firm do the work for a reasonable fee?

4.3 The firm will need to consider the amount of work required, resources available and the location of the client.

4.4 A preliminary estimate of the fee should establish if the return is likely to be acceptable.

Content of the proposal document

4.5 The basic format of the proposal will depend on the circumstances and the prospective client's requirements. The principal objective is to convince the client to appoint the audit firm. The firm will therefore want to demonstrate that it has understood the unique features and requirements of the business and has considered how best it can meet those.

4.6 The following matters will usually need to be covered.

- The fee and details of how it has been calculated
- An assessment of the requirements of the prospective client
- An outline of how the firm proposes to address those requirements for the fee
- The assumptions made, for example regarding deadlines or availability of information
- The proposed approach to the engagement
- An outline of the firm and the staff involved.

Criteria which might be used to evaluate the tender

4.7 Academic research has shown that proposals are often won on the quality of service offered, value for money and the chemistry with the client, rather than simply on fees. The following criteria are likely to be used by prospective clients to evaluate the tender.

- Location
- Personal knowledge of the partners and staff
- Prior experience of the industry or of a similar sized business
- Matching the service offered to the specific needs of the business
- Communication, including prior agreement of the impact on fees before any additional work is undertaken
- The development of an effective relationship between the client and the key members of the audit teams.

5 Acceptance

ISQC 1 (Chapter 4) sets out what a firm must consider and document in relation to accepting or continuing an engagement. There are a number of other specific issues that should also be considered.

- Does the firm have the necessary technical competence to perform the work?
- Does the firm have sufficient resources to perform the work?
- The auditor should obtain references for the entity's directors.
- The auditor should obtain professional clearance from the outgoing auditors.
- The terms of engagement should be discussed and agreed prior to accepting appointment.

6 Chapter summary

- There is nothing unusual about an entity **changing** its **auditors** and there are number of reasons why they would wish to do so.
- Auditors have a professional responsibility to charge **fees** that are fair and reasonable, all things being equal we can expect audit fees for a client to fall over time.
- **Advertising** by audit firms is perfectly acceptable; however, firms should be aware of their responsibility to the profession and do nothing to bring it into disrepute.
- **Tendering** is a very common way for businesses to select auditors.
- There are a number of considerations the auditor needs to assess before officially **accepting** a new engagement.

Additional Notes

7 Advertising publicity and obtaining professional work

Lecture example 3 — **Preparation question**

Required

By looking at the following scenario, identify any issues that may cause concern from a practice management or ethical point of view.

Albert Albion and Chris Baggie are partners in a successful firm of Certified accountants. Total fee income for the firm is $500,000 with $300,000 arising from audit services.

Last year a branch of the large national firm Anders Arthurson opened up in the same town and since that time Albion and Baggie Certified Accountants have been losing business.

Albert has therefore launched an advertising campaign, of which he is very proud, to try to win clients away from Anders Arthurson.

The campaign has consisted of the following quarter-page advert being placed in the local newspaper every day for three weeks.

Albert has also organised a door to door leaflet drop, paying his nephew $3.00 to deliver 500 leaflets to local businesses and personal addresses.

Chris has been reviewing outstanding fee income, he has noticed that one of the partnership's clients Virgo, owned by Dick Branston, has still not paid the previous year's audit fee. Virgo had tendered for a contract to run the National Lottery, however (due, they believe, to some element of bribery) they were unsuccessful. This has left them with cash flow problems. Dick and Chris are very good friends, Chris is sure that Dick would not default on the fee.

In reply to the advertising campaign Rolling Balls, a limited liability company have approached Albion & Baggie to be their auditor. Rolling Balls are a large company who currently run the Florida lottery and will be tendering for the National Lottery contract when it is up for renewal next year. Albert is immensely excited about this opportunity, as the audit fee is likely to be in the region of $50,000. As well as the audit, Rolling Balls would like Albion and Baggie to supply other services including accounts preparation and compliance monitoring. (This would involve ensuring that Rolling Balls is complying with all lottery regulations.)

Chris Baggie has two adult daughters, who both work for Albion & Baggie. Sophie who has worked for the partnership for seven years has recently taken out a $100,000 mortgage with Midwest bank, who are audit clients of the partnership.

Maggie, Chris' other daughter has only recently joined the partnership. Up until three months ago she was the financial accountant at Nibbles Pet Foods, which is also an audit client. Chris feels that Maggie's knowledge of this client will be a great help and is intending to use her as the manager on this year's audit. Maggie's husband Sid owns $10,000 worth of shares in this company.

Solution

8 Terms of audit engagements (ISA 210)

8.1 As you know from previous auditing studies, the auditor and the client should agree on the terms of the engagement. This should be recorded in writing.

8.2 Once the terms of the engagement have been agreed, they will remain in force from one year to the next unless they are replaced. The auditor should regularly review the terms of the engagement to ensure they are appropriate.

8.3 The engagement letter documents and confirms the auditor's acceptance of the appointment, the objective and scope of the audit, the extent of the auditor's responsibilities to the client and the form of any reports.

9 Descriptions of practicing firms

9.1 A firm may describe itself as a firm of "Chartered Certified Accountants" or "Certified Accountants" only where:

(a) at least half of the partners are ACCA members; and

(b) these partners control at least 51% of the voting rights under the firm's partnership agreements.

9.2 Firms holding an auditing certificate issued by the ACCA may describe themselves as "Registered Auditors".

9.3 A practice name should be consistent with the dignity of the profession in the sense that it should not project an image inconsistent with that of a professional bound by high ethical and technical standards.

END OF CHAPTER

Planning and risk assessment

6

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe the key features of six audit methodologies.
- Justify an appropriate approach to a given assignment and recognise when an approach is unsuitable.
- Specify matters that should be considered in planning a given assignment.
- Define materiality and demonstrate how it should be applied in financial reporting and auditing.
- Apply the criteria that determine whether or not a matter is material and discuss the use and limitations of prescriptive rules in making decisions about materiality.
- Identify business risks in given situations.
- Describe the factors that influence the assessment of a specified risk for a given assignment.
- Explain how and why the assessments of risks and materiality affect the nature timing and extent of auditing procedures in a given situation.
- Select and apply appropriate risk assessment procedures, including analytical procedures, to obtain an understanding of a given entity and its environment.
- Assess the risk of misstatement at the financial statement assertion level and design audit procedures in response to assessed risks.
- Recognise and assess the implications of a specified computer system on an assignment.
- Discuss how the potential problems associated with the audit of small enterprises may be overcome.

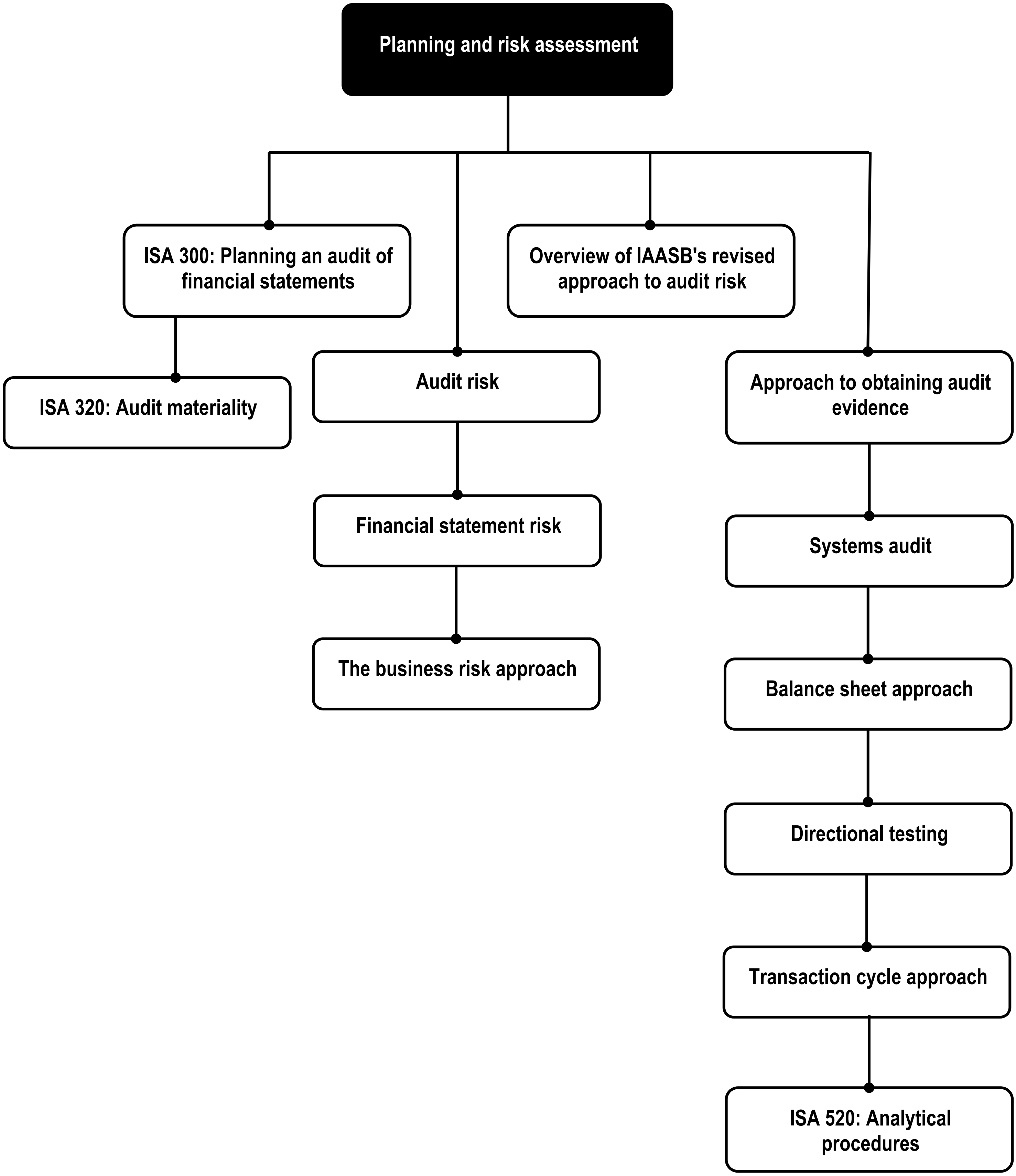
Exam Context

Planning and risk assessment are a fundamental part of the syllabus and appeared in the pilot paper compulsory section for 19 marks.

Business Context

The majority of medium to large audit firms are moving towards audit methodologies that focus on the business risk approach as way of making audits more efficient.

Overview


Planning and risk assessment
ISA 300: Planning an audit of financial statements
ISA 320: Audit materiality
Audit risk
Financial statement risk
The business risk approach
Overview of IAASB's revised approach to audit risk
Approach to obtaining audit evidence
Systems audit
Balance sheet approach
Directional testing
Transaction cycle approach
ISA 520: Analytical procedures

1 ISA 300: Planning an audit of financial statements

1.1 Planning an audit involves establishing the overall audit strategy for the engagement and developing an audit plan, in order to reduce audit risk to an acceptably low level.

Planning involves the engagement partner and other key members of the engagement team to benefit from their experience and insight and to enhance the effectiveness and efficiency of the planning process.

1.2 The objectives of planning are to:

(a) ensure that appropriate attention is devoted to important areas of the audit;

(b) ensure that potential problems are identified and resolved on a timely basis;

(c) ensure that the engagement is properly organised and managed in order to be performed in an effective and efficient manner;

(d) assist in the proper assignment of work to engagement team members;

(e) facilitate the direction and supervision of engagement team members;

(f) assist in co-ordination of work done by auditors of components and experts; and

(g) facilitate review.

1.3 The auditor considers materiality and its relationship with audit risk during the planning phase. This assists in meeting the first two objectives above.

Lecture example 1

Idea generation

You are the audit manager planning the audit of Johnson plc a multinational food and drinks manufacturer. Johnson has plants all over the world and its head office is based in London.

Required

What general matters would you consider when planning the engagement?

Solution

2 ISA 320: Audit materiality

2.1 Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements.

2.2 The audit firm must be concerned with identifying "material" errors, omissions and misstatements.

2.3 The level of materiality set at planning will always be a matter of professional judgement. Most firms set criteria for guidance. For example:

Between ½% and 1% revenue
Between 1% and 2% of total assets; or
Between 5% and 10% of profit before tax.

Judgement will be required when considering which basis to use.

Consider for example, a large company with a poor set of results one year. Basing materiality on a low profit before tax would result in a very low figure for materiality and could lead to over-auditing, hence it would be more appropriate to use revenue and/or total assets.

2.4 The level chosen will depend on the confidence the auditor has in the client's figures. Therefore, the level of risk attaching to the client will influence the level of materiality used.

2.5 The materiality level will impact on four key areas:

- the nature, timing and extent of audit procedures; and
- evaluating the effect of misstatements
- whether to seek adjustments; or
- the degree of any auditor’s report modification.

Chapter 6 Section 3.4

2.6 There is currently an exposure draft of ISA 320 *Audit Materiality* in issue. The exposure draft seeks to clarify and improve the consideration of materiality by auditors.

3 Audit risk

Question 6

3.1 ISA 200 *Objective and general principles governing an audit of financial statements* requires that the auditor plans and performs the audit to reduce audit risk to an acceptably low level.

3.2 Audit risk is the risk that the auditor expresses an inappropriate opinion when the financial statements are materially misstated.

It is made up of three component parts: inherent risk, control risk and detection risk.

Inherent risk

3.3 This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related internal controls.

Control risk

3.4 This is the risk that a misstatement could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Detection risk

3.5 This is the risk that the auditor will not detect a misstatement that exists in an assertion that could be material, either individually or when aggregated with other misstatements.

Financial statement risk

3.6 Financial statement risks are the risks that the financial statements are materially misstated.

3.7 The most obvious examples would be material errors in the income statement or balance sheet but the whole of the financial statements need to be considered. For example, the non-disclosure of a contingent liability, whilst not affecting the figures would lead to misstated financial statements as they would not comply with accounting standards.

Lecture example 2

Exam standard for 5 marks

You are an audit partner attending the planning meeting for the audit of Bauer plc, a large technology company with two main divisions. The year end is 31st December. The first division manufactures computer hardware for use by intelligence and security agencies and the second produces and distributes bespoke and off-the-shelf software for use on the hardware.

As part of your audit planning you attend a meeting with Bauer's Finance Director, Jack. He informs you that there have been no major changes in the business's operations during the year but the following significant events had occurred:

(a) Owing to an unexplained improvement in the security situation in the Los Angeles area a significant contract with the American Government for new hardware has not been renewed. This was a surprise and as a result 100 (out of 1,000) American staff were made redundant during December.

(b) During the year development commenced on new software for use in satellite tracking of vehicles. This has been capitalised as an intangible asset. In order to commence development significant staff training costs were incurred.

Required

Identify the financial statement risks deriving from items (a) and (b).

Solution

Internal control

3.8 Under ISA 315 *Understanding the entity and its environment and assessing the risk of material misstatement*, the auditor is required to obtain an understanding of internal control relevant to the audit.

Internal control consists of five components:

(a) The control environment

(b) The entity's risk assessment process

(c) The information system, including the related business processes, relevant to financial reporting, and communication

(d) Control activities

(e) Monitoring of controls.

3.9 Specific control procedures include:

P hysical access limited
A pproving and controlling documents
C omputer controls
A rithmetical accuracy checking
M aintaining and reviewing control accounts and trial balances
A pproving reconciliations
C omparisons – internal v external, physical counts v accounting records, actual v budget.

4 The business risk approach

4.1 The IAASB has recently revised its standards relating to audit risk and now requires an increased understanding of the business risks facing an entity and the entity's process for identifying and responding to them (where relevant to the financial statements) when evaluating audit risk.

Business risks ‘result from significant conditions, events, circumstances or actions that could adversely affect the entity’s ability to achieve its objectives and execute its strategies, or through the setting of inappropriate objectives and strategies’ [ISA 315].

4.2 The business risk model is not a replacement for the traditional audit risk model but rather a vehicle, or mechanism, for the identification of audit risk, recognising that most business risks will eventually have financial consequences and, therefore, an effect on the financial statements.

4.3 In adopting a business risk approach, the auditor identifies the risks that the business itself faces, which could threaten the business from meeting its goals, aims and objectives. Once identified, the auditor is then able to identify any corresponding audit risk.

4.4 The approach allows the auditor to gain a greater understanding of the business and the overall risks it faces and therefore increases the likelihood of identifying the risks of material misstatement of the financial statements as well as being able to provide constructive business advice to aid the mitigation (through relevant controls) of such risks.

Top down approach

4.5 The business risk approach is often referred to as the 'top down' approach. This is because everything is reviewed or tested at the highest level and then worked down to the lowest level or detail, if a material risk may be possible.

4.6 The business risk approach also focuses on the senior members of the audit team discussing the business with the senior members of the client staff. The whole process is managed and controlled from the top.

Lecture example 3

Idea generation

Required

From the following scenario, identify the business risk and any corresponding audit risk.

Scenario	Business risk	Audit risk
(i) CD Planet operates a chain of retail outlets selling chart CDs.		
(ii) Mucha Pasta operates several Italian restaurants and is subject to comprehensive and stringent Health and Safety food hygiene legislation.		
(iii) XYZ, based in the Eurozone, trades extensively abroad in the USA and invoices sales in US$.		

4.7 Business risks can be split into three categories:

- Financial risk
- Operational risk
- Compliance risk.

Financial risk

4.8 These are the risks arising from the company's financial activities or the financial consequences of operations. Examples include the following.

- Going concern problems
- Overtrading
- Credit risk

- Interest risk
- High cost of capital
- Unrecorded liabilities.

Operational risk

4.9 These are the risks arising from the operations of the business such as stockouts, physical disasters, loss of key staff, poor brand management and loss of orders.

Compliance risk

4.10 These are the risks arising from non compliance with laws, regulations, policies, procedures and contracts. Examples include the following.

- Breach of listing rules
- Breach of national legislation
- Litigation risk
- Sales tax (VAT) problems
- Tax penalties
- Health and Safety risks.

4.11 Once risks are identified, management must decide:

- whether they accept the risk; or
- what their control strategy will be to avoid the risk.

4.12 Management need to satisfy themselves that their systems of risk management and internal controls are working properly. Internal audit can make a valuable contribution to the monitoring of risk management.

Lecture example 4

Exam standard for 10 marks

The Melon Group operates a chain of fashion clothing shops for young women. The head office is based in Madrid. There are 280 shops spread across the Iberian peninsula and a further 65 shops across the European Union. The clothing is manufactured mainly in Spain and India by third party manufacturers and fixed quantities are pre-ordered six months in advance of the season. Most of the shop buildings are held on long leases although a small number are owned by the Group.

Approximately, 40% of the shops outside the Iberian market are run on a franchise basis whereby shop fittings are supplied and installed by the Melon Group and paid for by the franchisee over five years, after which time they are replaced; the clothes are sold at a 40% discount on local retail price to the franchisees on a sale or return basis. Franchisees choose which lines of the full season's range of clothes they wish to hold, based on samples.

Required

Identify and explain the principal business risks facing the Melon Group.

Solution

5 Overview of the IAASB's revised approach to audit risk

5.1 ISA 315: *Understanding the entity and its environment and assessing the risks of material misstatement*

Perform risk assessment procedures

Perform audit procedures to understand the entity and its environment:

- Industry, regulatory, and other external factors including applicable financial reporting framework
- Nature of the entity
- Objectives and strategies and related business risks
- Measurement and review of the entity's financial performance
- Internal control

↓

Assess the risks of material misstatement

Assess the risks of material misstatement at the financial statement level and the assertion level by:

- Identifying risks through considering
  – the entity and its environment, including its internal control
  – classes of transactions, account balances and disclosures
- Relating the identified risks to what can go wrong at the assertion level
- Considering the significance and likelihood of the risks

ISA 330 The auditor's procedures in response to assessed risks

↓

Respond to assessed risks

Respond to the risks at the financial statement level and assertion level by:

- Developing overall responses to the assessed risks at the financial statement level; and
- Determining the nature, timing and extent of further audit procedures at the assertion level

↓

Perform further audit procedures

Perform further audit procedures that are clearly linked to risks at the assertion level by:

- Performing tests of the operating effectiveness of controls
- Performing substantive procedures

↓

Evaluate audit evidence obtained

Evaluate whether sufficient and appropriate audit evidence has been obtained.

6 Approach to obtaining audit evidence

6.1 When the auditor has assessed the business and audit risks relating to the entity and decided on a materiality level, he must then decide on an approach for gathering audit evidence.

6.2 There are various approaches that could be adopted.

(a) Systems audits
(b) Balance sheet approach
(c) Directional testing
(d) Transaction cycle approach.

7 Systems audits

7.1 These focus on the strength, or otherwise, of the internal control systems. The idea is to perform extensive tests of controls and reduce the level of substantive testing.

7.2 During planning, the audit firm will ascertain, record and evaluate the internal controls. If they judge control risk to be low, the controls will be tested to confirm this.

7.3 **Tests of controls** will test that controls are properly designed, exist and have operated throughout the period. Deviations will be recorded and investigated regardless of the amount involved. If results are unsatisfactory then the initial assessment of control risk is not supported. The audit strategy will then need to be modified.

7.4 Tests of controls may include:

- enquiries about, and observation of, internal control functions
- inspection of documents supporting controls or events to gain audit evidence that internal controls have operated properly
- examination of evidence of management reviews e.g. minutes of board meetings
- reperformance of control procedures to ensure they were performed correctly
- testing of the internal controls operating on specific computerised applications or over the overall IT function.

8 Balance sheet approach

8.1 This is also known as the substantive approach. This strategy would usually be adopted when control risk is high, and controls cannot be relied upon.

8.2 Ultimately the auditor's report contains an opinion on the figures in the financial statements. Therefore, all audits will involve some substantive testing of these balances.

8.3 Substantive testing involves collecting evidence on the assertions implied in the accounts regarding balances. These are:

- **A**ccuracy
- **C**ompleteness
- **C**ut-off
- **A**llocation
- **C**lassification/understandability
- **O**ccurrence
- **V**aluation
- **E**xistence
- **R**ights and obligations

ACCA COVER

9 Directional testing

9.1 This is based on the principles of double entry bookkeeping. If a trial balance is in balance, there must be a debit entry for every credit entry.

9.2 If a debit entry has been overstated there should be a corresponding credit entry which is overstated, or another debit entry which is understated. Therefore, a test for overstatement of receivables will provide evidence concerning the overstatement of revenue.

9.3 Directional testing also refers to checking the financial statements to the underlying records. The auditor would issue a modified auditor's report if there was a material difference between records and the financial statements.

10 Transaction cycle approach

10.1 This approach is similar in some ways to the systems audit approach as it is based on the same transaction cycles. The difference here is that we are not focusing on controls testing but substantive procedures.

10.2 Under this approach transactions that have occurred during the year and result in entries to the income statement are tested.

10.3 In practical terms a sample of transactions relating to say, sales would be selected and substantiated to supporting documentation (order, invoice and despatch note) to ensure the transactions are correctly and completely recorded in the financial statements.

11 ISA 520: Analytical procedures

11.1 The auditor should apply analytical procedures as risk assessment procedures and in the overall review at the end of the audit.

They can also be used as a source of substantive audit evidence when their use is more effective or efficient than tests of details in reducing detection risk for specific financial statement assertions.

11.2 Analytical procedures include the following type of comparisons.

(a) Prior periods

(b) Budgets and forecasts

(c) Industry information

(d) Predictive estimates

(e) Relationships between elements of financial information i.e. ratio analysis

(f) Relationships between financial and non-financial information e.g. payroll costs to the number of employees.

Analytical procedures as risk assessment procedures

11.3 The auditor should apply analytical procedures as risk assessment procedures to obtain an understanding of the entity and its environment.

Application of analytical procedures may indicate aspects of the entity of which the auditor was unaware and will assist in assessing the risks of material misstatement in order to determine the nature, timing and extent of further audit procedures.

Analytical procedures as substantive procedures

11.4 When designing and performing analytical procedures as substantive procedures, the auditor needs to consider the following factors.

(a) The suitability of using substantive analytical procedures given the assertions.

(b) The reliability of the data, whether internal or external, from which the expectation of recorded amounts or ratios is developed.

(c) Whether the expectation is sufficiently precise to identify a material misstatement at the desired level of assurance.

(d) The amount of any difference of recorded amounts from expected values that is acceptable.

Overall review at the end of the audit

11.5 The auditor should apply analytical procedures at or near the end of the audit when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

11.6 When analytical procedures identify significant fluctuations or relationships that are inconsistent with other relevant information or that deviate from predicted amounts, the auditor should investigate and obtain adequate corroborative audit evidence.

12 Chapter summary

- **Planning** is the most critical stage of the audit.
- There are many aspects to the planning stage the most important being **risk assessment**.
- There are a number of risk assessment methods that can be employed; the most important are **business risk**, **financial statement** risk and **analytical review**.
- It is important that you are aware of the different audit methodologies and can identify when they are appropriate.

END OF CHAPTER

7

Evidence

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Evaluate the appropriateness and sufficiency of different sources of audit evidence and the procedures by which evidence may be obtained including: analytical procedures, management representations, the work of others, audit sampling, external confirmations and audit automation tools.
- Specify audit procedures to obtain sufficient audit evidence from identified sources.
- Apply the criteria for assessing the extent to which reliance can be placed on substantive analytical procedures and recognise situations in which analytical procedures may be used extensively.
- Apply analytical procedures to financial and non-financial data.
- Identify and evaluate the audit evidence expected to be available to verify specific assets, liabilities, transactions and events and support financial statement assertions and accounting treatments (including fair values).
- Explain the reasons for preparing and retaining documentation and the importance of reviewing working papers.
- Explain the specific audit problems and procedures concerning related parties and related party transactions.
- Recognise circumstances that may indicate the existence of unidentified related parties and select appropriate audit procedures.
- Demonstrate the use of written management representations as the primary source of audit evidence and as complimentary audit evidence.
- Discuss the implications of contradictory evidence being discovered.
- Recognise when it is justifiable to place reliance on the work of an expert (e.g. a surveyor employed by the audit client).
- Assess the appropriateness and sufficiency of the work of internal auditors and the extent to which reliance can be placed on it.

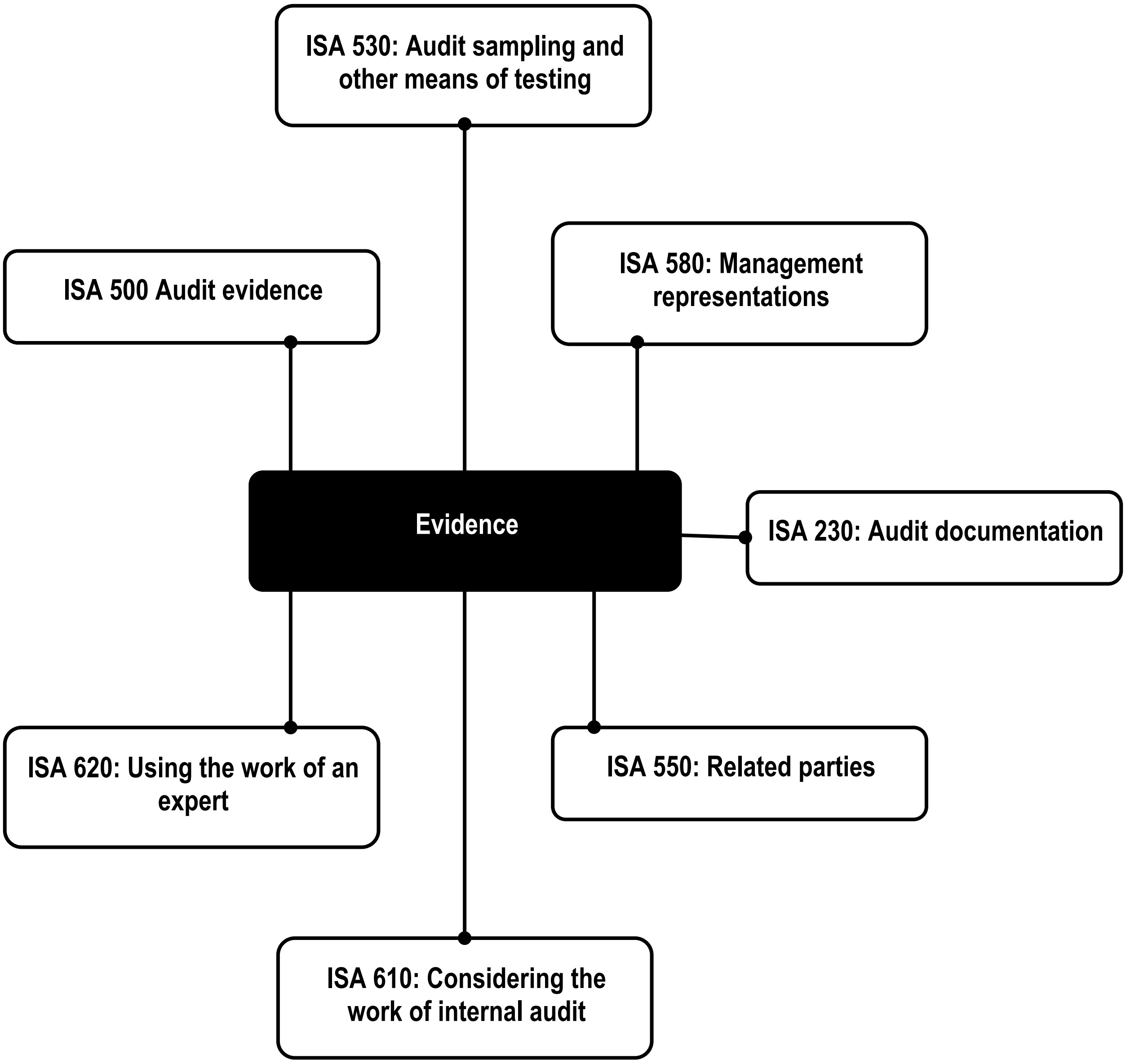
Exam Context

You could be required in the exam to specify sources of evidence to cover the financial statement assertions and discuss the sufficiency and appropriateness of different types and sources of evidence.

Business Context

The assessment of the quality and source of audit evidence is a key area of judgement for auditors when arriving at the audit opinion.

Overview


ISA 530: Audit sampling and other means of testing
ISA 500 Audit evidence
ISA 580: Management representations
Evidence
ISA 230: Audit documentation
ISA 620: Using the work of an expert
ISA 550: Related parties
ISA 610: Considering the work of internal audit

1 ISA 500: Audit evidence

1.1 We need evidence on the validity of the financial statement assertions:

A ccuracy

C ompleteness

C ut off

A llocation

C lassification/understandability

O ccurence

V aluation

E xistence

R ights and obligations

Completeness, rights and obligations, existence, valuation and allocation relate to assets and liabilities.

Completeness, cutoff, occurrence, accuracy and classification relate to transactions and events.

1.2 Audit evidence is obtained by performing audit tests.

⇒ **Tests of control** – Tests to obtain audit evidence about the suitability of design and effective operation of the accounting and internal control systems.

⇒ **Substantive tests** – Tests of detail of transactions and balances, and analytical procedures, performed to obtain audit evidence to detect material misstatements in the financial statements.

1.3 Audit evidence should be:

Chapter 7
Section 1.2

SUFFICIENT	Quantity of evidence is sufficient to support audit opinion
&	
APPROPRIATE	• **relevant** in supporting the financial statement assertions; and • **reliable**

Procedures for obtaining evidence

1.4 (a) **A**nalytical Procedures
(b) **E**nquiry/ confirmation
(c) **I**nspection
(d) **O**bservation
(e) recalc**U**lation/ reperformance

1.5 The appropriate combination of audit procedures is a matter of judgement for the auditor. It should be noted however that the mix of procedures is normally driven by the assessment of control risk.

1.6 For a large client with low control risk (confirmed through controls testing) the substantive stage of the audit is likely to focus mainly on enquiry and analytical review. In contrast a client with weak controls will have high control risk and the auditor will focus on detailed substantive work in the form of inspection of documentation and recalculation of the clients' figures.

2 ISA 530: Audit sampling and other means of testing

Selecting items for testing

2.1 Methods of item selection:

(a) Selecting all items (100% examination);
(b) Selecting specific items; and
(c) Audit sampling.

Audit sampling

2.2 Sampling means the application of audit procedures to less than 100% of the items within a class of transactions or account balance such that all sampling units have an equal chance of selection, in order to assist in forming a conclusion concerning the population from which the sample is drawn.

Selecting the sample

2.3 The auditor should select sample items in such a way that the sample can be expected to be representative of the population.

For a sample to be representative of the population, all items in the population are required to have an equal opportunity of being selected.

2.4 There are three principal methods of selecting samples.

(a) **Random selection**
(b) **Systematic selection**
(c) **Haphazard selection**

2.5 Sample size is influenced by the following factors:

(a) The **assessment of inherent and control risk**
(b) The **expected error rate** in the population
(c) The **tolerable error**, i.e. the maximum error rate or amount of error that the auditor will accept.

2.6 Audit efficiency may be improved by either of the following techniques:

(a) **Stratification:** the population is divided into discrete sub-populations which have an identifying characteristic.

(b) **Value-weighted selection:** the sampling unit is the individual monetary unit; the auditor examines the particular items (e.g. balances) containing those monetary units.

Evaluation of sample results

2.7 Having carried out the audit procedures on the sample, the auditor should evaluate the sample results to determine whether the assessment of the relevant characteristic of the population is confirmed or needs to be revised.

2.8 Analysis of errors in the sample

- What is the nature and cause of the error?
- Is there a possible effect on other areas of the audit?
- Is it an anomalous error? e.g. if testing receivables and the error is the result of a misposting to the wrong customer account then, we can still conclude the overall receivables figure is fair.

2.9 Inferences to be drawn for the population as a whole:

Tests of details

- The auditor should project monetary errors found in the sample to the population and compare this to the tolerable error.
- Where a class of transactions or account balance has been divided into strata, the error is projected for each stratum separately.

Tests of controls

- No explicit projection of errors is necessary since the sample error rate is also the projected rate of error for the population as a whole.
- The auditor must then decide if this error rate is acceptable.

3 ISA 580: Management representations

Question 9

3.1 The auditor should obtain written representations from management on matters material to the financial statements when other sufficient appropriate audit evidence cannot reasonably be expected to exist.

3.2 The auditor should obtain evidence that management acknowledges its collective responsibility for the fair presentation of the financial statements in accordance with the applicable financial reporting framework, and has approved the financial statements.

Procedures

3.3 The letter should normally be signed by the senior executive officer and the senior financial officer.

3.4 It should be dated after all the other audit work but before the date of the auditor's report.

When representations are appropriate evidence

3.5 Representations

- When facts are confined to management
- When it is a matter of opinion or judgement

If the client refuses to provide representations

3.6 If management refuses to provide a representation that the auditor considers necessary, this constitutes a limitation on scope – qualified ('except for') opinion or disclaimer of opinion depending on the materiality of the area concerned.

If contradictory evidence is discovered

3.7 If a representation by management is contradicted by other audit evidence, the auditor should investigate the circumstances and, when necessary, reconsider the reliability of other representations made by management.

4 ISA 230: Audit documentation

4.1 Contents

REPEAT	• Sufficiently complete and detailed to enable an experienced auditor with no previous connection with the audit subsequently to ascertain from them what work was performed and to support the conclusions reached.
RECORD	• Should record information on: – the nature, timing and extent of the audit procedures performed – results of audit procedures – conclusions drawn from the audit evidence obtained.
REASONING	• Auditor's reasoning and conclusions on all significant matters requiring exercise of judgement.

5 ISA 620: Using the work of an expert

5.1 An expert means a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and auditing.

5.2 Reliance on an expert might be necessary in the following situations:

(a) Valuation of certain types of asset, e.g. land and buildings, precious stones
(b) Determination of quantities or physical condition of assets
(c) Actuarial valuations on pensions or insurance liabilities
(d) Measurement of work completed and to be completed on contracts in process

(e) Legal opinions re interpretations of agreements and regulations, or the outcome of litigation.

5.3 The auditor should obtain sufficient appropriate audit evidence that the work of the expert is adequate for the purposes of the audit. This will involve an evaluation of the objectivity and professional competence of the expert.

6 ISA 610: Considering the work of internal auditing

6.1 The external auditor should consider the activities of internal audit and their effect, if any, on the external audit procedures.

6.2 The criteria for assessing the internal audit function are as follows:

(a) Organisational status
(b) Scope of function
(c) Technical competence
(d) Due professional care

6.3 Where the external auditor uses the work of internal audit, it should be evaluated and tested to confirm its adequacy for the external auditor's purposes.

Use of work conducted by internal auditors does not reduce the external auditor's responsibility in any way.

7 ISA 550: Related parties

7.1 There is a basic assumption that businesses trade with other parties at arm's length. However, if there is a relationship between two businesses, this assumption may not hold true because one business may have a high level of control or influence over the other.

7.2 Parties are considered to be related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions.

IAS 24 and FRS 8 *Related party disclosures* requires entities to disclose:

- related party relationships where control exists (whether or not transactions have occurred)
- transactions with these and other related parties

7.3 Under ISA 550 *Related parties*, the auditor **has an obligation** to perform audit procedures to obtain sufficient appropriate evidence regarding the identification and disclosure of related parties and related party transactions.

7.4 The **management are responsible** for the identification and disclosure of related party transactions. The auditor should review the information provided by the management and should be alert for other material related party transactions.

Lecture example 1

Idea generation

Required

What audit procedures should be performed to identify related parties?

Solution

7.5 During the audit, the auditor should be alert for transactions which may indicate the existence of unidentified related parties. Examples include the following.

- Transactions which have abnormal terms of trade such as unusual prices, interest rates, guarantees and repayment terms.
- Transactions which lack a logical business reason for their occurrence.
- Transactions in which substance differs from form.
- Transactions processed in an unusual manner.
- High volume or significant transactions with certain customers or suppliers as compared with others.
- Unrecorded transactions such as the receipt or provision of management services at no charge.

7.6 The auditor should obtain a **written representation** from management concerning the completeness of information provided concerning related parties and the adequacy of disclosures in the financial statements.

Audit conclusions and reporting

7.7 If the auditor is unable to obtain sufficient appropriate evidence regarding related parties and transactions with such parties, this gives rise to a modified auditor's report due to **limitation on scope**.

7.8 If the auditor concludes that the disclosure of related party transactions is not adequate, this gives rise to a modified auditor's report based on **disagreement**.

8 Chapter summary

- The auditor must obtain **sufficient appropriate** evidence to support the audit opinion. This evidence should be adequately documented.
- The aim of obtaining evidence is to cover the financial statement **assertions**.
- Apart from the five main procedures for obtaining audit evidence the auditor will need to consider other sources e.g. **Sampling**, **Management Representations**, **External Experts** and **Internal Auditors**.
- **Related parties** and related party transactions are very difficult to identify and audit; specific guidance is available to assist auditors in **ISA 550**.

END OF CHAPTER

Evaluation and review

8

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Explain review procedures (including the use of analytical procedures and checklists) and assess their role in detecting material misstatements.
- Evaluate findings quantitatively and qualitatively e.g. the results of audit tests and procedures and the effect of actual and potential misstatements.
- Compare and contrast how the auditor's responsibilities for corresponding figures, comparative financial statements, 'other information', subsequent events and going concern are discharged.
- Apply the further considerations and audit procedures relevant to initial engagements.
- Discuss the courses of action available to an auditor if a material inconsistency or misstatement of fact exists.
- Specify audit procedures designed to identify subsequent events that may require adjustment to, or disclosure in, the financial statements of a given entity.
- List indicators that the going concern basis may be in doubt and recognise mitigating factors.
- Evaluate the evidence that might be expected to be available and assess the appropriateness of the going concern basis in given situations.
- Assess the adequacy of disclosures in financial statements relating to going concern and explain the implications for the auditor's report with regard to the going concern basis.

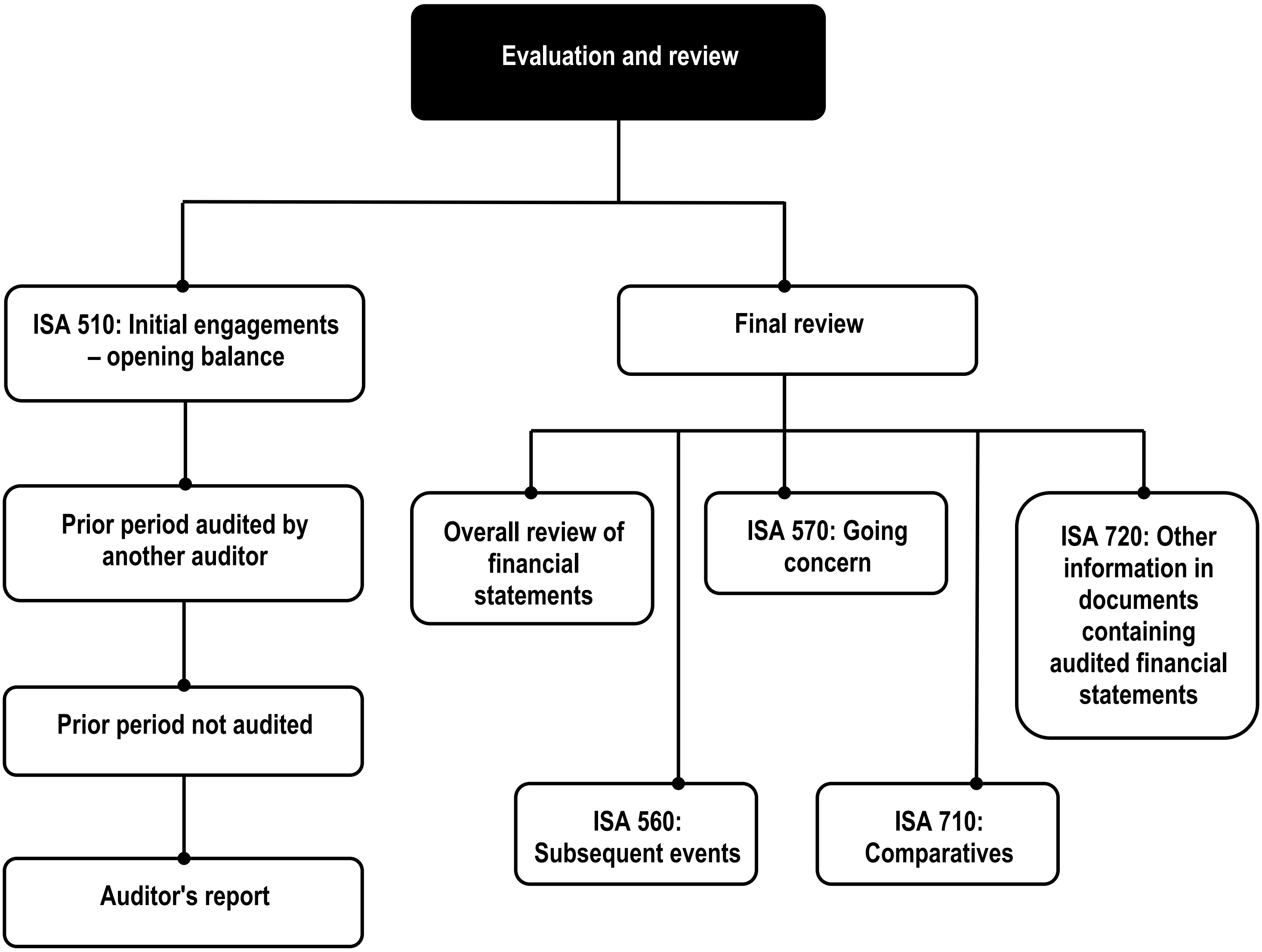
Exam Context

The issues in this chapter are likely to be very important in the exam, it is particularly important that you can identify threats to going concern and explain the impact of going concern issues on the financial statements and the audit report.

Business Context

The final review stage is a crucial phase in the audit process and is likely to be performed by senior members of staff. It is here that a judgement needs to be made as to whether the financial statements *as a whole* give a true and fair view.

Overview


Evaluation and review
ISA 510: Initial engagements – opening balance
Prior period audited by another auditor
Prior period not audited
Auditor's report
Final review
Overall review of financial statements
ISA 570: Going concern
ISA 720: Other information in documents containing audited financial statements
ISA 560: Subsequent events
ISA 710: Comparatives

1 ISA 510: Initial engagements – opening balances

Chapter 8 Section 2

1.1 For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

(a) the opening balances do not contain misstatements that materially affect the current period;

(b) the prior period's closing balances have been correctly brought forward or restated; and

(c) appropriate accounting policies are consistently applied or changes adequately presented and disclosed.

Prior period audited by another auditor

1.2 Audit procedures:

- Review predecessor's working papers, considering the professional competence and independence of the predecessor auditor.
- If the prior period auditor's report was modified, pay particular attention in the current period to the matter which resulted in the modification.

Prior period not audited

1.3 Other audit procedures need to be performed for example:

- Collection or payment of opening accounts receivable or payable in the current period
- Observation of current physical inventory count and reconciliation back to opening quantities
- Examination of records underlying opening non-current assets and liabilities, including confirmation from third parties where possible.

Auditor's report

1.4 Unable to obtain sufficient appropriate evidence	⇒ *Limitation on scope* modification (qualified 'except for' or disclaimer of opinion)
Opening balances contain material misstatements affecting current period (not corrected not adequately disclosed)	⇒ *Disagreement* modification (qualified 'except for' or adverse opinion)

2 Final review

2.1 Near the end of the audit process the auditor must assess a number of areas before an overall opinion can be formed on the financial statements. The main areas to consider are as follows.

(a) Overall review of the financial statements
(b) Subsequent events (ISA 560)
(c) Going concern (ISA 570)
(d) Comparatives (ISA 710)
(e) Other information (ISA 720)

3 Overall review of financial statements

3.1 The auditor should carry out a review of the financial statements that is sufficient in conjunction with the conclusions drawn from other evidence to give a reasonable basis for the opinion.

3.2 The review will determine whether

(a) acceptable accounting policies have been used

(b) information included in the accounts is compatible with audit findings

(c) adequate disclosure has been made and there is proper classification and presentation of information

(d) the financial statements comply with statutory and other regulatory requirements.

3.3 Auditors will, in practice, perform the overall review through a combination of audit completion checklists and analytical procedures.

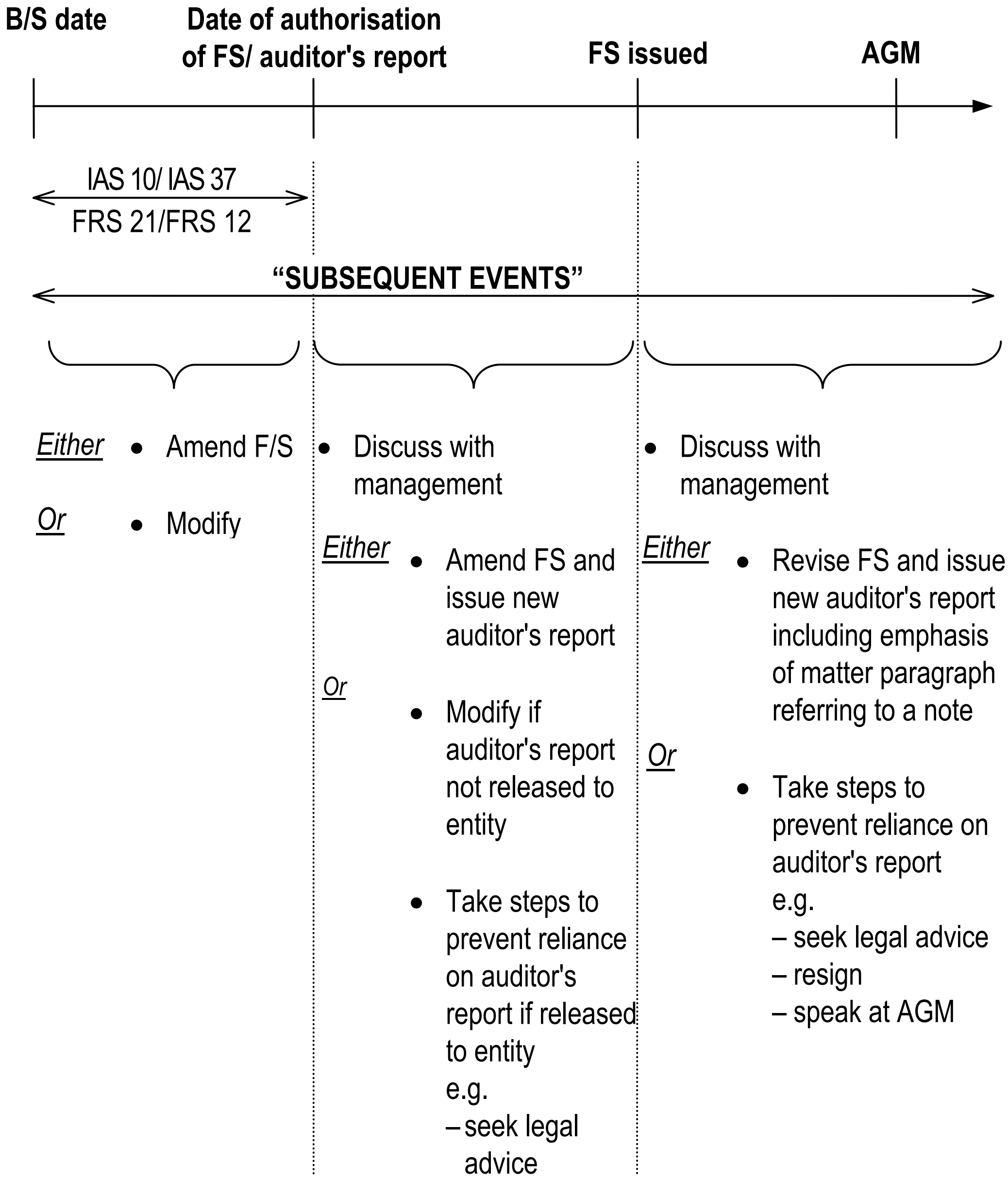
3.4 Prior to signing off consideration should also be given to misstatements identified during the audit. Material misstatements should have been adjusted, otherwise the auditor should consider the impact on the audit report.

3.5 Immaterial adjustments should have been recorded (though not necessarily adjusted) and prior to completion they should be aggregated. If the aggregate total of unadjusted immaterial errors is, in itself, material then all the adjustments should be posted to ensure the accounts are true and fair.

4 ISA 560: Subsequent events

Question 10

4.1 Subsequent events are defined as "both events occurring between the period end and the date of the auditor's report and facts discovered after the date of the auditor's report".



BPP LEARNING MEDIA

Lecture example 1

Idea generation

Required

What procedures should the auditor perform just prior to signing the audit report to ensure there are no unidentified material subsequent events that require adjustment or disclosure in the financial statements?

Solution

5 ISA 570: Going concern

Management and auditor responsibilities

Question 11

5.1 MANAGEMENT

- Assess entity's ability to continue as a going concern and present the financial statements accordingly
- The assessment should cover at least 12 months from the balance sheet date.

AUDITOR

- Consider the appropriateness of management's use of the going concern assumption
- Consider if there are material uncertainties that need to be disclosed

Indicators of going concern problems

5.2

FINANCIAL	OPERATIONAL	OTHER
• Net liability or net current liability position • Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment • Withdrawal of financial support by debtors and other creditors • Negative operating cash flows • Adverse key financial ratios • Substantial operating losses or significant fall in value of cash generating assets • Arrears/discontinuance of dividends • Inability to pay creditors on due dates • Inability to comply with terms of loan agreements • Change from credit to cash-on-delivery transactions with suppliers • Inability to obtain financing for essential new product development or other essential investments	• Loss of key management without replacement • Loss of major market, franchise, license, or principal supplier • Labour difficulties or shortages of important supplies	• Non-compliance with capital or other statutory requirements • Pending legal or regulatory proceedings that may, if successful, result in claims that are unlikely to be satisfied • Changes in legislation or government policy expected to adversely affect the entity

Auditor's report implications

5.3 **Going concern assumption appropriate, but a material uncertainty exists**

If the material uncertainty is adequately disclosed, the auditor should express an unqualified opinion, but add an emphasis of matter paragraph.

If there is not adequate disclosure, the auditor should express a qualified or adverse opinion.

5.4 **Going concern assumption inappropriate**

The auditor should express an adverse opinion if the financial statements have been prepared on a going concern basis.

5.5 **Management unwilling to make or extend an assessment**

This would result in a limitation on scope modification.

Chapter 8
Section 3

6 ISA 710: Comparatives

6.1 Comparatives can be of two types:

Corresponding figures: where amounts and disclosures for the preceding period are included as part of current period financial statements

Comparative financial statements: where amounts and disclosures for the preceding period are included separately for comparison purposes

6.2 The auditor should obtain sufficient appropriate evidence that:

- accounting policies used are consistent with those of the current period
- the amounts agree to those presented in the prior period.

Auditor's report

6.3 The auditor's opinion is on the current period financial statements as a whole (including corresponding figures) so corresponding figures are not separately identified.

6.4 Where the prior period auditor's was modified relating to the corresponding figures, and:

Issue remains unresolved	⇒	Modified report with regard to the corresponding figures
Issue leading to previous modification now resolved	⇒	No reference to previous modification, but consider an emphasis of matter paragraph if the matter is material to the current period

6.5 For comparative financial statements, the auditor should separately identify each period reported on within the auditor's report.

If the opinion on that period has changed since the original opinion was issued, an emphasis of matter paragraph should be used to explain why.

Chapter 8
Section 4

7 ISA 720: Other information in documents containing audited financial statements

7.1 The auditor is required to give an opinion as to whether the financial statements give a true and fair view.

The annual report may also include other information such as:

(a) the directors' or management's report
(b) financial summaries or highlights
(c) employment data
(d) selected quarterly data.

Material inconsistencies

7.2 A material inconsistency exists when other information contradicts information in the audited financial statements.

7.3

AMENDMENT NECESSARY TO	AUDITOR RESPONSE IF UNCORRECTED
Audited financial statements	• Qualified or adverse opinion.
The other information	• Include an emphasis of matter paragraph describing the material inconsistency; *or* • Take other actions, e.g. seek legal advice.

Material misstatements of fact in other information

7.4 A material misstatement of fact in other information exists when such information, not related to matters appearing in the audited financial statements, is incorrectly stated or presented.

7.5 When the auditor considers that there is an apparent misstatement of fact, he should request management to consult with a qualified third party, such as the entity's legal counsel and should consider the advice received.

7.6 If management refuses to correct the misstatement, the auditor should consider taking further action, such as notifying those charged with governance of the entity in writing or obtaining legal advice.

8 Chapter summary

- In most situations the auditors work in respect of **opening balances** is quite restricted. More work is required if it is a **new engagement** or if the **prior period was not audited**.
- The stage of the audit just before the opinion is signed is crucial and it is here that the auditor should carry out a **final review**.
- This final review will involve assessing whether the financial statements **as a whole** give a true and fair view.
- In addition the auditor will consider important areas such as **subsequent events**, **going concern**, **comparatives** and **other information** in the annual report.

END OF CHAPTER

Evaluation & review (II): Matters relating to specific accounting issues

9

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Evaluate the matters (e.g. materiality, risk, relevant accounting standards, audit evidence) relating to:
  - (i) Inventory
  - (ii) Standard costing systems
  - (iii) Construction/long term contracts
  - (iv) Non-current assets
  - (v) Fair value
  - (vi) Impairment
  - (vii) Goodwill
  - (viii) Brands
  - (ix) Research and development
  - (x) Other intangible assets
  - (xi) Capital instruments
  - (xii) Financial instruments
  - (xiii) Investment properties
  - (xiv) Agriculture
  - (xv) Held for sale non-current assets
  - (xvi) Exploration and evaluation assets

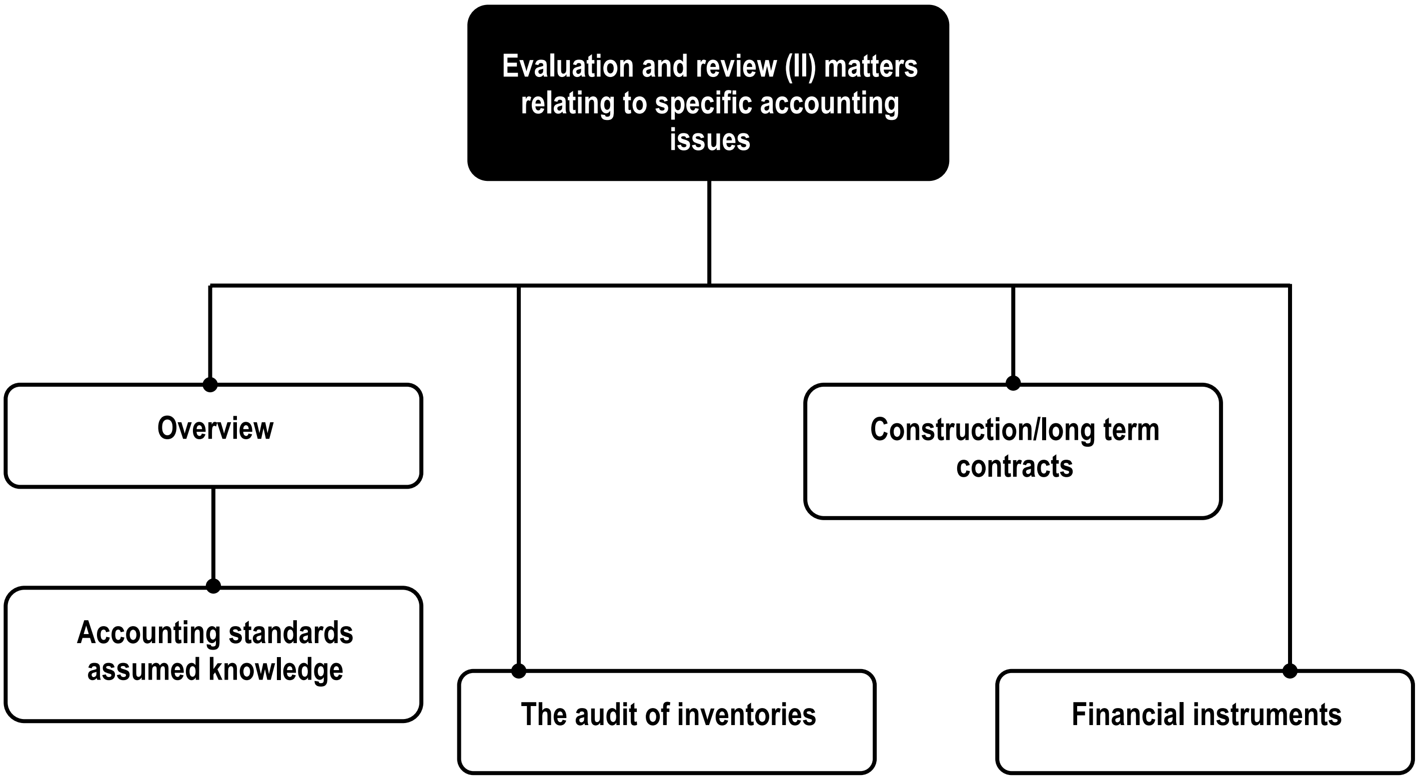
Exam Context

Chapters 9 and 10 are a core part of the syllabus and you should expect to see evidence questions appear regularly in the exam. The pilot paper contained 15 marks relating to evaluation and review in the context of a forensic audit engagement.

Business Context

Evaluation and review represents the most significant and time consuming stage of the audit; all auditors need to be able to recognise the key matters to consider in the context of any accounting issue.

Overview


Evaluation and review (II) matters relating to specific accounting issues
Overview
Accounting standards assumed knowledge
The audit of inventories
Construction/long term contracts
Financial instruments

1 Overview

1.1 Chapters 9 and 10 deal with the matters that the auditor should consider when testing specific accounting issues.

1.2 The accounting issues covered should all be familiar to you from your earlier studies. Additionally you have previously studied the audit of a basic set of financial statements. At this level, the issues you are presented with will be more complex.

1.3 It will not be possible in these two chapters to cover all of the accounting issues mentioned in the syllabus. Some items are assumed knowledge from previous studies and others will be covered during the revision phase of your studies. The skills developed in this chapter can be used interchangeably between accounting issues.

2 The audit of inventories

2.1 Inventories are normally a significant asset of any manufacturing company and is an item that has a direct impact on the profit reported. Therefore inventories is normally a risky and material balance which requires considerable audit effort. You will have covered the audit of inventories in your previous studies. We will be focusing on the more complex areas for this paper.

2.2 The financial reporting rules require that inventories are valued at the lower of cost and net realisable value. There are several methods available for the estimation of the cost of an item of inventory. These include FIFO, weighted average and standard cost.

Lecture example 1

Idea generation

Required

What matters would you consider before accepting standard costs as an appropriate basis for the estimation of cost?

Solution

3 Construction/long term contracts

3.1 The international definition of a construction contract is a contract specifically negotiated for the construction of an asset or a combination of assets that are closely interrelated or interdependent in terms of their design, technology and function or their ultimate purpose or use (IAS 11 *Construction contracts*).

The UK accounting standard defines a long-term contract as 'a contract entered into for the design, manufacture or construction of a single substantial asset or the provision of a service, where the time taken is such that the contract activity falls into different accounting periods' (SSAP 9 *Stock and long term contracts*).

Whilst there are subtle differences in accounting for construction/long-term contracts between the UK and international financial reporting standards, from an audit perspective the considerations are effectively the same.

3.2 The major risks attaching to such contracts are as follows.

(a) The costs incurred to date may be misstated

(b) The stage of completion may not be accurate leading to errors in the profit recognised in the financial statements

(c) Future costs may be inaccurate

(d) Invoices issued and cash received to date may not be properly calculated

(e) The receivable may be irrecoverable

Lecture example 2

Exam standard for 6 marks

You are the manager responsible for the audit of Moyes plc whose principal business is the construction of football stadia. The following matter has been left for your attention.

At the year end Moyes was part way through construction of a football stadium in Liverpool. The contract price is $100m and as of the year end costs of $72m had been incurred. The Finance Director estimates that the contract will cost a further $48m before it is complete per the customer's requirements. According to the Finance Director the stadium is 60% complete.

Required

Comment on:

(i) the matters that you should consider, and
(ii) the evidence you should expect to find

in respect of the amounts relating to the contract in the financial statements of Moyes plc.

Note: You should assume the contract is material and ignore foreign currency considerations.

Solution

4 Financial instruments

4.1 The accounting requirements for financial instruments are found in IASs 39 and 32/FRSs 25 and 26. You should be familiar with the examinable parts of these standards from your financial reporting and corporate reporting studies.

Lecture example 3

Exam standard for 4 marks

You are the manager on the audit of Holly Ltd; the audit team have left the following information for your attention.

In November 2007 Holly Ltd purchased 50,000 shares in Buddy plc, this purchase gave Holly approximately 1% of the issued share capital of Buddy. The shares were purchased for $2 each and transaction costs amounted to 1% of the value of the shares. The Finance Director of Holly has stated that he has no intention of selling the shares in the near future as he doesn't like to speculate and he sees this as a long-term investment that he may add to in the future.

The share price of Buddy at the year-end was $2.25.

You should assume that the purchase price of the shares and the transaction costs are both material to the financial statements of Holly Ltd.

Required

Comment on:

(i) the matters you would consider, and
(ii) the evidence you would expect to find

in respect of the audit of this transaction?

Solution

END OF CHAPTER

Evaluation & review (III): Matters relating to specific accounting issues

10

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Evaluate the matters (e.g. materiality, risk, relevant accounting standards, audit evidence) relating to:
  - (i) Cash flow statements
  - (ii) Changes in accounting policy
  - (iii) Taxation
  - (iv) Segment information
  - (v) Leases
  - (vi) Revenue recognition
  - (vii) Employee benefits / pension costs
  - (viii) Government grants
  - (ix) Borrowing / finance costs
  - (x) Related parties
  - (xi) Earnings per share
  - (xii) Provisions, contingent liabilities and contingent assets
  - (xiii) Transition to international financial reporting standards (IFRS)
  - (xiv) Share based payment transactions
  - (xv) Business combinations
  - (xvi) Discontinued operations

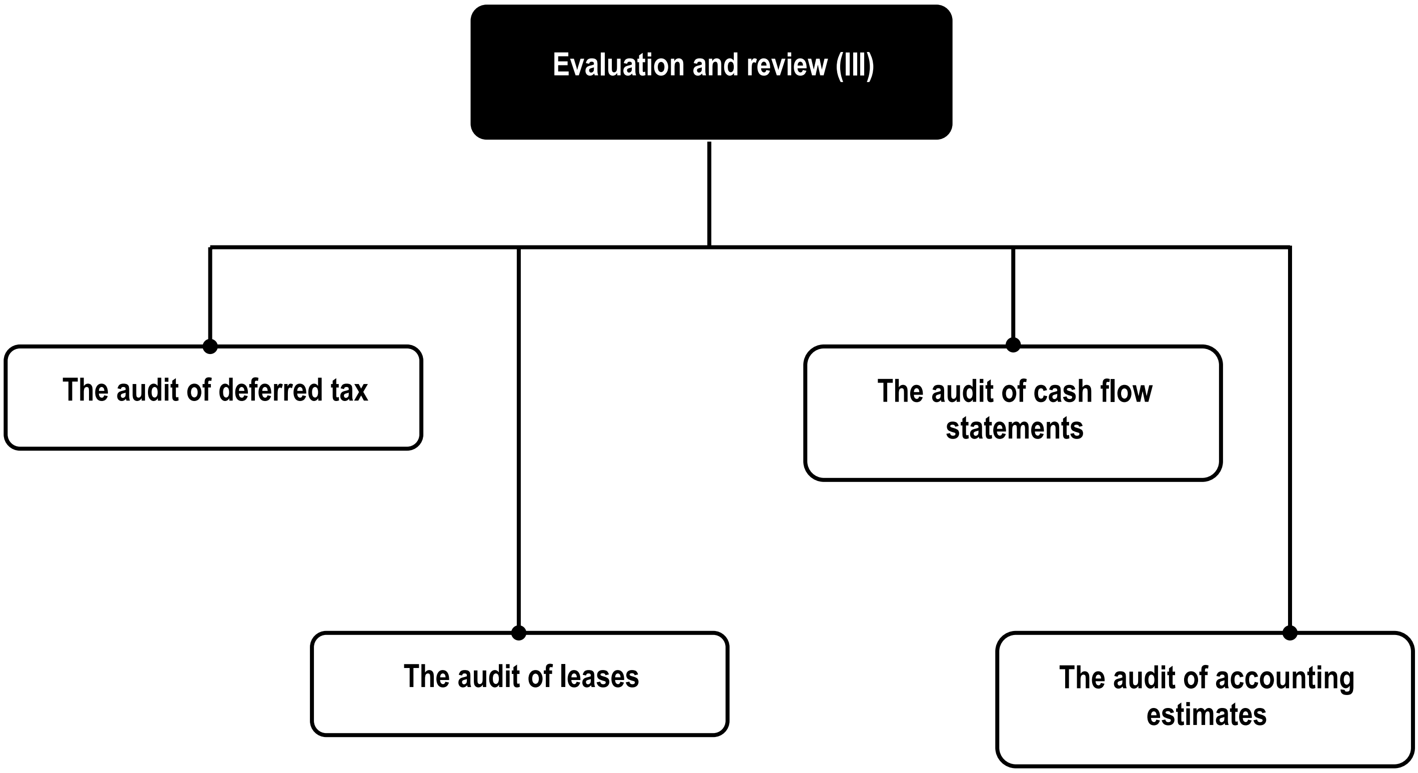
Exam Context

Chapters 9 and 10 are a core part of the syllabus and you should expect to see evidence questions appear regularly in the exam. The pilot paper contained 15 marks relating to evaluation and review in the context of a forensic audit engagement.

Business Context

Evaluation and review represents the most significant and time consuming stage of the audit, all auditors need to be able to recognise the key matters to consider in the context of any accounting issue.

Overview


Evaluation and review (III)
The audit of deferred tax
The audit of leases
The audit of cash flow statements
The audit of accounting estimates

1 The audit of deferred tax

1.1 The auditor should obtain sufficient appropriate audit evidence that the deferred tax liability is correctly calculated.

1.2 Both IAS 12 *Income taxes* and FRS 19 *Deferred tax* require deferred tax to be calculated on the full provision basis.

Lecture example 1

Exam standard for 6 marks

You are the manager responsible for the audit of Armstrong Ltd a start up company producing sporting equipment for the retail market. The draft accounts for the year ended December 20X6 show profit before taxation of $3m and total assets of $11.6m.

The following matters relating to deferred tax have been left for your attention.

At the year end Armstrong had plant and equipment with a net book value of $3.6m. The tax written down value of the plant and equipment was $2.1m. (There was no deferred tax provision in the prior year as this is the first year of trade.)

The accounts have disclosed a deferred tax provision of $450,000 based on a tax rate of 30%.

Required

Comment on:

(i) the matters that you should consider, and
(ii) the evidence you should expect to find

in respect of the amounts relating to deferred tax in the financial statements in relation to Armstrong Ltd.

Solution

2 The audit of leases

2.1 The auditor should ensure that leased assets are correctly classified in the accounts. The following procedures would be performed.

(a) Review the lease agreement for each leased asset to determine whether it is a finance lease or an operating lease.

(b) Confirm to board minutes that each lease was authorised.

(c) Recalculate the interest on each finance lease.

(d) Physically verify the existence of assets held under finance leases.

(e) Recalculate depreciation on leased assets.

(f) Check the notes to the accounts to confirm that correct disclosure is given regarding leased assets.

Lecture example 2

Exam standard for 7 marks

Beckham, a limited liability company, entered into an arrangement to lease an item of production equipment for nine years on 1 January 20X3. Under the terms of the agreement, annual premiums of $9,000 are paid in advance annually on the 1 January. The lease agreement states the internal rate of return of the lease is 8%. The lease has been classified as a finance lease in Beckham's books and the equipment capitalised in the balance sheet and depreciated straight-line to a nil residual value over its expected remaining life of 15 years.

Beckham's year end is 31 December. The draft accounts show profit before tax of $84,300 and total assets of $1,416,000.

An eight year cumulative factor at 8% is 5.747.

Required

As manager responsible for the audit of Beckham:

(i) comment on the matters you should consider; and
(ii) state the audit evidence you should expect to find

in undertaking your review of the working papers and financial statements of Beckham.

Solution

3 The audit of cash flow statements

3.1 As you know, the audit opinion covers the cash flow statement. The audit work required is as follows.

(a) Trace and reconcile all details to the working papers.

(b) Obtain or prepare a supporting analysis of items, such as tax payments and dividends paid, that do not already appear in the working papers.

(c) Cross-check the amount of any items (e.g. depreciation) that appear elsewhere in the financial statements.

4 ISA 540: The audit of accounting estimates

4.1 The auditor should obtain sufficient appropriate audit evidence as to whether an accounting estimate (such as a provision for warranty costs) is reasonable in the circumstances and, when required, is appropriately disclosed.

4.2 The evidence available to support an accounting estimate is often more difficult to obtain and less conclusive than evidence available to support other items in the financial statements.

4.3 Three approaches are available to the auditor.

(a) Review and test the process used by management to develop the estimate;

(b) Use an independent estimate for comparison with that prepared by management; or

(c) Review subsequent events to provide evidence of the reasonableness of the estimate made.

Review and testing the process used by management

4.4 Where the auditor reviews and tests the process used by management, the following steps would normally be appropriate.

(a) Evaluation of the data and consideration of the assumptions on which the estimate is based

(b) Testing of the calculations involved in the estimate

(c) Comparison, where possible, of estimates made for prior periods with actual results of those periods

(d) Consideration of management's approval process.

Use of an independent estimate

4.5 The auditor may make or obtain an independent estimate and compare it with the accounting estimate prepared by management. When using an independent estimate the auditor would ordinarily evaluate the data, consider the assumptions and perform audit procedures on the calculation procedures used in its development. It may also be appropriate to compare independent estimates made for prior periods with actual results of those periods.

Review of subsequent events

4.6 Transactions and events which occur after period end, but prior to completion of the audit, may provide audit evidence regarding an accounting estimate made by management. The auditor's review of such transactions and events may reduce, or even remove, the need for the auditor to review and perform audit procedures on the process used to develop the accounting estimate or to use an independent estimate in assessing the reasonableness of the accounting estimate.

5 Chapter summaries (for chapters 9 and 10)

- At paper P7 level you are examinable, from an audit perspective, on all of the accounting standards you have studied in your **financial and corporate reporting** studies.
- When faced with a complex accounting issue the auditor should **consider** a number of different **matters** which will ensure that all relevant areas are covered.
- These matters include, but are not restricted to, **materiality**, **risk**, **relevant accounting standards** and **audit evidence**.

END OF CHAPTER

Group audits and transnational audits

11

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Recognise the specific matters to be considered before accepting appointment as principal auditor to a group in a given situation.
- Compare and contrast the organisation, planning, management and administration issues specific to group audits with those of joint audits.
- Recognise the specific audit problems and describe audit procedures in a given situation relating to: the correct classification of investments, differing accounting policies and frameworks, fair values on acquisition, intangibles, taxation, goodwill on consolidation, intra-group balances, transactions and profits, related parties, share options, post balance sheet events and entities in developing countries.
- Discuss letters of support ('comfort letters') as audit evidence.
- Identify and describe the matters to be considered and the procedures to be performed when a principal auditor uses the work of other auditors in a given situation.
- Explain the implications for the auditor's report on the financial statements of an entity where the opinion on a component is qualified or otherwise modified in a given situation.
- Define 'transnational audits' and explain the role of the Transnational Audit Committee (TAC) of IFAC.
- Discuss how transnational audits may differ from other audits of historical financial information.
- Discuss the need for international audit firm networks in implementing international auditing standards.
- Distinguish, for example, between 'global auditing firms' and second tier firms.
- Discuss the impact of globalisation on audit firms and their clients.
- Explain the advantages and problems of current trends (eg to merge, to divest consultancy services).
- Discuss the dominance of the global firms and their influence and impact on the accounting profession.

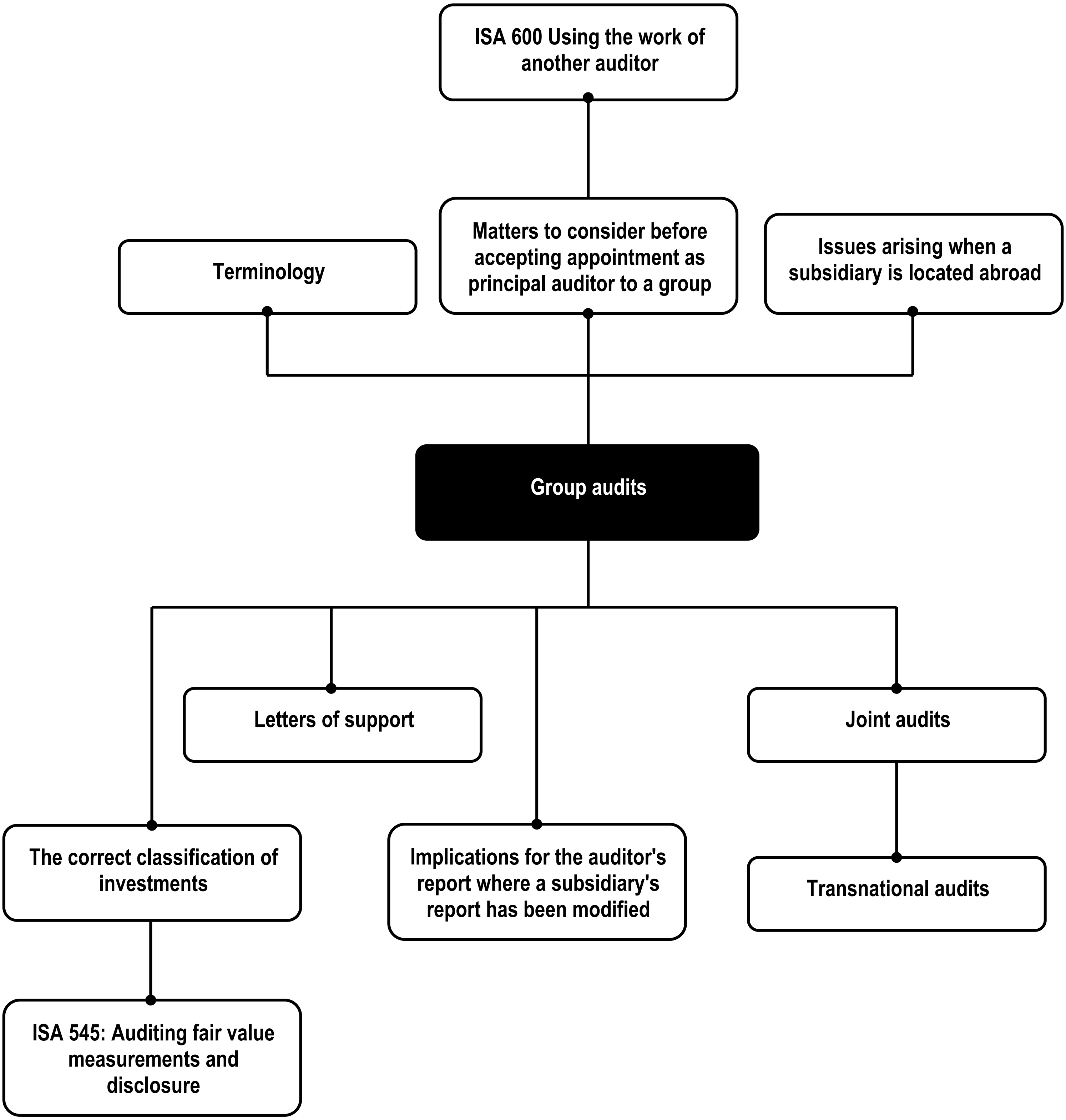
Exam Context

Exam questions are very likely to come from the perspective of a client with a number of subsidiaries, hence the areas covered in this chapter are very important and will require practical application in the exam. Question 1 in the pilot paper required identification of business risks for a group and knowledge of support letters.

Business Context

It is not just large multinational businesses that are arranged as groups of companies; many small and medium-sized enterprises are structured as groups. Therefore, the issues in this chapter will affect the vast majority of audit firms.

Overview


ISA 600 Using the work of another auditor
Terminology
Matters to consider before accepting appointment as principal auditor to a group
Issues arising when a subsidiary is located abroad
Group audits
Letters of support
Joint audits
The correct classification of investments
Implications for the auditor's report where a subsidiary's report has been modified
Transnational audits
ISA 545: Auditing fair value measurements and disclosure

1 Terminology

1.1 As you know from your financial reporting studies, in a group situation the parent company will have to prepare its own audited accounts together with the audited consolidated accounts incorporating all subsidiary companies.

1.2 The consolidated accounts will be audited by the parent company auditor, who is referred to as the '**principal auditor**'. If any subsidiary company is audited by an auditor other than the principal then that auditor is referred to as the '**other auditor**'.

1.3 A '**component**' means a division, branch, subsidiary, joint venture or associate whose financial information is included in the financial statements audited by the principal auditor

2 ISA 600: Using the work of another auditor

2.1 The principal auditor has responsibility for the opinion on the group financial statements. In most countries this responsibility is not diminished by reliance on the work of the other auditors of the subsidiary companies or associates. The auditors of the subsidiary companies are a source of evidence only.

2.2 The principal auditor must decide how much reliance he will place on the work performed by these other auditors. In order to do this he will consider the qualifications, experience and resources of the other auditors.

2.3 Generally the principal auditor should have the right to ask the other company auditors for all reasonable information and explanations required to form the audit opinion. ISA 600 states that the other auditors should co-operate with the principal auditor.

Lecture example 1

Idea generation

You are the engagement partner for the audit of The Crane Group plc, there are seven subsidiaries and your firm is the auditor to six of them. The seventh subsidiary Niles Ltd is audited by another firm of auditors. All seven subsidiaries trade in the UK.

Required

What matters would you discuss with the auditors of Niles Ltd?

Solution

2.4

Marks & Spencer plc
Y/e 31.12.07
Auditor = Ernst & Young

M&S = 'Parent'

EY = 'Principal Auditor' – has the sole responsibility for forming the auditor's opinion on the group accounts

100% | 75% | 100%

T Ltd	V Ltd	X GmbH
Y/e 31.12.07	Y/2 30.9.07	31.12.07
Auditor = Ernst & Young	Auditor = PwC	Auditor = KPMG (Germany)

T, V and X are 'Components'

PwC and KPMG – 'Other Auditors' – still have the responsibility for forming the opinion on the individual company accounts….

T Ltd: There should not be a problem here

V Ltd: (1) Non-coterminous y/e not a problem. As long as within 3 months of y/e. If > 3m – interim accounts should be prepared.
(2) 'Other auditor' – EY has the right to require from PwC all info and explanations as they may

X GmbH: For a non-UK subsidiary, the directors of the parent have a responsibility to ensure that the principal auditors receive all the co-operation they require.

Naturally, there are other problems:

- language
- foreign currency translation – both individual and group considerations
- other cultural problems (eg. high inflation)

Other considerations:

Are any of the subsidiaries immaterial? If so, obtain draft accounts from them and perform an analytical review. If this review suggests any errors exist more detailed work will be needed.

3 Matters to consider before accepting appointment as principal auditor to a group

3.1 The principal auditor should consider whether the auditor's own participation is sufficient to be able to act as the principal auditor. For this purpose the principal auditor would consider the following.

(a) The **materiality** of the portion of the financial statements which the principal auditor audits;

(b) The principal auditor's degree of **knowledge** regarding the business of the components;

(c) The **risk** of material misstatements in the financial statements of the components audited by the other auditor;

(d) The ability, where necessary, to perform **additional procedures** to enable them to act as principal auditors; and

(e) The nature of the principal auditor's **relationship** with the firm acting as other auditor.

4 Issues arising when a subsidiary is located abroad

4.1 When a subsidiary is located abroad a number of potential difficulties could arise such as the following.

(a) Different accounting policies might be used in the foreign country. The subsidiary accounts must be brought into line with the accounting policies used by the parent company in order to consolidate properly. The principal auditor will use the checklist mentioned above to determine the accounting policies used.

(b) There may be cultural problems unique to the country in which the subsidiary operates. The principal auditor will need to be sensitive to these during dealings with the other auditors.

(c) Language problems might arise. This problem can be easily overcome by using staff who can speak the relevant language or by using a translator.

(d) There may be issues in existence which are specific to the country in which the subsidiary operates. For example, some countries are subject to hyperinflation; accounts produced in these circumstances will need to be adjusted prior to consolidation with the parent. Factors such as these will need to be identified for each subsidiary and tackled as appropriate during the audit.

5 The correct classification of investments

5.1 You know from your accounting studies that an investment is treated as a subsidiary when the parent company has control over that company. Where significant influence is held the investment is treated as an associate. It is important that the degree of control exercised by the parent company is tested by the auditor.

5.2 The auditor needs to consider how an investment fits into the activities of the group. He should review board minutes for evidence of the degree of influence exercised by the parent. He should also discuss the matter with the parent directors.

5.3 The existence of other significant shareholders may indicate that the parent company has little influence. The auditor should check the register of members to determine the level of shareholding and potential influence held by other shareholders.

5.4 The auditor should also consider how easy it is to obtain information about the investee company. This could also be an indicator of significant influence.

6 ISA 545: Auditing fair value measurements and disclosures

6.1 Goodwill must be calculated based on fair values. The auditor will need to audit these calculations.

6.2 ISA 545 gives the auditor guidance on the audit of fair values. The overall approach the auditor should follow can be summarised as follows.

- Obtain an understanding of the entity's process for determining fair values
- Identify and assess the risks of material misstatement at the assertion level
- Perform audit procedures on the data used to develop the fair values, and
- Evaluate whether the fair value measurements have been properly determined.

6.3 Other factors to consider:

(a) Often fair values are dependent on future actions by management. The auditor should obtain evidence about management's intent to carry out specific courses of action, and consider its ability to do so.

(b) Where alternative methods for measuring fair value are available under the entity's applicable financial reporting framework, or where the method of measurement is not prescribed, the auditor should evaluate whether the method of measurement is appropriate in the circumstances.

(c) The auditor should consider the need to use the work of an expert.

Chapter 11 Section 3

(d) The auditor should evaluate whether the fair value measurements and disclosures in the financial statements are in accordance with the entity's applicable financial reporting framework and whether the measurement method is applied consistently.

Lecture example 2

Technique demonstration

One of your firm's largest clients, Russell, a public company, is in the process of negotiating a substantial takeover of Crowe, a limited liability company. The following calculation of goodwill has been prepared:

	$m	$m
Cost of business combination:		
Cash	280.6	
Shares	145.0	
		425.6
Fair value of identifiable assets, liabilities and contingent liabilities acquired		231.6
Goodwill		194.0

Required

State the audit work that you would perform on the fair value of Crowe's:

(i) inventories
(ii) payables
(iii) land and buildings.

Solution

7 Letters of support

7.1 A 'letter of support' is an agreement made between a company and its subsidiary or fellow subsidiary under which one company agrees to provide support in the form of funding to enable the other company to meet its debts and liabilities.

7.2 A letter of support may be required from the parent where it appears that a subsidiary is not a going concern and will be unable to pay non-group payables as they fall due.

Audit work

7.3 The auditor needs to determine whether the parent has the power to provide a letter of support. The following should be obtained.

(a) Written confirmation from the company's solicitors to the effect that the giving of the support is permitted under the company's constitution and is not *ultra vires* the company, and that it is within the powers of the board of directors to give the support; or

(b) If the transaction is not permitted by the company's constitution, a certified copy of the resolution amending it to give the company the necessary capacity to give the letter of support.

8 Implications for the auditor's report where a subsidiary's report has been modified

8.1 In a group situation, materiality and risk must be assessed in the context of the group as a whole. The principal auditor must consider the materiality of any modifications to a components audit report in relation to the whole of the consolidated accounts.

8.2 This can lead to situations where a subsidiary may have a material qualification that has no impact on the group opinion which would remain unmodified. Similarly a pervasive qualification in a subsidiary's audit report may only have a material impact on the group opinion.

8.3 Ultimately the decision as to the impact of a modification to a subsidiary's audit report on the consolidated opinion is a matter of judgement for the principal auditor.

8.4 Where the principal auditor concludes that adequate evidence about the work of the other auditor cannot be obtained and has been unable to perform sufficient additional procedures with respect to that subsidiary, he should consider the implications for the auditor's report. A subsequent modification in these circumstances would be on the grounds of a limitation on scope.

9 Joint audits

9.1 A joint audit can be defined as one "where two or more auditors are responsible for an audit engagement and jointly produce an audit report to the client".

9.2 **Reasons for joint audits**

Two or more firms could act as joint auditors for the following reasons.

(a) In a new **acquisition** the parent may insist that their auditor acts jointly with those of the new subsidiary.

(b) A company operating from widely **dispersed locations** may find it useful to have joint auditors.

(c) **Foreign subsidiaries** may need to employ local audit firms to satisfy the laws of the country in which they operate. These local auditors may act jointly with the principal auditors.

(d) Some companies may prefer to use **local accountants** while at the same time enjoying the wider range of services offered by a large national firm.

9.3 Before accepting appointment as a joint auditor it will be necessary to consider the experience and standards of the other firm.

9.4 The allocation of work between the firms needs to be agreed and the auditors should agree whether joint or separate engagement letters will be sent.

9.5 Both firms must sign the audit report and both are responsible for the whole audit. They are jointly liable in the event of litigation.

10 Transnational audits

Chapter 11 Section 5.3

10.1 A transnational audit means an audit of financial statements which are or may be relied upon outside the entity's home jurisdiction for purposes of significant lending, investment or regulatory decisions; this will include audits of all financial statements of companies with listed equity or debt and other public interest entities which attract particular public attention because of their size, products or services provided.

10.2 In response to the trend towards globalisation a Forum of Firms (FOF) has been formed by the big four firms with BDO and Grant Thornton also members.

10.3 To support and provide guidance to the FOF the IAASB has set up the Transnational Auditors Committee.

10.4 Specific responsibilities of the TAC include the following.

(a) Identifying audit practice issues. When the issues suggest changes in auditing or assurance standards may be required, recommending to the appropriate IFAC standard setting boards that the issue be reviewed.

(b) Providing a forum to discuss "best practices" in areas including quality control, auditing practices, independence, and training and development.

(c) Proposing members to the IFAC Regulatory Liaison Group and identifying qualified candidates to serve on IFAC standard setting boards.

(d) Acting as a formal conduit for interaction among transnational firms and international regulators and financial institutions with regard to audit quality, systems of quality control, and transparency of international networks.

11 Chapter summary

- Many audit engagements will involve clients with a **group** of companies rather than one single entity.
- This leads to some additional factors the auditor will need to take into account at the planning stage particularly.
- There will be **logistical issues** to take into account, for example the location of group companies. In addition there will be **audit issues** arising from consolidation adjustments such as fair values.
- In the global economy auditors are increasingly involved in **transnational audits**. The profession has responded to this by forming a **Forum of Firms** to give guidance as to best practice. (See additional notes.)

Additional Notes

12 Audit firms

Question 17

12.1 The accountancy sector is broken down into three generally accepted 'tiers':

- '**The Big Four**'. The largest four firms based on fee income. They consist of: PricewaterhouseCoopers, Deloitte, KPMG and Ernst & Young.
- **The Medium Tier**. This is normally based on the number of partners including firms with over 16. The medium tier firms are substantially smaller with the largest firms being Grant Thornton, BDO Stoy Hayward and Baker Tilly. The medium tier consists of approximately 50 firms.
- **Small firms**. This is the remainder of the accountancy firms and is by far the largest tier.

12.2 **Globalisation**

'The Big Four' firms are all fully international partnerships who pride themselves in being able to offer a seamless provision of services throughout the world. Many of the medium firms are also part of strategic alliances and have affiliated firms around the world to offer a similar service.

Lecture example 3

Idea generation

Recently there has been a trend for accountancy firms to merge: in the 1980s we had the 'Big Eight', in the 1990s the 'Big Six' and in the 2000s the 'Big Four'. The medium tier firms have also gone through a period of mergers.

Required

Discuss the advantages and disadvantages of such mergers to the audit firms themselves and also to the clients they service.

Solution

END OF CHAPTER

Audit-related services and other assurance services

12

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Describe the nature of audit-related services, the circumstances in which they might be required and the comparative levels of assurance provided by professional accountants.
- Distinguish between: audit-related services and an audit of historical financial statements and an attestation engagement and a direct reporting engagement.
- Plan review engagements, for example: a review of interim financial information or a 'due diligence' assignment (when acquiring a company, business or other assets).
- Explain the importance of enquiry and analytical procedures in review engagements and apply these procedures.
- Describe and apply the general principles and procedures relating to a compilation engagement (e.g. to prepare financial statements).
- Explain why agreed-upon procedures and compilation engagements do not (usually) meet the requirements for an assurance engagement.
- Illustrate the form and content of a report on factual findings and a compilation report.
- Describe the main categories of assurance services that audit firms can provide and assess the benefits of providing these services to management and external users: risk assessments, business performance measurement, systems reliability and electronic commerce.
- Justify a level of assurance (reasonable, high, moderate, limited, negative) for an engagement depending on the subject matter evaluated, the criteria used, the procedures applied and the quality and quantity of evidence obtained.
- Recognise the ways in which different types of risk (eg strategic, operating, information) may be identified and analysed and assess how management should respond to risk.
- Recommend operational measures and describe how the reliability of performance information systems is assessed (including benchmarking).
- Describe a value for money audit and recommend measures of economy, efficiency and effectiveness.
- Explain the demand for reliable and more timely reporting on financial information and the development of continuous auditing.
- Select procedures for assessing internal control effectiveness.
- Describe how entities are using core technologies (e.g. EDI, email, Internet, World Wide Web) and explain how e-commerce affects the business risk of a given entity.
- Analyse the form and content of the professional accountant's report for an assurance engagement with an auditor's report.
- Discuss the effectiveness of the 'negative assurance' form of reporting and evaluate situations in which it may be appropriate to express a reservation or deny a conclusion.
- Describe recent trends in IT and their current and potential impact on auditors (e.g. the audit implications of 'cyberincidents' and other risks).
- Explain how IT may be used to assist auditors and discuss the problems that may be encountered in automating the audit process.

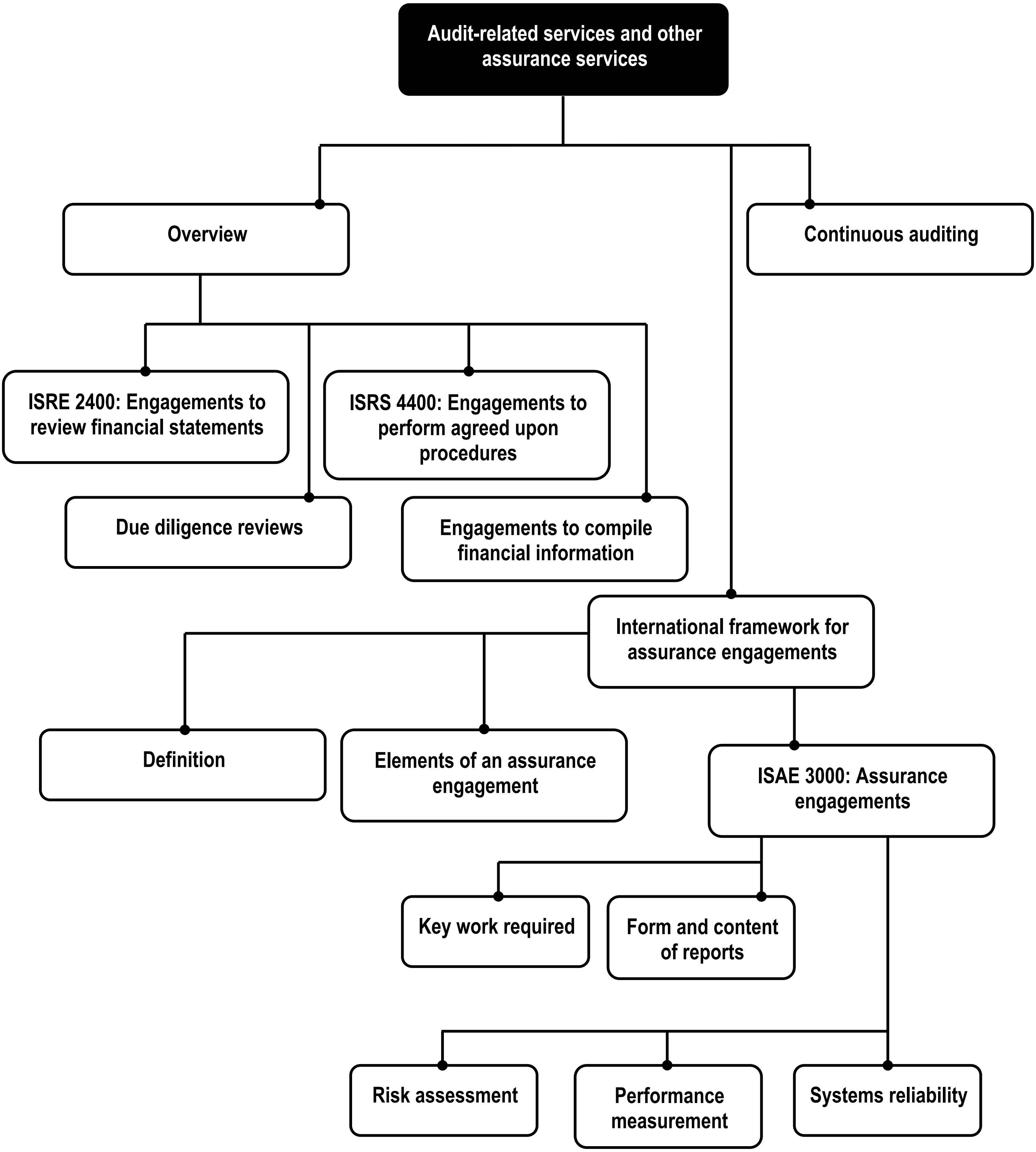
Exam Context

It is important to have a sound knowledge of the types of engagements covered in this chapter; you are very likely to be required to apply this knowledge to practical scenarios in the exam.

Business Context

The statutory audit is just one of the revenue streams available for professional firms in the business world. It is important that you understand the importance of other engagements to audit firms, this has become more relevant in recent years as the audit exemption threshold has increased throughout the EU and clients have also become more prone to seek assurance on a variety of subject matters.

Overview


Audit-related services and other assurance services
Overview
Continuous auditing
ISRE 2400: Engagements to review financial statements
ISRS 4400: Engagements to perform agreed upon procedures
Due diligence reviews
Engagements to compile financial information
International framework for assurance engagements
Definition
Elements of an assurance engagement
ISAE 3000: Assurance engagements
Key work required
Form and content of reports
Risk assessment
Performance measurement
Systems reliability

1 Overview

1.1 Audit firms are often asked to provide services to clients which do not involve the expression of an opinion on the truth and fairness of the accounts. For example, the firm might be asked to give assurance that interim financial statements are correctly prepared in a business or they might be asked to prepare the financial statements for a private company audit client.

1.2 Related services comprise *reviews*, *agreed-upon procedures* and *compilations* (IAASB Glossary).

	Auditing	*Related services*		
Nature of service	Audit	Review (ISRE 2400)	Agreed-upon Procedures (ISRS 4400)	Compilation (ISRS 4410)
Comparative level of assurance provided by the auditor	Reasonable assurance	Limited assurance	No assurance	No assurance
Report provided	Positive assurance	Negative assurance	Factual findings of procedures	Identification of information compiled

2 ISRE 2400: Engagements to review financial statements

2.1 A review will enable the auditor to state that nothing has come to his attention that causes him to believe that the financial statements are not prepared in accordance with an identified financial reporting framework. This is known as negative assurance.

2.2 The auditor should plan and perform the review with an attitude of professional scepticism recognising that circumstances may exist which cause the financial statements to be materially misstated.

2.3 The auditor should obtain sufficient appropriate evidence primarily through enquiry and analytical procedures, to be able to draw conclusions.

2.4 The auditor and the client should agree on the terms of the engagement and an engagement letter should be signed.

2.5 A review report is addressed to the directors of the company and not to the shareholders.

Lecture example 1

Idea generation

Required

List the main procedures you would undertake if asked to perform a review for a client whose financial statements you previously audited but is now exempt from the statutory audit.

Solution

Conclusions and reporting

2.6 The review report should contain a clear expression of negative assurance.

2.7 The report should fulfil the following.

(a) State that nothing has come to the auditor's attention based on the review that causes the auditor to believe the financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with the identified financial reporting framework; or

(b) If matters have come to the auditor's attention, describe those matters that impair a true and fair view ('or a fair presentation, in all material respects') in accordance with the identified financial reporting framework including, unless impracticable, a quantification of the possible effect(s) on the financial statements and either

(i) express a qualification of negative assurance; or

(ii) express an adverse opinion if the matter is so material and pervasive that the financial statements are misleading

(c) If there has been a material scope limitation, describe the limitation and either:

(i) express a qualification of the negative assurance provided regarding the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed; or

(ii) when the possible effect of the limitation is so significant and pervasive that the auditor concludes that no level of assurance can be provided, not provide any assurance.

2.8 **Example of an unqualified review report:**

REVIEW REPORT TO …..

We have reviewed the accompanying balance sheet of ABC Company at December 31, 20XX, and the related statements of income and cash flows for the year then ended. These financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on these financial statements based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400. This Standard requires that we plan and perform the review to obtain limited assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view (or 'are not presented fairly, in all material respects') in accordance with International Financial Reporting Standards.

AUDITOR

Date
Address

Due diligence reviews

2.9 Due diligence reviews are a specific type of review engagement. A typical due diligence engagement is where an adviser (often an audit firm) is engaged by one company planning to take over another to perform an assessment of the material risks associated with the transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts. This is important when determining purchase price. Similarly, due diligence can also be requested by sellers.

2.10 It may include some or all of the following aspects.

- Financial due diligence (a review of the financial position and obligations of a target to identify such matters as covenants and contingent obligations)
- Operational and IT due diligence (extent of operational and IT risks, including quality of systems, associated with a target business)
- People due diligence (key staff positions under the new structure, contract termination costs and costs of integration)
- Regulatory due diligence (review of the target's level of compliance with relevant regulation)
- Environmental due diligence (environmental, health and safety and social issues in a target)

2.11 Due diligence work is primarily limited to enquiry and analytical procedures.

2.12 Note that although due diligence uses the techniques of a review engagement it is unlikely hat any assurance (positive or negative) will be provided. It is normally a report of factual findings.

3 ISRS 4400: Engagements to perform agreed-upon procedures regarding financial information

3.1 The objective of an agreed-upon procedures engagement is for the auditor to carry out procedures of an audit nature to which the auditor and the entity and any appropriate third parties have agreed and to report on factual findings.

3.2 Such an engagement may involve the audit firm performing certain procedures concerning individual items of financial data, a financial statement or even a complete set of financial statements.

3.3 Some of the areas covered by such procedures are as follows.

- Compliance with best practice recommendations on directors' remuneration
- Going concern review
- Supply of information to directors.
- Compliance with the Combined Code.

3.4 The auditor should ensure with representatives of the entity and, ordinarily, other specified parties who will receive copies of the report of factual findings, that there is a clear understanding regarding the agreed procedures and the conditions of the engagement.

3.5 The auditor should carry out the procedures agreed upon and use the evidence obtained as a basis for the report of factual findings. Procedures may include:

- enquiry and analysis
- recomputation, comparison and other clerical accuracy checks
- observation
- inspection
- obtaining confirmations

3.6 No assurance is expressed because the audit firm is simply reporting factual findings.

3.7 The report must be restricted to only those parties who have agreed to the procedures to be performed.

3.8 **Example of a report of factual findings:**

REPORT OF FACTUAL FINDINGS

To (those who engaged the auditor)

We have performed the procedures agreed with you and enumerated below with respect to the accounts payable of ABC Company as at (date), set forth in the accompanying schedules (not shown in this example). Our engagement was undertaken in accordance with the International Standard on Related Services (or refer to national standards or practices) applicable to agreed-upon procedures engagements. The procedures were performed solely to assist you in evaluating the validity of the accounts payable and are summarised as follows:

1 We obtained and checked the addition of the trial balance of accounts payable as at (date) prepared by ABC Company, and we compared the total to the balance in the related general ledger account.

2 We compared the attached list (not shown in this example) of major suppliers and the amounts owing at (date) to the related names and amounts in the trial balance.

3 We obtained suppliers' statements or requested suppliers to confirm balances owing at (date).

4 We compared such statements or confirmations to the amounts referred to in 2. For amounts which did not agree, we obtained reconciliations from ABC Company. For reconciliations obtained, we identified and listed outstanding invoices, credit notes and outstanding checks, each of which was greater than $xxx. We located and examined such invoices and credit notes subsequently received and checks subsequently paid and we ascertained that they should in fact have been listed as outstanding on the reconciliations.

We report our findings below:

(a) With respect to item 1 we found the addition to be correct and the total amount to be in agreement.

(b) With respect to item 2 we found the amounts compared to be in agreement.

(c) With respect to item 3 we found there were suppliers' statements for all such suppliers.

(d) With respect to item 4 we found the amounts agreed, or with respect to amounts which did not agree, we found ABC Company had prepared reconciliations and that the credit notes, invoices and outstanding checks over $xxx were appropriately listed as reconciling items with the following exceptions:

(Detail the exceptions)

Because the above procedures do not constitute either an audit or a review made in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices) we do not express any assurance on the accounts payable as of (date).

Had we performed additional procedures or had we performed an audit or review of the financial statements in accordance with International Standards on Auditing or International Standards on Review Engagements (or relevant national standards or practices), other matters might have come to our attention that would have been reported to you.

Our report is solely for the purpose set forth in the first paragraph of this report and for your information and is not to be used for any other purpose or to be distributed to any other parties. This report relates only to the accounts and items specified above and does not extend to any financial statements of ABC Company, taken as a whole.

AUDITOR

Date
Address

4 ISRS 4410: Engagements to compile financial information

4.1 The objective of a compilation engagement is for the accountant to use accounting expertise, as opposed to auditing expertise, to collect, classify and summarise financial information. This would ordinarily include the preparation of financial statements, but may also include the collection, classification and summary of other financial information.

4.2 The accountant does not give any assurance on the information. However, the reader of the information will gain some benefit from the accountant's involvement because the service will be performed with professional competence and due care.

4.3 The terms of the engagement should be agreed with the client and the management should acknowledge their responsibility for the presentation of the information.

4.4 **Example of a compilation report:**

COMPILATION REPORT TO.....

On the basis of information provided by management we have compiled, in accordance with the International Standard on Related Services (or refer to national standards or practices) applicable to compilation engagements, the balance sheet of ABC Company as of December 31, 20XX and statements of income and cash flows for the year then ended. Management is responsible for these financial statements. We have not audited or reviewed their financial statements and accordingly express no assurance thereon.

ACCOUNTANT

Date
Address

5 International framework for assurance engagements

Definition

5.1 An **assurance engagement** is an engagement in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

Elements of an assurance engagement

5.2 Whether a particular engagement is an assurance engagement will depend upon whether it exhibits *all* the following elements:

(a) A three party relationship involving:

(i) a practitioner;
(ii) a responsible party; and
(iii) intended users (i.e. the person(s) that the report is prepared for).

(b) An appropriate subject matter;

(c) Suitable criteria: i.e. the benchmarks used to evaluate or measure the subject matter

(d) Sufficient appropriate evidence; and

(e) A written assurance report (providing either *reasonable* or *limited* assurance).

5.3 Forms of subject matter:

Form of subject matter	Example subject matter	Subject matter information
(a) Financial performance or conditions	Historical or prospective financial information, financial performance and cash flows	Recognition, measurement, presentation and disclosure represented in financial statements
(b) Non-financial performance or conditions	Performance of an entity	Key indicators of efficiency and effectiveness
(c) Physical characteristics	Capacity of a facility	Specifications document
(d) Systems and processes	An entity's internal controls over IT systems	Assertion about effectiveness
(e) Behaviour	Corporate governance, compliance with regulation, human resource practices	Statement of compliance/ statement of effectiveness

Lecture example 2

Preparation question

Required

State specifically what the elements of an assurance engagement would be for an audit of financial statements.

Solution

In the three party relationship, who is/are:

(i) the practitioner?

(ii) the responsible party?

(iii) the intended users?

What is the subject matter?

What are the suitable criteria?

What is the sufficient appropriate evidence?

What form would the written assurance report take?

Types of assurance engagement

5.4 The objective of a **'reasonable assurance engagement'** is to reduce assurance engagement risk to an acceptably low level as the basis for a *positive* form of expression of the practitioner's conclusion.

e.g. in the case of assurance on effectiveness of internal controls, the report would be worded, 'In our opinion *internal control is effective*, in all material respects, based on XYZ criteria'.

5.5 The objective of a **'limited assurance engagement'** is to reduce assurance engagement risk to a level that is acceptable as the basis for a *negative* form of expression of the practitioner's conclusion.

e.g. 'Based on the work described in this report, *nothing has come to our attention that causes us to believe that internal control is not effective*, in all material respects, based on XYZ criteria.'

Assertion-based vs direct reporting engagements

5.6 In an **assertion-based engagement**, the subject matter information is in the form of an assertion by the responsible party that is made available to the intended users. The assurance report therefore reports on this assertion.

e.g. 'In our opinion, *the responsible party's assertion* that internal control is effective, based on XYZ, is fairly stated.'

5.7 In a **direct reporting engagement**, the practitioner either directly performs the evaluation or measurement of the subject matter, or obtains a representation from the responsible party that has performed the evaluation or measurement that is not available to the intended users.

e.g. 'In our opinion *internal control is effective*, in all material respects, based on XYZ criteria.'

Lecture example 3

Preparation

Required

State, with reasons, which of the following would be classed as an assurance engagement:

(1) A report giving an opinion on a client's responses to a regulatory questionnaire on solvency.

(2) Preparation of the entity's tax computation.

(3) A report to shareholders covering the effectiveness of the implementation of the new BPP logo and corporate image in BPP offices and published materials.

(4) Advice on the introduction of a new accounting system.

(5) A due diligence report covering pension fund liabilities in a potential investee company.

(6) A review of the effectiveness and adequacy of a company's internal control system.

Solution

6 ISAE 3000: Assurance engagements

6.1 ISAE 3000 provides standards for assurance engagements other than audits or reviews of historical financial information. In substance, many of the requirements are similar to those required for an audit or a review.

Key work required

6.2 The practitioner should agree on the **terms** of the engagement with the engaging party.

6.3 Effective **planning** is required as with an audit.

6.4 The **appropriateness of the subject matter** and the **suitability of the criteria** to be used in the engagement should be assessed. Suitable criteria must be relevant, complete, reliable, neutral and understandable.

6.5 Sufficient appropriate **evidence** is required on which to base the conclusion. **Documentation** of matters significant in providing evidence to support the assurance report and to show that the engagement was performed in accordance with ISAEs is also required.

Form and content of reports

6.6 ISAE 3000 does not stipulate a standardised format for the report. Different wording will have to be used depending on the engagement.

6.7 The report should include the following basic elements.

(a) A title that clearly indicates that the report is an independent assurance report;

(b) An addressee;

(c) An identification and description of the subject matter information and, when appropriate, the subject matter;

(d) Identification of the criteria;

(e) Where appropriate, a description of any significant inherent limitation associated with the evaluation or measurement of the subject matter against the criteria;

(f) When the criteria are available only to specific intended users/relevant only to a specific purpose a statement restricting the use of the assurance report to those users/ that purpose;

(g) A statement to identify the responsible party and to describe the responsible party's and the practitioner's responsibilities;

(h) A statement that the engagement was performed in accordance with ISAEs;

(i) A summary of work performed;

(j) The practitioner's conclusion;

(k) The assurance report date; and

(l) The name of the firm or practitioner, and a specific location.

6.8 ISAE 3000 does not provide any sample reports. The following example was prepared by the previous examiner under the old syllabus (amended for subsequent terminology changes).

> **'Reasonable' level assurance assertion-based report (extracts)**
>
> The objective of this Assurance engagement is to report on the effectiveness of the internal control structure for financial reporting of Jasper Inc. The directors of Jasper Inc are responsible for maintaining an effective internal control structure including controls in relation to financial reporting. The directors' assertion about the effectiveness of the internal control structure for financial reporting is included on page 23 of the Jasper Inc 20X0 Annual Report.
>
> Our responsibility is to express a conclusion on the effectiveness of the internal control structure for financial reporting to the shareholders of Jasper Inc. This conclusion is based on the procedures that we determined to be necessary for the collection of sufficient appropriate evidence, that evidence being persuasive rather than conclusive in nature, in order to obtain a reasonable level of assurance as to the effectiveness of the internal control structure. Because of the inherent limitations of any internal control structure, errors or irregularities may occur and not be detected. Also, projections of any evaluation of internal control to future periods are subject to the risk that the internal control may become inadequate because of changes in conditions, or that the degree of compliance with the control procedures may deteriorate.
>
> This Assurance engagement has been undertaken in accordance with the International Standard on Assurance Engagements and accordingly included such tests and procedures, as we considered necessary in the circumstances. These procedures have been undertaken to determine whether the internal control structure has been adequately designed and operated effectively based on the Combined Code [or other Framework]. Based on our engagement procedures, the inherent limitations outlined above and the evidence collected, we conclude that Jasper Inc maintained, in all material respects, an effective internal control structure in relation to financial reporting for the period .... to .... in accordance with the Combined Code [or other Framework].

7 Risk assessment

Introduction

7.1 We discussed business risk in Chapter 5. We will now deal with the identification of business risks and how they are managed. An audit firm might be engaged to give assurance on the management of such risks.

7.2 The management of business risk is critical as directors must safeguard the assets of the company.

Lecture example 4

Exam standard for 15 marks

You have just been appointed as a manager for Watton, Wheaton & Wakefield a firm of Chartered Certified Accountants. One of your first assignments has been to prepare a report for the board of Robinson Travel (RT), a public company, trying to identify and mitigate their business risk. This is in part to ensure the company is in good shape for the rights issue intended next year. You find the following summary of the operations of RT on last year's audit file.

Background

RT was formed in 1998 when a billionaire (Lorna Robinson) purchased two small low cost airlines. The company was then floated on the London Stock Exchange in 2002 as part of an expansion. Lorna still has a substantial shareholding and is the Chief Executive Officer of RT. The company operates mainly out of London Luton and London Stansted Airports.

The airline has a mixed fleet of old aeroplanes, which it has acquired mostly at auctions as other airlines have sold them off. They are then painted up in the company's distinctive pink colour.

Some of the planes have recently been fitted with new engines, as the old engines do not meet the new Environment Department's Emission Standards. The rest of the fleet needs to be updated before the Standard comes into force in the spring.

The airline has always competed in the low cost market and has recently received some bad press when an undercover journalist wrote an article detailing the company's policy of selling more tickets for each flight than there are seats on the plane. Ms Robinson did not help matters by making an unofficial public appearance and is reported as saying, "Do you want to fly cheap or fly seated?"

New booking system

During the year RT implemented a new booking system, which operates on the Internet, and closed its call centre in the West Midlands. Some of the personnel dismissed in this move are suing RT as they are unhappy with the way that they have been treated. The new Internet server is located on the Isle of Man in an attempt to take advantage of a tax loophole identified by one of RT's competitors.

Staff

The company has very few full-time staff and employees do not tend to stay with the firm for long. Most of the pilots, air stewards and ground staff are either on short contracts or locally employed temps. Most of the aircrew are foreign, coming from Latvia as this is one of the new routes started by RT. This means that the wage bill has been substantially reduced, but few of the staff has English as a first language. Aircrew must be well trained in safety procedures to comply with even more stringent new regulations developed under anti-terrorism developments.

New developments

RT has invested heavily in a new licence, which will allow it to apply for the right to fly long haul. RT is currently trying to break into the transatlantic market with flights to New York and Washington DC. RT would need to use larger planes to make these routes viable and it intends to lease these if it obtains the long haul slots.

RT has also just received the go ahead to start flying passengers into military air bases in Eastern Europe as the civilian airports are at full capacity. It is hoped the reduced landing charges will mean they can easily beat their competitors on ticket price.

Required

Identify and explain the business risks RT faces and describe procedures which RT could use to transfer or mitigate the risk.

Solution

8 Performance measurement

Introduction

8.1 An audit firm may be asked to provide assurance on performance measures operating within a business.

8.2 Performance measurement aims to establish how well something or somebody is performing in relation to previous or expected activity or in comparison with another item or body.

The 'item' may be a machine, a factory, a subsidiary or the business as a whole. The 'body' may be an employee, a manager or a group of staff.

Performance measures

8.3 Different measures are appropriate for different businesses. Traditional financial performance measures are:

- profit
- revenue
- costs
- share price
- cash flow
- return on investment.

8.4 Financial measures do not give a full picture of a business' performance. Increasingly companies are turning to non-financial performance measures.

Lecture example 5

Idea generation

Required

Suggest five non-financial performance measures that a manufacturing business could use internally.

Solution

9 Systems reliability

9.1 Businesses are exposed to risk if their computerised systems are unreliable. An audit firm may be asked to give assurance on the reliability of the systems in operation.

Lecture example 6

Idea generation

Required

What risks are a business exposed to as a result of unreliable systems?

Solution

9.2 Controls over computerised systems have been covered in your earlier auditing studies.

10 Continuous auditing

10.1 Continuous auditing is possible where there is a good working relationship with the client and the audit team is able to visit the client on a regular basis. This approach is more valid with risk based audits as, by the very nature of business risks, they are constantly changing, therefore the auditor will be able to address those changes as they occur rather than waiting until the year-end or later.

10.2 There are two main advantages of continuous auditing.

(a) The first is that if any control weaknesses are identified during the audit a management letter point can be raised and the matter rectified prior to the year-end; this should improve the chance that controls can be relied upon.

(B) A continuous auditing approach will make the audit more efficient and it should allow for quicker post year-end sign off of the accounts. This is especially important for large, listed entities whose shareholders tend to demand that financial information is published as quickly as possible.

11 Chapter summary

- There are many **additional services** an audit firm can offer their clients.
- Some of these engagements provide **no assurance** and involve the auditor using their skills to perform **agreed upon procedures** or a **compilation** of financial statements.
- In many cases engagements will involve the provision of **assurance**, either **positive or negative**.
- Any engagement can be an assurance engagement provided the nature of the engagement satisfies the **elements** of an assurance engagement as laid down in ISAE 3000.
- There are many different types of assurance engagements; the most important for P7 are **review engagements**, **risk assessments**, **performance measurement** and **systems reliability**.

Additional Notes

12 Value for money audits (VFM)

Value for money audit (VFM)

Chapter 12 Section 4.3

12.1 Value for money audit is an investigation into whether proper arrangements have been made for securing economy, efficiency and effectiveness in the use of resources.

12.2 **Economy** is taken to mean the achievement of a given result with the least expenditure of money, manpower or other resources.

Efficiency means converting resources into the desired product of service in the most advantageous way.

Effectiveness is concerned with how well an activity is achieving its policy objectives or other intended effects.

12.3 VFM have been used in the public sector for many years. The auditor reviews systems of control together with investigating individual cases of waste or extravagance where these come to his attention.

13 Electronic commerce

Chapter 12 Section 6

13.1 **The Internet**

Many clients now conduct their business through the Internet.

13.2 Risks associated with the Internet

Companies that engage in electronic commerce are subject to additional risks. Inherent risks arising can be categorised as follows:

– **Financial:** if transactions fail then an entity will have difficulty remaining in business.

– **Reputational:** if the entity's reputation is damaged or confidence in its operations is lost the entity will also have difficulty remaining in business.

– **Legal:** new legal issues need to be faced. Breach of these could give rise to serious problems.

13.3 Companies who sell via the Internet are faced with the following potential risks.

- **Customer validity:** how do they know that a customer is who they say they are?
- **Server reliability:** the site may be subject to denial of service attacks preventing the receipt of legitimate orders.
- **Data theft:** firewalls can prevent this as they will deny external users from accessing parts of the system.
- **Message integrity**: must ensure the message and pricing has not been changed.
- **Non-repudiation**: need to ensure the message has been received. Delivery receipts.
- **Authorisation**: Did the sender have authority to make such a request/perform such a transaction? Passwords, restricted access.

13.4 A number of business risks are also faced including:

- cash flow difficulties due to investment in the systems
- loss of competitive advantage in a fast moving market place if systems or processes fail or are suspended
- failure of systems development
- lack of profitability
- customer dissatisfaction due to poor service

13.5 **Assessment of internal controls**

The assessment of controls becomes more complex as technology advances. The audit firm must consider the following in order to assess the system properly.

- How many servers does the company have?
- What processing methods are used?
- How is the network configured?
- How are customers and suppliers authenticated?
- What security methods are used?
- How good are the general internal controls?

13.6 **E-mail**

E mail reduces paperwork and results in speedier communication. However, there is a risk that unauthorised e-mails could result in unauthorised processing. Therefore, access controls over the system are paramount.

13.7 **Electronic data interchange (EDI)**

EDI refers to the exchange of electronic business documents between trading partners. The exchange of a fully integrated EDI system involves no papers and no human input.

13.8 The organisation needs to have controls in place to ensure that the data exchanged is authentic.

END OF CHAPTER

13

Prospective financial information (PFI)

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define 'prospective financial information' (PFI) and distinguish between a 'forecast', a 'projection', a 'hypothetical illustration' and a 'target'.
- Explain the principles of useful PFI.
- Identify and describe the matters to be considered before accepting a specified engagement to report on PFI.
- Discuss the level of assurance that the auditor may provide and explain the other factors to be considered in determining the nature, timing and extent of examination procedures.
- Describe examination procedures to verify forecasts and projections relating to: revenue, capital expenditure, revenue expenditure, profits, cash flows and working capital.
- Compare the content of a report on an examination of PFI with reports made in providing audit-related services.
- Draft the content of a report on examination of prospective financial information.

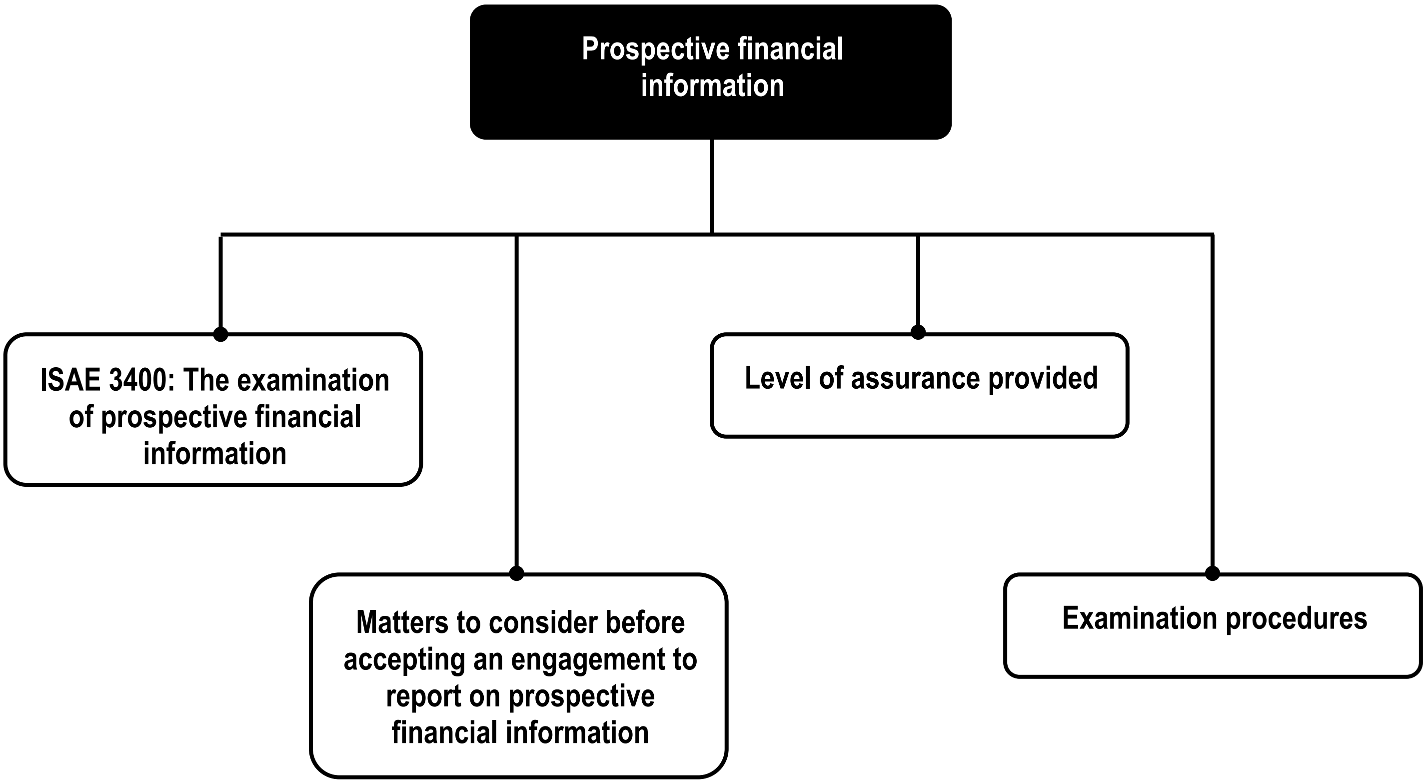
Exam Context

Prospective financial information is an important area; you could be given forecast information in the exam and be required to explain the procedures you would perform in order to provide assurance on it.

Business Context

Prospective financial information is another example of an assurance engagement and is one that is very commonly undertaken by many audit firms, normally for existing audit clients.

Overview


Prospective financial information
ISAE 3400: The examination of prospective financial information
Matters to consider before accepting an engagement to report on prospective financial information
Level of assurance provided
Examination procedures

1 ISAE 3400: The examination of prospective financial information

Terminology

1.1 Prospective financial information means financial information based on assumptions about events that may occur in the future and possible actions by the entity.

Auditors are regularly engaged to provide assurance on prospective financial information.

1.2 Prospective financial information can be of two types (or a combination of both).

A forecast: Prospective financial information based on assumptions as to future events which management expects to take place and the actions management expects to take (best-estimate assumptions).

A projection: Prospective financial information based on hypothetical assumptions about future events and management actions, or a mixture of best-estimate and hypothetical assumptions.

There are two other terms commonly associated with prospective financial information:

A Hypothetical Illustration: Prospective financial information based on assumptions about uncertain future events and management actions which have not yet been decided on.

A Target: Prospective financial information based on assumptions about the future performance of the entity.

1.3 Listed companies should have procedures that allow them to generate reliable PFI, compare it to market expectations, publish it when necessary and subsequently report actual performance against it.

2 Matters to consider before accepting an engagement to report on prospective financial information

2.1 Before accepting such an engagement, the audit firm should consider the following.

(a) The intended use of the information. For example, is it intended for internal or external use?

(b) Whether the information will be for general or limited distribution.

(c) The nature of the assumptions on which the information is based.

(d) The information to be included.

(e) The period covered by the information.

Lecture example 1

Idea generation

Required

Prospective financial information has a key role for businesses in terms of providing information to third parties as well as an internal management tool. Can you think of some examples of different types of prospective financial information?

Solution

3 Level of assurance provided

3.1 Due to the nature of PFI, the audit firm will be unable to conclude on whether the results forecast will be achieved. Also there may be insufficient evidence available to conclude that the assumptions are free from material misstatement. Therefore, the audit firm can generally only provide a limited level of assurance.

3.2 The audit firm will normally provide negative assurance. This means they will state that "nothing has come to their attention" which causes them to believe that the assumptions are not a reasonable basis for the forecast.

3.3 **Example of an unqualified report on a forecast**

> REPORT TO....
>
> We have examined the forecast in accordance with the International Standard on Assurance Engagements applicable to the examination of prospective financial information. Management is responsible for the forecast including the assumptions set out in Note X on which it is based.
>
> Based on our examination of the evidence supporting the assumptions nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with International Financial Reporting Standards.
>
> Actual results are likely to be different from the forecast since anticipated events frequently do not occur as expected and the variation may be material.
>
> AUDITOR
>
> Date
> Address

3.4 The auditor can express a qualified (disagreement or limitation on scope) opinion if he believes:

(a) the presentation and disclosure of the PFI is not adequate;
(b) one or more of the assumptions do not provide a reasonable basis for the PFI.

4 Examination procedures

4.1 The auditor should obtain sufficient appropriate evidence as to whether:

(a) management's assumptions on which the PFI is based are not unreasonable.

(b) the information is properly prepared on the basis of the assumptions.

(c) the information is properly presented and all material assumptions are adequately disclosed.

(d) the PFI is prepared on a consistent basis with historical financial statements, using appropriate accounting policies.

4.2 The auditor should obtain a sufficient knowledge of the business to be able to evaluate whether the assumptions are justified.

4.3 The historical information will be used as a yardstick to assess the assumptions underlying the information.

4.4 The auditor will check computations and consider the internal consistency of the information.

4.5 The auditor should obtain written representations from management regarding the intended use of the information, the completeness of significant assumptions and management's acceptance of its responsibility for the PFI.

Lecture example 2

Technique demonstration

Prism, a public company, is one of the world's leading suppliers of fast moving consumer goods. The company is looking to increase its operations in Eastern Europe and requires some additional finance.

You are the manager of a Firm of Chartered Certified Accountants and have been approached by Paul Robinson the Chief Executive of Prism. He is trying to obtain some additional finance from the bank and they have asked that he obtain an independent review of the figures that have been produced to support the loan application.

Income statement

	Unaudited	
	20X4	*20X3*
	$m	$m
Revenue	47.6	40.9
Cost of sales	(33.3)	(30.7)
Gross profit	14.3	10.2
Profit on disposal of investment	1.0	0.6
Other expenses	(5.3)	(4.6)
Profit before tax	10.0	6.2

Balance sheet

	Unaudited	
	20X4	*20X3*
	$m	$m
Non-current assets		
Property, plant and equipment	14.9	10.9
Intangible assets	22.1	25.0
Investments	–	2.3
	37.0	38.2
Current assets		
Inventories	5.6	4.1
Receivables	9.1	7.3
Cash	2.5	2.4
	17.2	13.8
	54.2	52.0
Equity		
Share capital	5.3	5.3
Revaluation surplus	3.2	3.2
Retained earnings	9.8	8.3
	18.3	16.8
Non-current liabilities	18.1	18.3
Current liabilities	17.8	16.9
	54.2	52.0

Required

Describe the audit work that a professional certified accountant would perform on the forecast income statement and balance sheet.

Solution

5 Chapter summary

- Prospective financial information relates to any financial data prepared based on assumptions relating to **future** events or actions.
- Auditors must consider some additional factors before accepting an engagement to report on prospective financial information.
- In practice the **level of assurance** given in a prospective financial information engagement will always be **negative** and the type of audit work performed will, in the main, be restricted to **enquiry** and **analytical review**.

END OF CHAPTER

14

Forensic audits

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Define the terms 'forensic accounting', 'forensic investigation', and 'forensic audit'.
- Describe the major applications of forensic auditing (e.g. fraud, negligence, insurance claims) and analyse the role of the forensic auditor as expert witness.
- Apply the fundamental ethical principles to professional accountants engaged in forensic audit assignments.
- Select investigative procedures and evaluate evidence appropriate to determining the loss in a given situation.
- Explain the terms under which experts make reports.

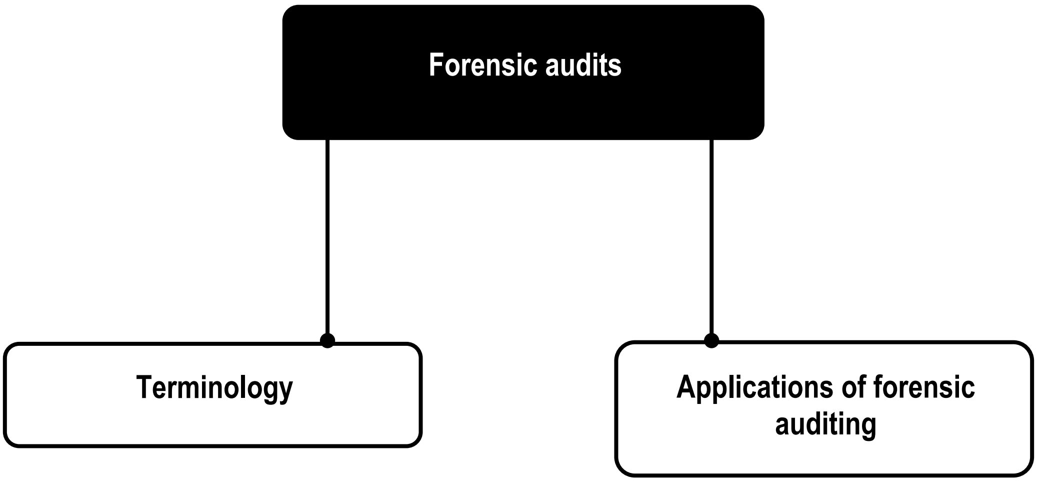
Exam Context

In the pilot paper a 30-mark compulsory question was based around a forensic accounting scenario which required a definition of forensic accounting as well as practical application of forensic skills.

Business Context

Forensic audit is a rapidly growing area. The major accountancy firms all offer forensic services, as do a number of specialist companies. The demand for these services comes in part from the recent moves towards more stringent corporate governance requirements as well as governments' concern regarding criminal funding of terrorist groups.

Overview


Forensic audits
Terminology
Applications of forensic auditing

1 Terminology

1.1 **Forensic auditing** can be defined as:

"The process of gathering, analysing and reporting on data, in a pre-defined context, for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities and giving preventative advice in this area."

1.2 **Forensic investigation** applies similar procedures to a forensic audit but is carried out for specific civil or criminal cases. Such cases could involve fraud or asset tracing in money laundering cases.

1.3 **Forensic accounting** involves undertaking a financial investigation in response to a particular event, where the findings of the investigation may be used as evidence in court or to otherwise help resolve disputes.

2 Applications of forensic auditing

2.1 A professional accountant could be engaged in a number of different contexts to perform forensic work, the following practical situations could all feature in the exam.

2.2 The forensic accountant could be engaged to investigate **fraud**. For example, a business that has fallen victim to fraud may engage the accountant to quantify the extent of the losses. Alternatively, a forensic accountant may be called in to investigate and/or quantify financial statement fraud (e.g. overstatement of revenue).

2.3 In a case where an auditor or accountant is being sued for **negligence** both parties may wish to employ forensic accountants either to investigate the standard of work performed or to establish the losses suffered by the plaintiff.

2.4 **Insurance companies** often engage forensic accountants to verify and report on the amounts of losses suffered by a claimant where there is a dispute between the claimant and the company.

2.5 Due to the nature of this work forensic accountants will very often be called as **expert witnesses** in civil or criminal cases. This is a very important function and some jurisdictions have specific rules governing their duties

2.6 For example, in England & Wales experts have a duty to exercise reasonable skill and care to those instructing them, and to comply with any relevant professional code of ethics. However, when they are instructed to give or prepare evidence for the purpose of civil proceedings they have an overriding duty to help the court on matters within their expertise. This duty overrides any obligation to the person instructing or paying them. Experts must not serve the exclusive interest of those who retain them.

Lecture example 1

Exam standard for 10 marks

You are a manager in an audit firm with a small team dedicated to forensic investigations. You have been approached by the Finance Director of SL Ltd to perform an investigation into a fraud perpetrated by a purchase ledger clerk.

You have ascertained the following.

The fraud came to light after another employee drew attention to the activities of the purchase ledger clerk Sam Seel. Initial investigations have identified that Sam had been paying money into his own bank account by raising false invoices and paying them through SL Ltd's purchase ledger. The fraud had gone undetected for an unknown amount of time because SL Ltd's controls only require invoices in excess of $1,000 to be authorised by a senior member of staff. Invoices below this amount are processed and authorised for payment by the relevant purchase ledger clerk.

SL Ltd is a very large company with revenue in excess of $100m and operates in the construction industry. Sam Seel joined the finance department nine months ago and has since been suspended from duties pending this investigation.

The Finance Director has requested that your firm perform such procedures as necessary to quantify the extent of the loss suffered by the business.

Required

(a) In the context of the ACCA's fundamental ethical principals what factors should you take into account before accepting this engagement?

(b) Assuming you accept the engagement what specific procedures would you perform to allow you to quantify the loss suffered by SL Ltd?

Solution

3 Chapter summary

- Auditors are increasingly being called upon to use their skills in forensic work.
- The work can involve **fraud investigations**, **evidence gathering** where an auditor is being sued for negligence or performing work for insurance companies to **verify customer claims**.
- Due to the nature of the work it is likely the forensic accountant will be called to a court of law as an **expert witness** and care must be taken to ensure that this function is fulfilled in the appropriate way.

END OF CHAPTER

15

Social and environmental auditing

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Discuss the increasing importance of policies that govern the relationship of an organisation to its employees, society and the environment.
- Describe the difficulties in measuring and reporting on economic, environmental and social performance and give examples of performance measures and sustainability indicators.
- Explain the auditor's main considerations in respect of social and environmental matters and how they impact on entities and their financial statements (e.g. the impairment of assets, provisions and contingent liabilities).
- Describe substantive procedures to detect potential misstatements in respect of socio-environmental matters.
- Discuss the form and content of an independent verification statement (e.g. on an environmental management system (EMS) and a report to society).

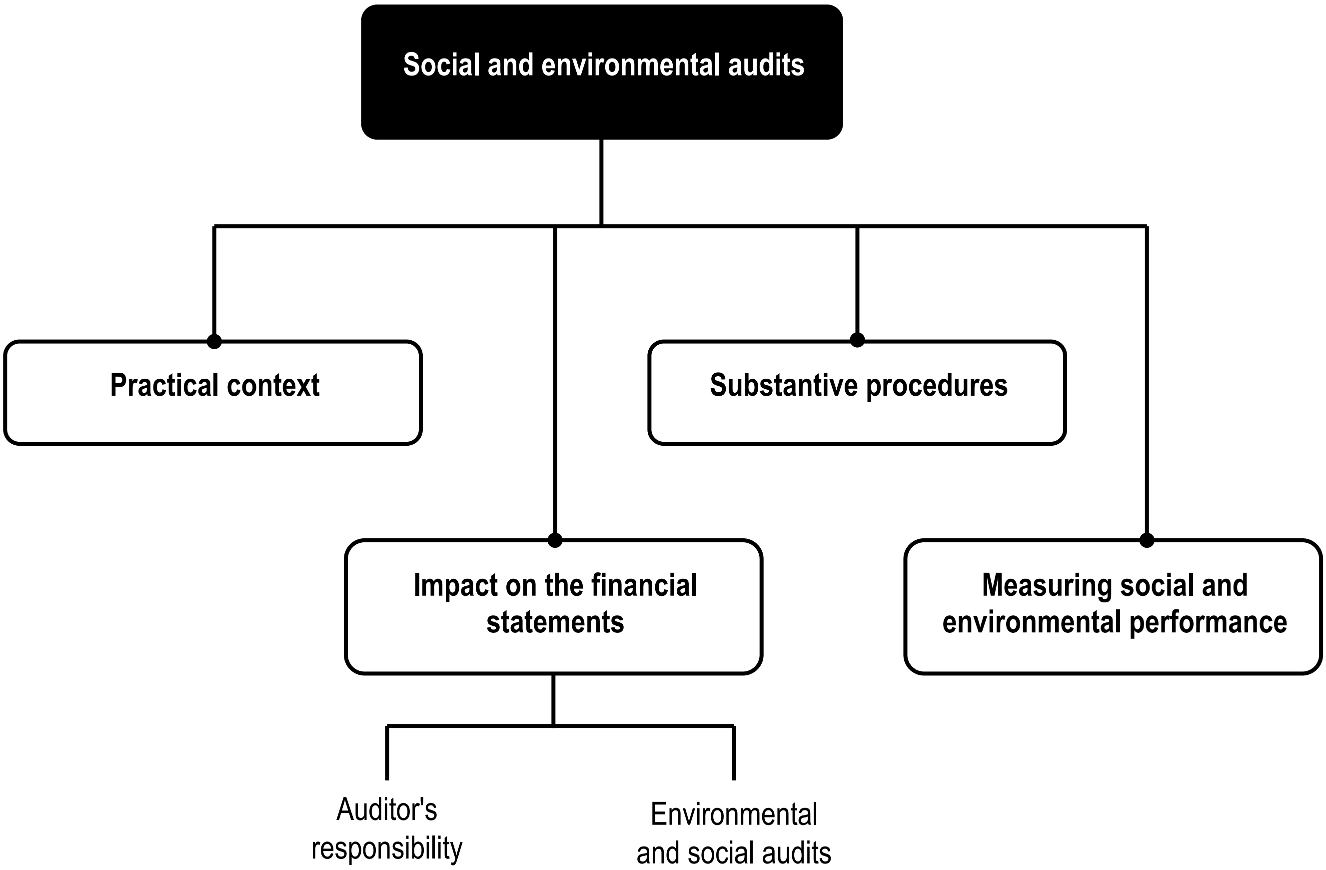
Exam Context

Questions on environmental issues could appear in the compulsory section of the exam, particularly in the context of business risk and/or performance indicators.

Business Context

Social and environmental issues are a critical issue for most audit clients in the modern world. The auditor must be aware of this in the context of risk assessment in the statutory audit as well as the opportunity it provides in terms of the provision of other assurance services.

Overview



Social and environmental audits
Practical context
Substantive procedures
Impact on the financial statements
Measuring social and environmental performance
Auditor's responsibility
Environmental and social audits

1 Practical context

Lecture example 1

Idea generation

The importance of social and environmental factors is increasingly recognised by the business community. Many businesses now have specific policies governing their relationship with their employees, society and the environment.

Required

What factors have led to the rapid growth in business awareness of these issues?

Solution

2 Impact on the financial statements

Question 24

2.1 Environmental issues cannot be ignored by external auditors. Potential impacts on the financial statements may arise from:

(a) the application of environmental laws and regulations;

(b) the operation of processes that may cause pollution or the use of hazardous substances;

(c) the holding of an interest in land and buildings that have been contaminated by previous occupants; or

(d) dependence on a major customer segment whose business is threatened by environmental pressures.

Auditor's responsibility

2.2 Auditors do not have a specific knowledge of environmental matters. However, in planning the audit, they should obtain sufficient knowledge of the business to understand the events, transactions and practices that may have a significant effect on the financial statements or the audit (ISA 250 *Laws and regulations*).

Environmental and social audits

2.3 Environmental audit has been defined as 'A management tool comprising a systematic, documented, periodic and objective evaluation of how well organisations, management and equipment are performing with the aim of contributing to safeguarding the environment by facilitating management control of environmental practices, and assessing compliance with company policies which would include meeting regulatory requirements and standards applicable'.

3 Substantive procedures

3.1 The auditor may perform substantive testing to obtain evidence in relation to environmental matters. Below are some suggested procedures from IAPS 1010 *The Consideration of environmental matters in the audit of financial statements*. It is not intended that all of the procedures will be appropriate in any particular case. In many cases, the auditor may judge it unnecessary to perform any of these procedures.

General

Documentary review

1 Consider minutes from meetings of directors, audit committees, or any other subcommittees of the board specifically responsible for environmental matters.

2 Consider publicly available information regarding any existing or possible future environmental matters.

3 Where relevant, consider:

(a) reports by environmental experts about the entity, such as site assessments, due diligence investigations or environmental impact studies;

(b) internal audit reports and other internal reports dealing with environmental matters;

(c) reports issued by, and correspondence with, regulatory and enforcement agencies;

(d) publicly available registers or plans for the restoration of soil contamination;

(e) environmental performance reports issued by the entity; and

(f) correspondence with the entity's lawyers.

4 Obtain written representations from management that it has considered the effects of environmental matters on the financial statements, and that it:

(a) is not aware of any material liabilities or contingencies arising from environmental matters, including those resulting from illegal or possibly illegal acts;

(b) is not aware of environmental matters that may result in a material impairment of assets; or

(c) if aware of such matters, has disclosed to the auditor all related facts.

Assets

Asset impairment

5 Enquire about any planned changes in capital assets, for example, in response to changes in environmental legislation or changes in business strategy and their impact on the valuation of those assets or the company as a whole.

6 For any asset impairments related to environmental matters that existed in previous periods, consider whether the assumptions underlying a write-down or related carrying values continue to be appropriate.

Liabilities, provisions and contingencies

Completeness

7 Enquire about policies and procedures operated to identify liabilities, provisions or contingencies arising from environmental matters.

8 Enquire about events or conditions that may give rise to liabilities, provisions or contingencies arising from environmental matters, for example

(a) Penalties or possible penalties arising from breaches of environmental laws and regulations; or

(b) Claims or possible claims for environmental damage.

9 For property abandoned, purchased, or closed during the period, enquire about requirements or intentions for site clean-up and restoration.

10 For property sold during the period and in prior periods, enquire about any liabilities relating to environmental matters retained by contract or by law.

Accounting estimates

11 For liabilities, provisions, or contingencies related to environmental matters, consider whether the assumptions underlying the estimates continue to be appropriate.

Disclosure

12 Review the adequacy of any disclosure of the effects of environmental matters on the financial statements.

4 Measuring social and environmental performance

4.1 As a result of the ideas discussed in Lecture example 1 stakeholders are demanding that businesses are accountable not just in a financial context but also in terms of social and environmental performance.

4.2 This presents challenges for businesses as very often the outputs that need to be measured are either difficult to measure (e.g. emissions of a pollutant) or intangible in nature (e.g. impact on the local community).

4.3 It is accepted that measuring social and environmental performance is difficult. The following types of measures may be used.

(a) Direct – for example, the number of kilos of contaminant emitted.

(b) Relative – data compared to another parameter. For example, kilos of contaminant/kilo of product.

(c) Indexed – measured over a period of time.

(d) Aggregated – information of the same type, but from different sources expressed as a combined value.

(e) Weighted – information modified by applying a factor relating to its significance.

4.4 Examples of specific indicators included in environmental and social reports on which the auditor may be asked to provide assurance include:

- toxic gas emissions
- energy use
- waste reduction
- average wage levels vs minimum wage
- job satisfaction levels
- job retention levels
- customer complaints
- financial assistance to charitable organisations.

Real World example in Course Companion

4.5 Given the demand for accountability from consumers, investors and staff many businesses now produce social and environmental information as part of the annual report.

4.6 This represents an opportunity for auditors to provide assurance on social and environmental reports and this is currently a growth area for many audit firms. We should also consider why the business would want to engage the auditor in this capacity.

Lecture example 2

Idea generation

Required

(a) What are the perceived benefits from an entity's point of view of paying for assurance on its environmental and social report?

(b) What would you expect to be the key contents of the assurance report?

Solution

5 Chapter summary

- Social and environmental issues are now of **critical importance** to the vast majority of businesses and cannot be ignored.
- The auditor must have an understanding of the **impact** of these issues **on** the **financial statements**, as social and environmental issues can generate significant audit risks.
- The auditor should respond to any specific risks identified with **substantive procedures**.
- Stakeholders are demanding accountability from businesses and increasingly businesses are responding by producing **social and environmental information** as part of the annual report.
- In many cases the auditor will provide **assurance** on this information.

END OF CHAPTER

16

Internal audit and outsourcing

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Compare the objectives and principal characteristics of internal audit with other assurance engagements.
- Compare and contrast operational and compliance audits.
- Justify a suitable approach (e.g. cyclical compliance) to specified multi-site operations.
- Discuss outsourcing internal audit services.
- Explain the different approaches to 'outsourcing' and compare with 'insourcing'.
- Discuss and conclude on the advantages and disadvantages of outsourcing finance and accounting functions including: data (transaction) processing, pensions, information technology (IT), internal auditing, due diligence work and taxes.
- Recognise and evaluate the impact of outsourced functions on the conduct of an audit.

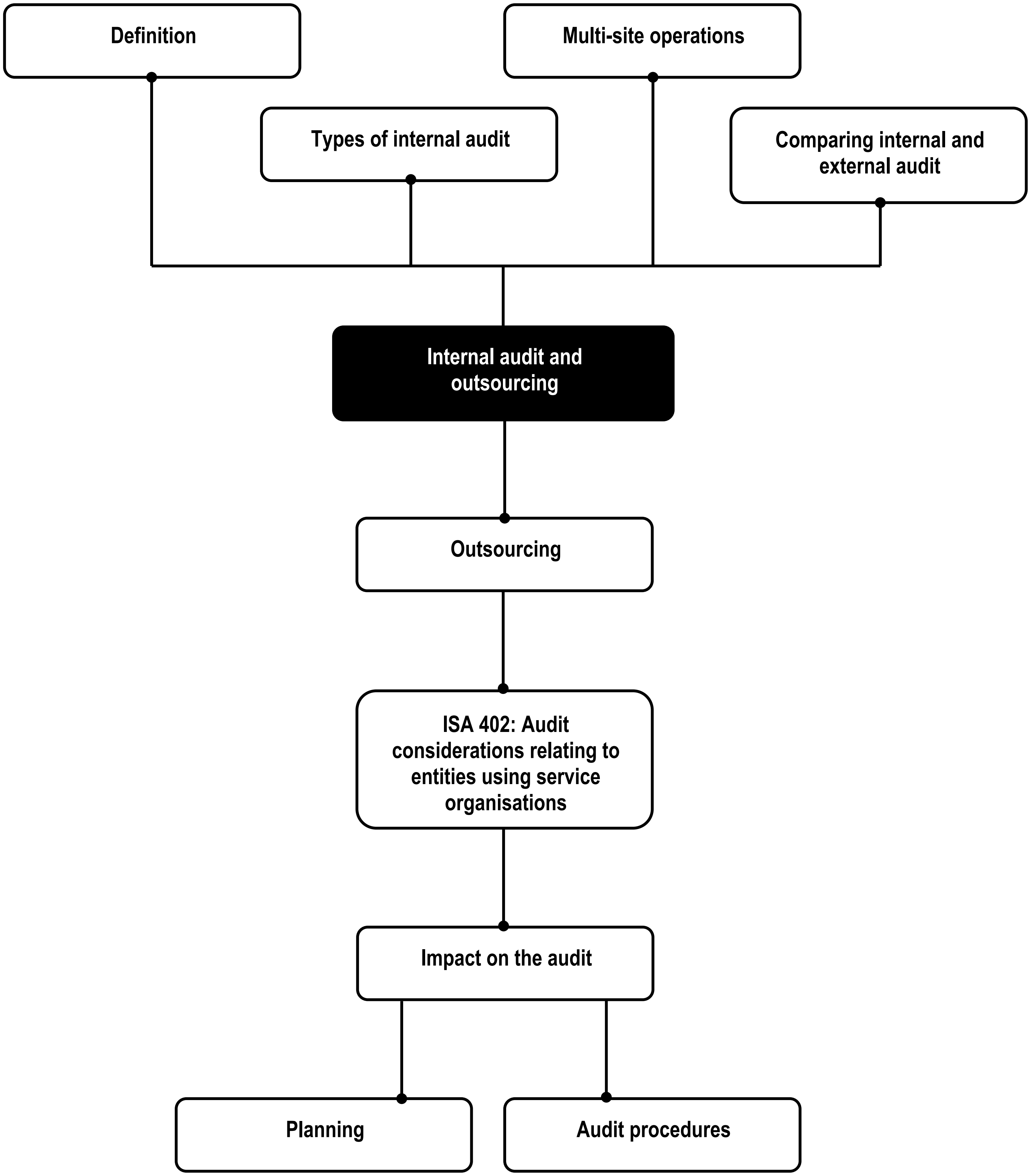
Exam Context

You should ensure you have a sound knowledge of the issues in this chapter as internal audit and outsourcing could appear in the exam in a variety of practical contexts.

Business Context

Both internal audit and outsourcing are issues for audit firms and their clients. The fact that more and more businesses are outsourcing non-core activities (such as internal audit) gives audit firms extra considerations in terms of audit risk as well as a possible source of extra revenue should they be approached by clients to perform the work; this in turn gives rise to ethical issues which must be considered.

Overview


Definition
Types of internal audit
Multi-site operations
Comparing internal and external audit
Internal audit and outsourcing
Outsourcing
ISA 402: Audit considerations relating to entities using service organisations
Impact on the audit
Planning
Audit procedures

1 Definition

Question 25

1.1 Internal audit is defined as "An appraisal activity established within an entity as a service to the entity. Its functions include, amongst other things, examining, evaluating and monitoring the adequacy and effectiveness of internal control".

2 Types of internal audit

There are numerous different types of audit that internal auditors can be involved in such as efficiency and effectiveness audits. For P7 the two most important are compliance and operational audits.

Compliance audits: Audit checks intended to determine whether the actions of employees are in accordance with company policy, laws and regulations.

Operational audits: Audits of the operational processes of the organisation to check not only compliance with controls, but also the effectiveness of controls as part of the risk management process.

3 Multi-site operations

An internal audit function is especially useful for large entities with dispersed operations that all operate the same, or similar, systems. With a multi-site operation the internal audit department will need to determine a suitable approach to planning visits to the different locations. The internal auditors can use one of two options (or a combination):

Cyclical: This approach is based on visiting all the sites within a given timeframe. For example, the internal auditors may wish to ensure that every site is visited at least once every three years.

Risk based: This alternative determines which branches are to be visited based on the risk attached to them.

4 Comparing internal and external audit

4.1 It is important that you can distinguish between the objectives and characteristics of internal audit as opposed to other assurance engagements. A good way to ensure you are comfortable here is to compare internal audit with external audit.

Lecture example 1

Idea generation

	External Audit	Internal Audit
Objectives		
Reports to…		
Status		
Qualifications		

5 Outsourcing

Chapter 16
Section 3

5.1 Outsourcing is the use of external suppliers as a source of finished products, components or services. It is also known as 'sub-contracting'.

5.2 The use of an external supplier in this way does not diminish the ultimate responsibility of the directors for conducting the business of the company.

5.3 Business functions that are commonly outsourced include, but are not limited to: payroll, information technology, accounting, recruitment and internal audit.

Lecture example 2

Exam standard for 5 marks

Required

What are the advantages and disadvantages to an entity of outsourcing its non-core functions?

Solution

6 ISA 402: Audit considerations relating to entities using service organisations

Definition

6.1 A client may use a service organisation such as one that executes transactions and maintains related accountability or records transactions and processes related data (eg a computer systems service organisation).

Other activities include:

- facilities management
- training
- maintenance or safe custody of assets.

6.2 Service organisations may undertake activities on a dedicated basis for one company, or on a shared basis, either for members of a single group of entities or for unrelated customers.

7 Impact on the audit

Planning

7.1 In obtaining an understanding of the entity and its environment, the auditor should determine the significance of service organisation activities to the entity and relevance to the audit, by considering:

(a) nature of services provided

(b) terms of contract and relationship between the entity and the service organisation

(c) extent to which the entity's accounting and internal control interact with the systems at the service organisation

(d) the entity's internal controls relevant to the service organisation activities

(e) service organisation's capability and financial strength, including the possible effect of the failure of the service organisation on the entity

(f) information about the service organisation such as that reflected in user and technical manuals

(g) information available on controls relevant to the service organisation's computer systems such as general IT controls and application controls.

Audit procedures

7.2 Where the service organisation's activities are significant, the auditor should obtain a sufficient understanding of the entity and its environment, including its internal control, to identify and assess the risks of material misstatement and design further audit procedures in response to the assessed risk.

If the understanding obtained is insufficient the auditor could:

- request that the service organisation have its auditor perform some such risk assessment procedures to supply the necessary information
- visit the organisation
- use a third-party report or auditor's report on the service organisation.

7.3 The auditor may also conclude that it would be efficient to obtain audit evidence from tests of controls. Audit evidence about the operating effectiveness of controls may be obtained by:

- performing tests of the entity's controls over activities of the service organisation
- obtaining a service organisation auditor's report that expresses an opinion as to the operating effectiveness of the service organisation's internal control for the activities relevant to the audit
- visiting the service organisation and performing tests of controls.

7.4 Where an auditor's report on a service organisation is used, the auditor should consider the scope of work performed, evaluate the usefulness and appropriateness of the report and make enquiries as to the professional competence of the auditor concerned.

7.5 Summary of procedures the auditor would normally perform.

(a) Inspect records and documents held by the company.

(b) Establish the effectiveness of controls.

(c) Obtain representations to confirm balances and transactions from the service organisation.

(d) Perform analytical review procedures on records maintained by the company or on returns received from the service organisation.

(e) Inspect records and documents held by the service organisation.

(f) Request the service organisation auditor or the company's internal auditors to perform specified procedures.

(g) Review information from the service organisation and its auditors concerning the design and performance of control systems.

8 Chapter summary

- It is seen as best practice for large entities to have an **internal audit** function, the work performed is varied and not prescribed but will often include **compliance and operational audits**.
- The skills used by internal auditors are very similar to those of external auditors but the two functions differ in their objectives and characteristics.
- **Outsourcing** is a common practice with many companies engaging service providers to perform non-core functions, for example **internal audit**, **payroll**, **recruitment** or **IT**.
- At the planning stage the external auditor should assess the impact outsourced activities may have on the audit and consider performing **additional procedures** to obtain sufficient appropriate evidence.

END OF CHAPTER

Reporting (International Stream)

17

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Critically appraise the form and content of a standard unmodified auditor's report.
- Recognise and evaluate the factors to be taken into account when forming an audit opinion in a given situation.
- Justify audit opinions that are consistent with the results of audit procedures relating to the sufficiency of audit evidence and/or compliance with accounting standards (including the going concern basis).
- Draft extracts suitable for inclusion in an audit report.
- Discuss the implications for the auditor's report on financial statements that report compliance with IFRS.
- Assess whether or not a proposed audit report is appropriate.
- Discuss a 'true and fair view'.
- Describe special purpose auditors' reports (e.g. on summary financial statements) and analyse how and why they differ from an auditor's report on historical financial information.
- Draft suitable content for a report to management, on the basis of given information, including statements of facts, their potential effects and appropriate recommendations for action.
- Critically assess the quality of a management letter.
- Advise on the content of reports to those charged with governance in a given situation.
- Explain the need for timely communication, clearance and follow up.
- Discuss the relative effectiveness of communication methods.

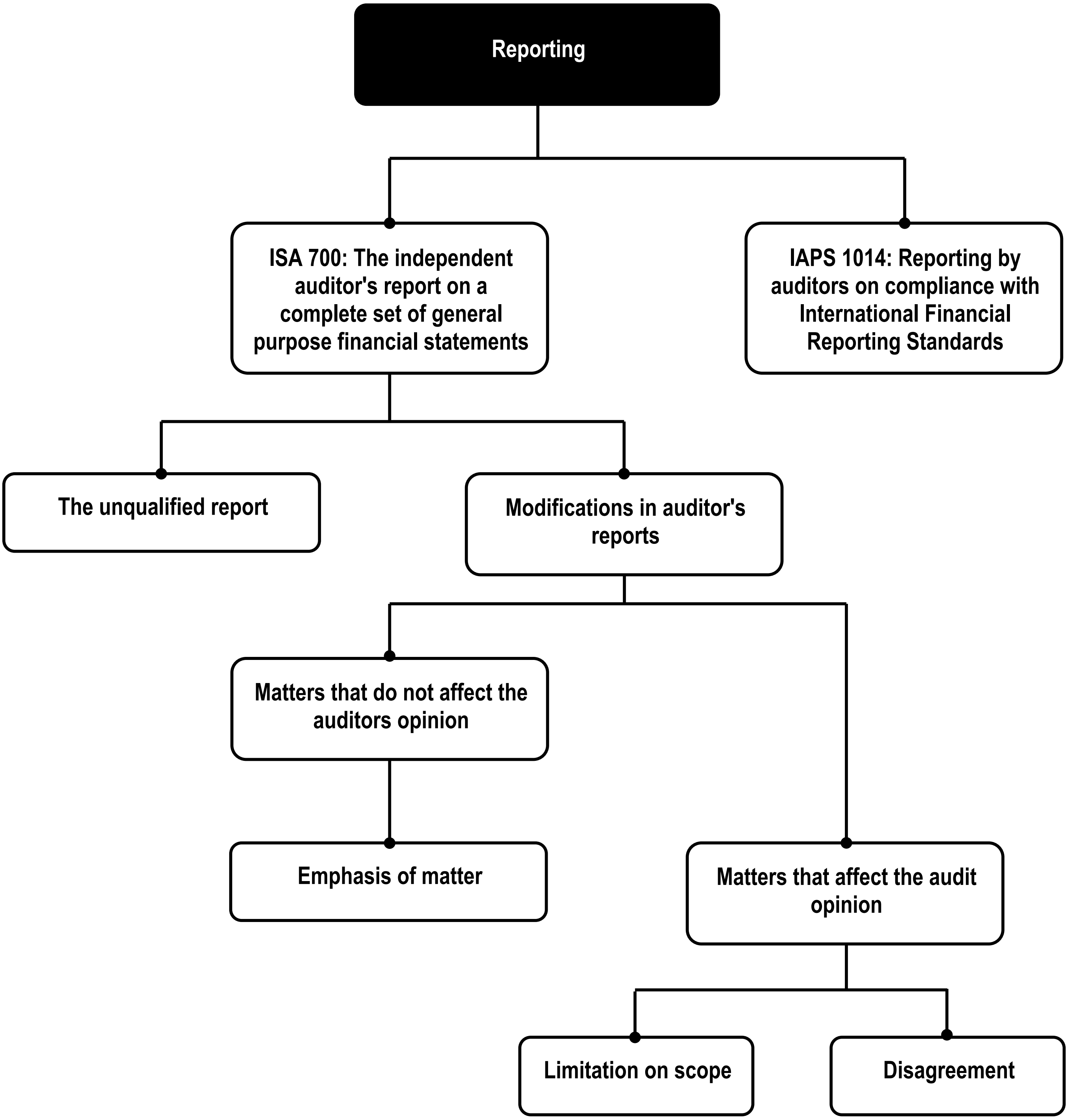
Exam Context

Audit reports are a very heavily examined area of the syllabus and are likely to appear in most exams. The optional section of the pilot paper contained a 20-mark question containing four short reporting scenarios.

Business Context

The audit report represents the only visible output produced by the audit firm. It is imperative that the opinion given is appropriate in the circumstances; as we have seen in Chapter 3 an incorrect opinion can have devastating consequences for the auditor.

Overview


Reporting
ISA 700: The independent auditor's report on a complete set of general purpose financial statements
IAPS 1014: Reporting by auditors on compliance with International Financial Reporting Standards
The unqualified report
Modifications in auditor's reports
Matters that do not affect the auditors opinion
Emphasis of matter
Matters that affect the audit opinion
Limitation on scope
Disagreement

1 ISA 700: the independent auditor's report on a complete set of general purpose financial statements

1.1 You will know from your previous studies that the primary objective of the audit is an expression of an opinion on the truth and fairness of the financial statements.

1.2 The format of the auditor's report is laid down in ISA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements*.

2 The unqualified report

2.1 **Example 1**

Unqualified report

INDEPENDENT AUDITOR'S REPORT

[Appropriate Addressee]

Report on the Financial Statements

We have audited the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management's Responsibility for the Financial Statements

Management is responsible for the preparation and fair presentation of these financial statements in accordance with International Financial Reporting Standards. This responsibility includes: designing, implementing and maintaining internal control relevant to the preparation and fair presentation of financial statements that are free from material misstatement, whether due to fraud or error; selecting and applying appropriate accounting policies; and making accounting estimates that are reasonable in the circumstances.

Auditor's Responsibility

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatement.

An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend of the auditor's judgement, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements.

We believe that the audit evidence we have obtained is sufficient and appropriate to provide a basis for our audit opinion.

Opinion

In our opinion, the financial statements give a true and fair view of *("or present fairly, in all material respects,")* the financial position of ABC Company as of December 31, 20X1, and of its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Report on Other Legal and Regulatory Requirements

[Form and content of this section of the auditor's report will vary depending on the nature of the auditor's other reporting responsibilities.]

[Auditor's signature]

[Date of the auditor's report]

[Auditor's address]

2.2 An **unqualified opinion should** be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework.

Forming an opinion includes considering whether, in the context of the applicable financial reporting framework:

(a) the accounting policies selected and applied are consistent with the financial reporting framework and appropriate to the circumstances;

(b) the accounting estimates made by management are reasonable in the circumstances;

(c) the information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and

(d) the financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements.

2.3 Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.

Lecture example 1

Idea generation

ISA 700 prescribes a standard format for auditors’ reports.

Required

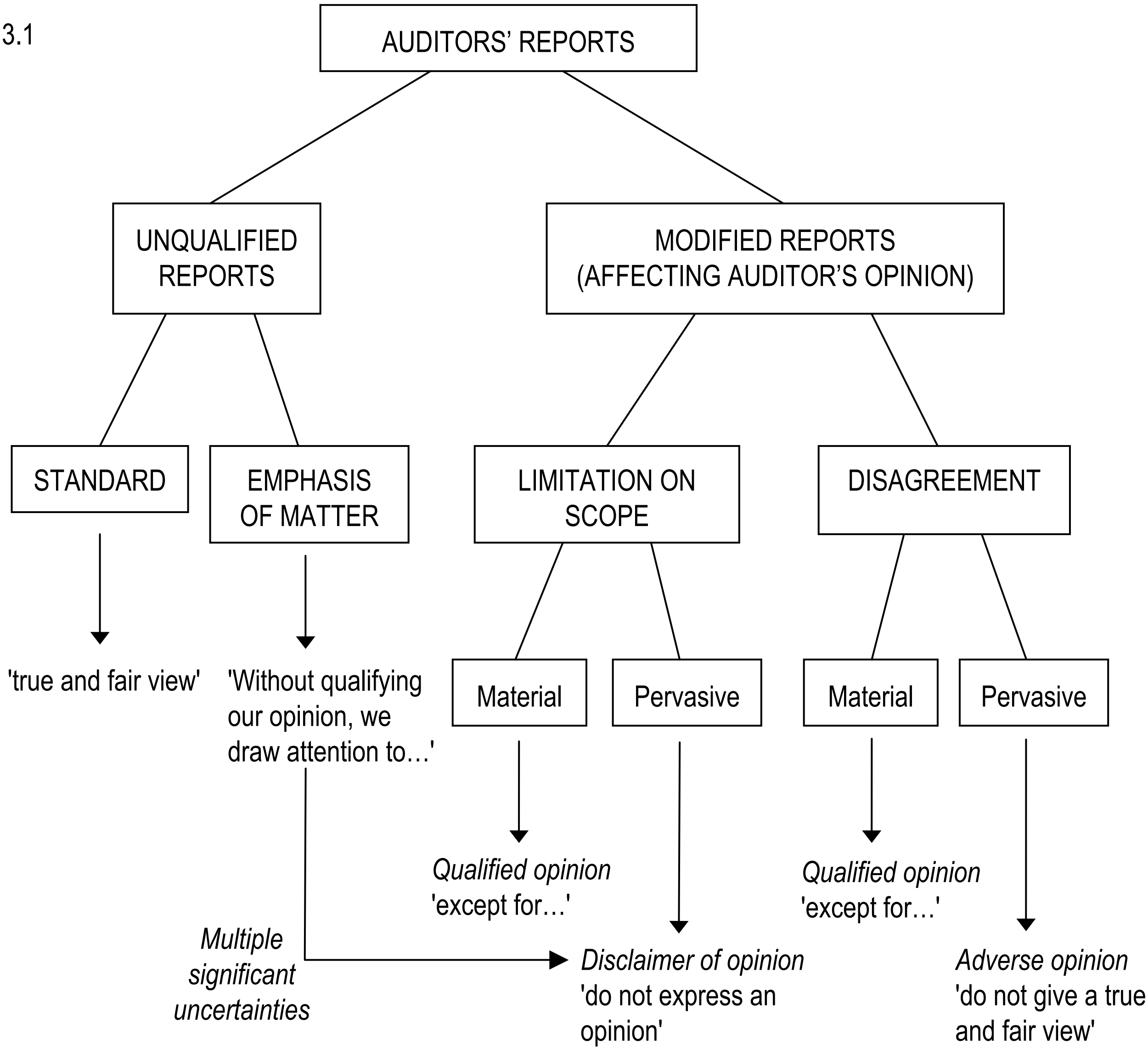
What are the pros and cons of having a standardised format?

Solution

3 Modifications in auditors' reports (ISA 700)

Summary diagram

3.1



4 Matters that do not affect the auditor's opinion

Emphasis of matter

4.1 This emphasis of matter paragraph may be used in two main circumstances:

(a) to highlight a material matter regarding a going concern problem

(b) if there is significant uncertainty (other than a going concern problem) which may affect the financial statements on its future resolution

It is also used in other specific circumstances, e.g. where a prior year report modification relating to the current year's corresponding figures has been resolved, but is material to the current period.

The additional paragraph should be added *after* the opinion paragraph. This paragraph will start by stating 'Without qualifying our opinion…' It will then go on to describe the issue and make a reference to the note in the financial statements which explains the issue further.

4.2 Note, this does *not* change the auditor's opinion – it is still unqualified. It merely serves to highlight something significant, that may, or may not affect the company in the future.

4.3 Where there are many uncertainties the auditor may feel it is appropriate to express a disclaimer of opinion instead.

Example 2

Unqualified opinion with emphasis of matter paragraph for a significant uncertainty

"In our opinion … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above)

Without qualifying our opinion we draw attention to Note X to the financial statements. The company is the defendant in lawsuit alleging infringement of certain patent rights and claiming royalties and punitive damages. The Company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements."

5 Matters that affect the auditor's opinion

Limitation on scope

5.1 A limitation on the scope of the auditor's work may occur in three ways.

(a) The entity does not allow the auditor to perform an audit procedure that he believes is necessary;

(b) The auditor is unable to perform procedures due to circumstances, e.g. when the auditor is appointed too late to attend the inventory count; or

(c) The entity's records are inadequate and the auditor is unable to satisfy himself as to their accuracy by other means.

5.2 The auditor's report should include an explanatory paragraph *before* the opinion paragraph covering:

(a) a description of the limitation; and

(b) an indication of the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Example 3

Qualified opinion: material limitation on scope

"We have audited … (remaining words are the same as illustrated in the introductory paragraph – Example 1 above).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to express an opinion on these financial statements based in our audit. *Except as discussed in the following paragraph,* we conducted our audit in accordance with … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – Example 1 above).

We did not observe the counting of the physical inventories as of December 31, 20X1, since that date was prior to the time we were initially engaged as auditors for the Company. Owing to the nature of the Company's records, we were unable to satisfy ourselves as to inventory quantities by other audit procedures.

In our opinion, *except for the effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical inventory quantities,* the financial statements give a true and fair view of … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above)."

Example 4

Disclaimer of opinion: pervasive limitation on scope

"We were engaged to audit the accompanying financial statements of ABC Company, which comprise the balance sheet as at December 31, 20X1, and the income statement, statement of changes in equity and cash flow statement for the year then ended, and a summary of the significant accounting policies and other explanatory notes.

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

(Omit the sentence stating the responsibility of the auditor.)

(The paragraph discussing the scope of the audit would either be omitted or amended according to the circumstances.)

(Add a paragraph discussing the scope of limitation as follows:

We were not able to observe all physical inventories and confirm accounts receivable due to limitations placed on the scope of our work by the Company.)

Because of the significance of the matters discussed in the preceding paragraph, we do not express an opinion on the financial statements."

Disagreement

5.3 The auditor may disagree with management about matters such as:

(a) the acceptability of accounting policies
(b) the application of those policies
(c) the adequacy of disclosures

5.4 An explanatory paragraph should be added *before* the opinion paragraph covering:

(a) description of the disagreement
(b) quantification of the effect on the financial statements.

Example 5

Qualified opinion: disagreement on accounting policies – inappropriate accounting method

> "We have audited … (remaining words are the same as illustrated in the introductory paragraph – Example 1 above).
>
> Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).
>
> Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – Example 1 above).
>
> *As discussed in Note X to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards. The provision for the year ended December 31, 20X1, should be xxx based on the straight-line method of depreciation using annual rates of 5% for the building and 20% for the equipment. Accordingly, the non-current assets should be reduced by accumulated depreciation of xxx and the loss for the year and accumulated deficit should be increased by xxx and xxx, respectively.*
>
> In our opinion, *except for the effect on the financial statements of the matter referred to in the preceding paragraph,* the financial statements give a true and fair view of …(remaining words are the same as illustrated in the opinion paragraph – Example 1 above)."

Example 6

Qualified opinion: disagreement on accounting policies – inadequate disclosure

"We have audited … (remaining words are the same as illustrated in the introductory paragraph – Example 1 above).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – Example 1 above).

On January 15, 20X2, the company issued debentures in the amount of xxx for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after December 31, 20X1. In our opinion, disclosure of this information is required by …

In our opinion, *except for the omission of the information included in the preceding paragraph,* the financial statements give a true and fair view of … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above)."

Example 7

Adverse opinion

"We have audited … (remaining words are the same as illustrated in the introductory paragraph – Example 1 above).

Management is responsible for … (remaining words are the same as illustrated in the management's responsibility paragraph – Example 1 above).

Our responsibility is to … (remaining words are the same as illustrated in the auditor's responsibility paragraphs – Example 1 above).

(Paragraph(s) discussing the disagreement.)

In our opinion, *because of the effects of the matters discussed in the preceding paragraph(s), the financial statements do not give a true and fair view of (or do not 'present fairly, in all material respects,') the financial position of ABC Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards."*

Lecture example 2

Exam standard for 10 marks

You are an audit partner. Your firm carries out the audit of Santa, a listed company. Because the company is listed, you have been asked to perform a second partner review of the audit file for the year ended 31 December 20X3 before the audit opinion is finalised. Reported profit before tax is $2.35 million and total assets are $9.5 million.

You have read the following note from the audit file.

'Debt: Rudolph

There is a debt outstanding from Rudolph, a limited liability company from January 20X3 in respect of a vehicle developed by Santa to Rudolph's own specification. Rudolph has disputed the quality of the vehicle and also does not agree that it was made completely to the specification. The company has submitted the dispute with Santa to arbitration, in accordance with their contractual agreement. Rudolph was a major customer up until the time of the dispute, often accounting for 50% of sales ledger total. It has not placed any orders with Santa in 20X3 or 20X4, preferring a French supplier who is Santa's only real competitor in the European market.

The directors of Santa are confident that at arbitration Rudolph will be required to pay the full bill, which is in the region of $1 million. They state that the quality of the machine is irrefutable and that any amendments to the specification were only safety improvements. The arbitral decision, which is not subject to appeal, is expected after the date of the AGM. Given their confidence, the directors of Santa have refused to refer to the dispute in the financial statements.

Given that the outcome of this arbitration is by no means certain, the potential overstatement of the debt is material and the permanent loss of Rudolph's custom could affect the going concern opinion, the following modification to the auditor's report is proposed.

Disagreement on Accounting Policies – Inappropriate Accounting Method – Adverse opinion

No allowance has currently been made for the impairment of an outstanding debt from Rudolph in respect of a dispute over a contract which has currently been submitted to arbitration, which, in our opinion is not in accordance with International Financial Reporting Standards. A allowance of $1 million should be made in respect of this debt. Accordingly, receivables, profit for the period and retained earnings should be reduced by $1 million. Also, due to its significance, this allowance should have been disclosed separately in accordance with IAS 1 *Presentation of Financial Statements*.

In our opinion, because of the effects of the matters discussed in the preceding paragraph, the financial statements do not give a true and fair view of the financial position of Rudolph Company as of December 31, 20X3, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.'

Required

Comment on the suitability of the proposed audit opinion and any other relevant matters. Your comments should include an indication of what form the auditor's report should take.

Solution

6 IAPS 1014: Reporting by auditors on compliance with International Financial Reporting Standards

6.1 IAPS 1014 supplements ISA 700 *The independent auditor's report on a complete set of general purpose financial statements* in cases where financial statements are prepared under IFRSs.

It covers opinions of financial statements asserted to be prepared:

- solely in accordance with IFRSs
- in accordance with IFRSs and a national financial reporting framework
- in accordance a national financial reporting framework with disclosure of the extent of compliance with IFRSs.

6.2 Additionally, the IAASB has produced a set of questions and answers (*First-time Adoption of IFRS – Guidance for Auditors on Reporting Issues*) to assist auditors reporting on an entity's first IFRS financial statements.

Financial statements prepared solely in accordance with IFRSs

6.3 For an unqualified opinion to be expressed, the financial statements must be fully IFRS compliant. The IAPS gives example of situations where this is not the case, e.g. where a note states that the financial statements are prepared in accordance with IFRS, but then goes on to specify certain material departures.

6.4 A qualified/adverse or disclaimer of opinion would be necessary if the financial statements contain any material departure from IFRS.

Financial statements prepared in accordance with IFRS and a national reporting framework

6.5 For financial statements to have been prepared in accordance with more than one financial reporting framework, they must comply with each of the indicated frameworks individually. A set of financial statements prepared in accordance with one framework containing a note or supplementary statement reconciling the financial statements to the other is not sufficient.

In practice, simultaneous compliance with both IFRSs and a national financial reporting framework is unlikely unless the country has adopted IFRSs as its national framework.

6.6 The auditor considers each framework separately. It is therefore possible to express an unqualified opinion on compliance with one framework and a qualified/adverse opinion on compliance with the other.

Additionally, it may be possible for non-compliance with one financial reporting framework to cause failure to comply with the other financial reporting framework, in which case a modified opinion would be issued on compliance with both frameworks.

6.7 *Illustrative modified auditor's opinion:*

> Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and International Financial Reporting Standards. As discussed in Note Y to the financial statements, the Company has investment properties in the amount of $X that are carried at cost less accumulated depreciation. This accounting is required by [relevant national financial reporting framework] and permitted by International Financial Reporting Standards. The fair value of these investment properties of $X has not been disclosed. Such disclosure is not required by [relevant national financial reporting framework], but is required by International Financial Reporting Standards.
>
> In our opinion, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with [title of national financial reporting framework with reference to the country of origin] (and comply with [refer to relevant statutes or law]), **and**, *except for the effect on the financial statements of the matter referred to in the preceding paragraph*, the financial statements give a true and fair view of (or 'present fairly, in all material respects,') the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Financial statements prepared in accordance with a national financial reporting framework with disclosure of the extent of compliance with IFRS

6.8 Financial statements prepared in accordance with a national financial reporting framework may disclose the extent to which they comply with IFRSs.

A note containing disclosure about compliance with IFRS is treated no differently to any other note as it contains management assertions on which the auditor can obtain sufficient appropriate evidence.

6.9 A qualified or adverse opinion is expressed if the auditor concludes that the note contains misleading information such that the financial statements fail to comply with the entity's national financial reporting framework, e.g. because it contains materially inaccurate information or incomplete information that is material and pervasive to the financial statements.

6.10 *Illustrative modified auditor's opinion:*

> Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and are substantially in accordance with International Financial Reporting Standards (IFRSs) except that they do not comply with IAS 39, *Financial Instruments: Recognition and Measurement*. Because of the effect on the Company's financial statements of non-compliance with IAS 39 is material and pervasive, the reference to compliance with IFRSs is misleading.
>
> In our opinion, *except for the inclusion of the reference to compliance with IFRSs*, the financial statements give a true and fair view of (or 'present fairly in all material respects') the financial position of the Company as of December 31, 20X1, and of its financial performance and its cash flows for the year then ended in accordance with [title of national financial reporting framework with reference to the country of origin] (and comply with [refer to relevant statutes or law]).

6.11 If the auditor concludes that the note containing disclosure about compliance with IFRS is not misleading, in certain circumstances, an emphasis of matter paragraph may be added to highlight it.

This is not a substitute for issuing a qualified or adverse opinion on compliance with the national financial reporting framework when disclosures as to compliance with IFRS are misleading such that they fail to comply with that framework.

7 Chapter summary

- Auditors' reports are the only tangible output produced by the auditor; it is therefore very important that the opinion expressed is appropriate in the circumstances.
- It is very important that you are able to understand the **different type and degrees of modifications** that can be made to the standard audit report.
- In situations where there is a **significant uncertainty** affecting the financial statements but this has been **adequately disclosed** in the accounts the auditor may consider including an **emphasis of matter paragraph** after an **unqualified** opinion.
- In situations where the auditors consider the directors' **accounting treatment or disclosures** are **inappropriate or inadequate** a **disagreement** modification will be issued, depending on the magnitude of the problem this will be either a material (**except for…**) or pervasive (**adverse**) modification.
- In situations where the auditors have been **unable to gather sufficient appropriate evidence** in respect of items in the financial statements a **limitation on scope** modification will be issued, depending on the magnitude of the problem this will be either a material (**except for…**) or pervasive (**disclaimer**) modification.

Additional Notes

8 IAASB Staff paper: financial reporting on the Internet (August 2002)

8.1 The IFAC staff paper deals with the use of the Internet to provide financial information about an enterprise through that enterprise's corporate website.

It describes control considerations when an enterprise uses the Internet for communicating with investors, creditors, analysts and other interested users, and how management might implement such controls.

It is intended to provide guidance for enterprises that choose to supplement their paper reporting with reporting on their corporate website and raises issues that need to be considered to ensure the financial information on the enterprise's corporate website has the same integrity as that published in paper form.

Responsibilities of directors and management

8.2 The paper highlights the need for a published policy to enable a consistent approach to the provision of financial information on the enterprise's website.

The policy should cover:

(i) the type of information to be provided
(ii) the involvement of the auditor
(iii) in what format the information will be provided
(iv) when the information will be provided
(v) the approvals necessary before information is provided.

8.3 Management should address the following control issues in developing the policy:

(i) Authority of information
(ii) Security of information
(iii) Enterprise contact details.

Other relevant matters

8.4 Management should implement procedures to ensure access to the auditor's report.

Other financial information made available should be reconciled to amounts reported in the financial statements.

Management should clearly identify which information has been audited.

9 Reports on summarised financial statements

Introduction

9.1 Listed companies may in certain circumstances send summary financial statements to their shareholders instead of full statutory financial statements. The summary financial statements must be derived from the annual accounts.

9.2 The auditor is required to give an opinion as to whether the summary financial statements are consistent with the annual accounts and directors' report and comply with the relevant sections of the Companies Act.

9.3 The auditor must also state whether the report on the annual accounts was qualified or unqualified.

9.4 There is no requirement to form an opinion on the truth and fairness of the summary financial statements.

Scope and timing of work

9.5 Usually the work performed on the full financial statements, coupled with a review of the summary financial statements, will be sufficient to enable the auditor to make the required statements.

9.6 The work on the summary financial statements should normally be carried out at the same time as the completion of the audit of the annual accounts.

Inconsistency

9.7 Inconsistency may result where:

(a) the information in the summary financial statements has been inaccurately extracted from the annual financial statements

(b) headings have been used which are incompatible with the statutory headings in the full accounts

(c) information has been included which in the auditor's opinion has been summarised in a manner that is not consistent with the annual financial statements.

(d) information has been omitted which the auditor believes should be included in the summary financial statements.

9.8 Any inconsistencies should be discussed with the management. They should be asked to remove the inconsistency by amending the summarised financial statements.

Examples of auditors' statements

9.9 **Unqualified**

An example of an unqualified statement is as follows:

> Auditor's statement to the members of ……………………
>
> In our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

9.10 Qualified

A qualified statement will arise where there is an inconsistency between the summarised financial statements and the annual statements or all information required by the Act has not been given.

(a) **Information not disclosed**

> Auditor's statement to the members of ……………………
>
> The summary financial statements do not disclose net interest payable of $6 million as required by the Companies (Summary Financial Statements) Regulations 1990.
>
> Except for the non disclosure of net interest payable, in our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

(b) **Inconsistency with the annual financial statements**

> Auditor's statement to the members of ……………………
>
> The summary financial statements include in the figure for revenue the share of revenue of associated companies attributable to the company's interests which amounts to $50 million. In the annual financial statements this amount is not included in the total revenue shown in the income statement.
>
> Except for the matter referred to above, in our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

END OF CHAPTER

17

Reporting (UK Stream)

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Critically appraise the form and content of a standard unmodified auditor's report.
- Recognise and evaluate the factors to be taken into account when forming an audit opinion in a given situation.
- Justify audit opinions that are consistent with the results of audit procedures relating to the sufficiency of audit evidence and/or compliance with accounting standards (including the going concern basis).
- Draft extracts suitable for inclusion in an audit report.
- Discuss the implications for the auditor's report on financial statements that report compliance with IFRS.
- Assess whether or not a proposed audit report is appropriate.
- Discuss a 'true and fair view'.
- Describe special purpose auditors' reports (e.g. on summary financial statements) and analyse how and why they differ from an auditor's report on historical financial information.
- Draft suitable content for a report to management, on the basis of given information, including statements of facts, their potential effects and appropriate recommendations for action.
- Critically assess the quality of a management letter.
- Advise on the content of reports to those charged with governance in a given situation.
- Explain the need for timely communication, clearance and follow up.
- Discuss the relative effectiveness of communication methods.

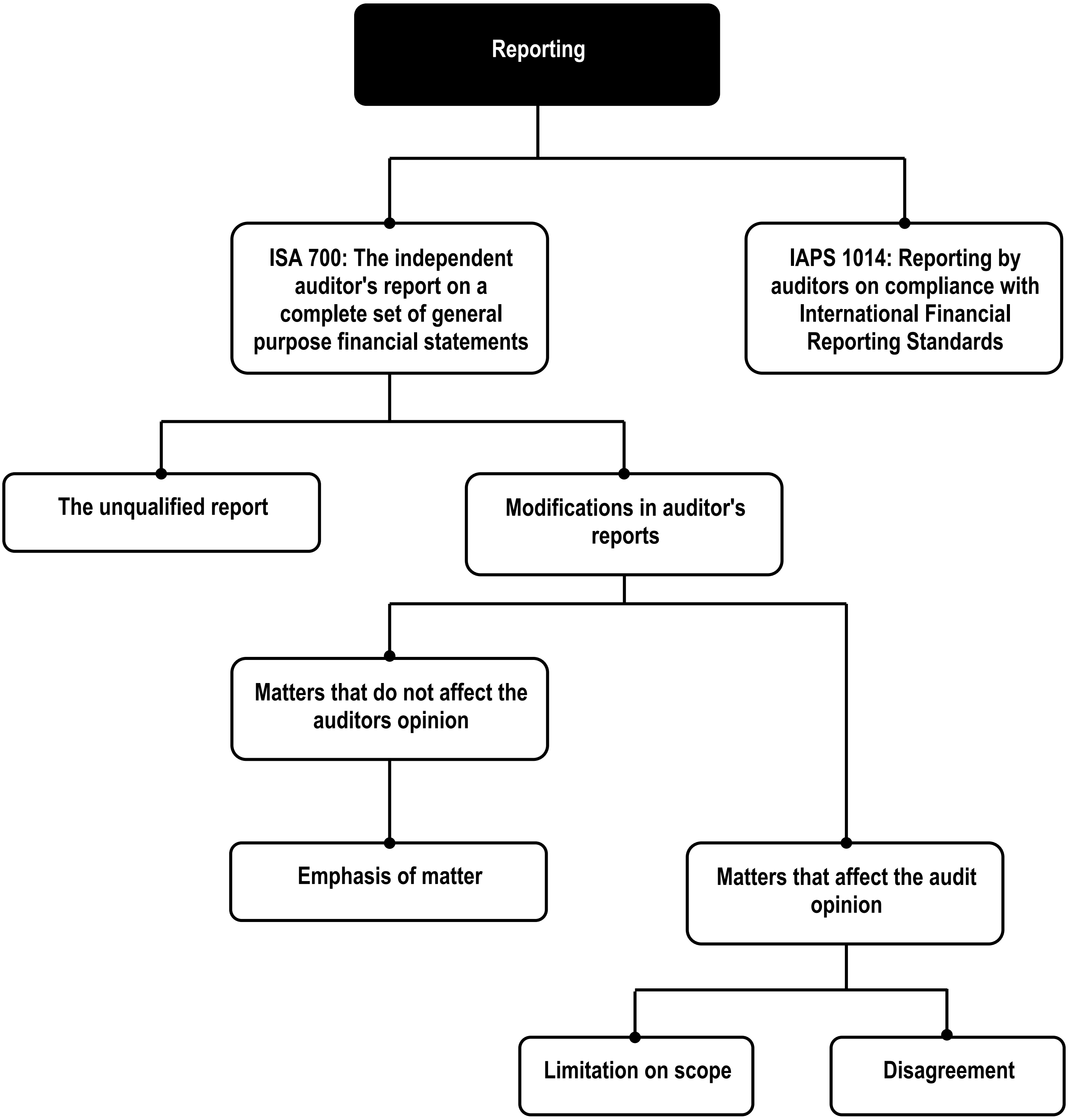
Exam Context

Audit reports are a very heavily examined area of the syllabus and are likely to appear in most exams. The optional section of the pilot paper contained a 20-mark question containing four short reporting scenarios.

Business Context

The audit report represents the only visible output produced by the audit firm. It is imperative that the opinion given is appropriate in the circumstances, as we have seen in Chapter 3 an incorrect opinion can have devastating consequences for the auditor.

Overview


Reporting
ISA 700: The independent auditor's report on a complete set of general purpose financial statements
IAPS 1014: Reporting by auditors on compliance with International Financial Reporting Standards
The unqualified report
Modifications in auditor's reports
Matters that do not affect the auditors opinion
Emphasis of matter
Matters that affect the audit opinion
Limitation on scope
Disagreement

1 ISA 700: Independent auditor's report on a complete set of general purpose financial statements

1.1 You will know from your previous studies that the primary objective of the audit is an expression of an opinion on the truth and fairness of the financial statements.

1.2 The format of the auditor's report is laid down in ISA 700 *The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements* supplemented by APB Bulletin 2006/6 – see sample reports on following pages.

2 The unqualified report

2.1 **Example 1**

Unqualified report

INDEPENDENT AUDITORS' REPORT TO THE SHAREHOLDERS OF XYZ LIMITED

We have audited the financial statements of XYZ Limited for the year ended 31 December 20X1 which comprise [state the primary financial statements such as the Profit and Loss Account, the Balance Sheet, the Cash Flow Statement, the Statement of Total Recognised Gains and Losses] and the related notes. These financial statements have been prepared under the accounting policies set out therein.

Respective responsibilities of directors and auditors

The directors' responsibilities for preparing the Annual Report and the financial statements in accordance with applicable law and the United Kingdom Accounting Standards (United Kingdom Generally Accepted Accounting Practice) are set out in the Statement of Directors' Responsibilities.

Our responsibility is to audit the financial statements in accordance with relevant legal and regulatory requirements and International Standards on Auditing (UK and Ireland).

We report to you our opinion as to whether the financial statements give a true and fair view and are properly prepared in accordance with the Companies Act 1985. We also report to you whether in our opinion, the Directors' Report is consistent with the financial statements. [The information given in the Directors' Report includes that specific information presented in the Operating and Financial review that is cross referred from the Business Review section of the Directors' Report.]

In addition we report to you if, in our opinion the company has not kept proper accounting records, if we have not received all the information and explanations we require for our audit, or if information specified by law regarding directors' remuneration and other transactions is not disclosed.

We read other information contained in the Annual Report, and consider whether it is consistent with the audited financial statements. This other information comprises only [the Directors' Report, the Chairman's Statement and the Operating and Financial Review]. We consider the implications for our report if we become aware of any apparent misstatements or material inconsistencies with the financial statements. Our responsibilities do not extend to any other information.

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board. An audit includes examination, on a test basis, of evidence relevant to the amounts and disclosures in the financial statements. It also includes an assessment of the significant estimates and judgments made by the directors in the preparation of the financial statements, and of whether the accounting policies are appropriate to the company's circumstances, consistently applied and adequately disclosed.

We planned and performed our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion

In our opinion the financial statements:

- give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 20X1 and of its profit [loss] for the year then ended; and
- have been properly prepared in accordance with the Companies Act 1985.
- The information given in the Directors' Report is consistent with the financial statements.

Registered auditors *Address*
Date

2.2 An **unqualified opinion should** be expressed when the auditor concludes that the financial statements give a true and fair view (or are presented fairly, in all material respects) in accordance with the applicable financial reporting framework.

Forming an opinion includes considering whether, in the context of the applicable financial reporting framework:

(a) the accounting policies selected and applied are consistent with the financial reporting framework and appropriate to the circumstances;

(b) the accounting estimates made by management are reasonable in the circumstances;

(c) the information presented in the financial statements, including accounting policies, is relevant, reliable, comparable and understandable; and

(d) the financial statements provide sufficient disclosures to enable users to understand the effect of material transactions and events on the information conveyed in the financial statements.

2.3 Under the Companies Act 1985 (SI 1011, 2005 revisions) the auditor must state in the auditor's report whether the information in the directors' report is consistent with the annual accounts.

2.4 In addition, the auditor must report by exception (section 237) where any of the following are not the case:

- **R**eturns adequate for the audit have been received from branches not visited
- **A**ccounts agree with the accounting records
- **P**roper accounting records have been kept
- all **I**nformation and explanations which are necessary have been received
- **D**irectors' emoluments and benefits in the remuneration report agree to the accounting records.

2.5 Where IFRSs are not used as the financial reporting framework, the reference to the financial reporting framework in the wording of the opinion should identify the jurisdiction or country of origin of the financial reporting framework.

Lecture example 1

Idea generation

ISA 700 prescribes a standard format for auditors' reports.

Required

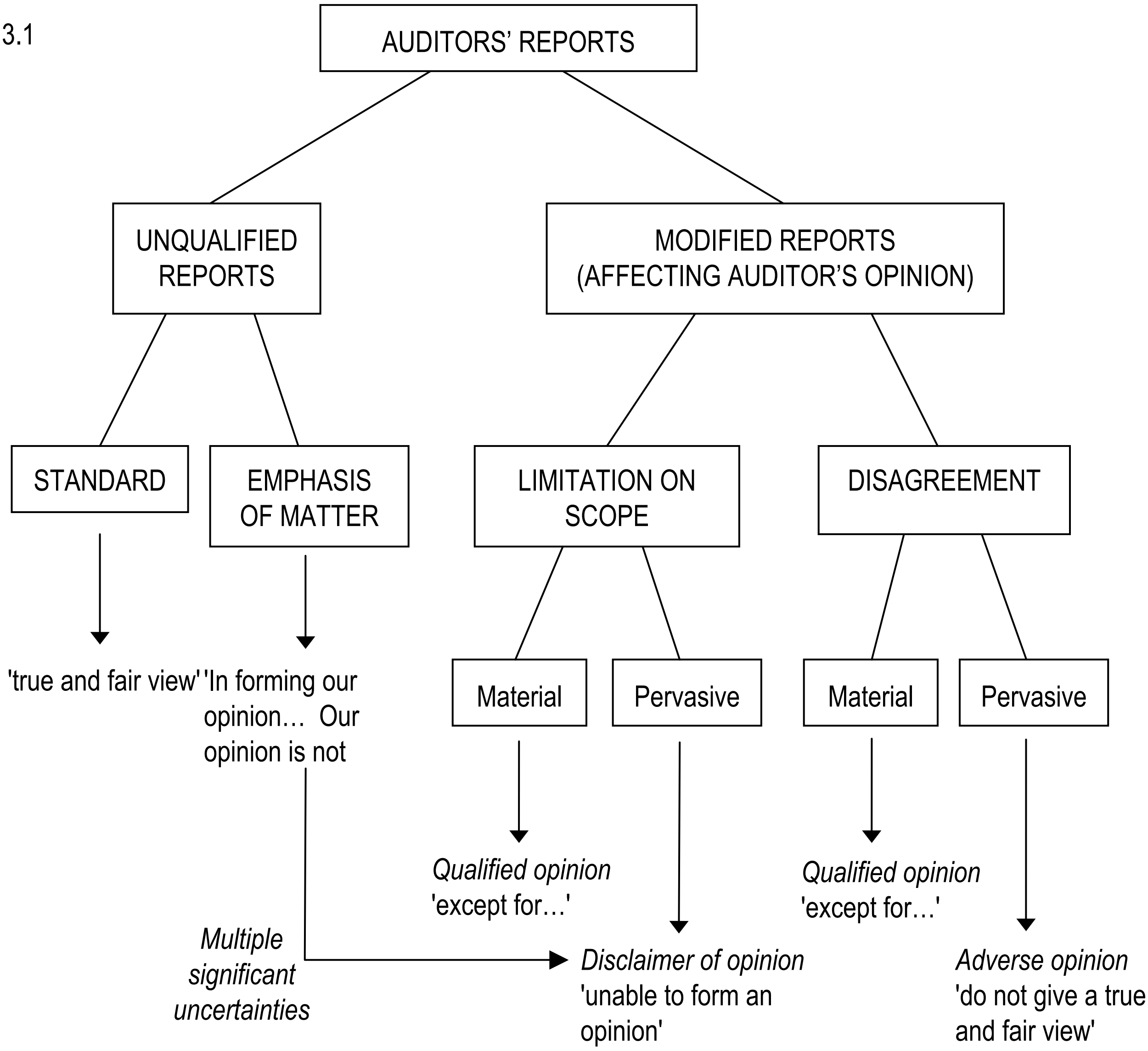
What are the pros and cons of having a standardised format?

Solution

3 Modifications in auditors reports

Summary diagram

3.1



4 Matters that do not affect the auditors opinion

Emphasis of matter

4.1 This emphasis of matter paragraph may be used in two main circumstances:

(a) to highlight a material matter regarding a going concern problem

(b) if there is significant uncertainty (other than a going concern problem) which may affect the financial statements on its future resolution

It is also used in other specific circumstances, e.g. where a prior year report modification relating to the current year's corresponding figures has been resolved, but is material to the current period.

The additional paragraph should be added *after* the opinion paragraph. The paragraph will start by stating 'In forming our opinion, which is not qualified, ….'. It will then go on to describe the issue and make a reference to the note in the financial statements which explains the issue further.

4.2 Note, this does *not* change the auditor's opinion – it is still unqualified. It merely serves to highlight something significant, that may, or may not affect the company in the future.

4.3 Where there are many uncertainties the auditor may feel it is appropriate to express a disclaimer of opinion instead.

Example 2

Unqualified opinion with emphasis of matter paragraph for a significant uncertainty

Opinion

In our opinion: … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above).

Emphasis of matter – possible outcome of a lawsuit

In forming our opinion, which is not qualified, we have considered the adequacy of the disclosures made in note to the financial statements concerning the possible outcome of a lawsuit, alleging infringement of certain patent rights and claiming royalties and punitive damages, where the company is the defendant. The company has filed a counter action, and preliminary hearings and discovery proceedings on both actions are in progress. The ultimate outcome of the matter cannot presently be determined, and no provision for any liability that may result has been made in the financial statements.

Registered auditors *Address*

5 Matters that affect the audit opinion

Limitation on scope

5.1 A limitation on the scope of the auditor's work may occur in three ways.

(a) The entity does not allow the auditor to perform an audit procedure that he believes is necessary;

(b) The auditor is unable to perform procedures due to circumstances, e.g. when the auditor is appointed too late to attend the stock count; or

(c) The entity's records are inadequate and the auditor is unable to satisfy himself as to their accuracy by other means.

5.2 The auditor's report should include an explanatory paragraph *in the basis of audit opinion section* covering:

(a) a description of the limitation; and

(b) an indication of the possible adjustments to the financial statements that might have been determined to be necessary had the limitation not existed.

Example 3

Qualified opinion: material limitation on scope

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board*, except that the scope of our work was limited as explained below*. … (remaining words are the same as illustrated in the first paragraph of the basis of audit opinion – Example 1 above).

We planned ~~*and performed*~~ our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. *However, with respect to stock having a carrying value of £X the evidence available to us was limited because we did not observe the counting of the physical stock as of 31 December 20X1, since that date was prior to our appointment as auditors of the company. Owing to the nature of the Company's records, we were unable to obtain sufficient appropriate audit evidence regarding the stock quantities by using other audit procedures.*

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Qualified* opinion *arising from limitation on scope

Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to physical stock quantities, in our opinion the financial statements: … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above).

In respect solely of the limitation on our work relating to stocks:

- *we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and*
- *we were unable to determine whether proper accounting records had been maintained.*

Example 4

Disclaimer of opinion: pervasive limitation on scope

Basis of audit opinion

We conducted our audit in accordance with International Standards on Auditing (UK and Ireland) issued by the Auditing Practices Board, *except that the scope of our work was limited as explained below*. … (remaining words are the same as illustrated in the first paragraph of the basis of audit opinion – Example 1 above).

We planned ~~*and performed*~~ our audit so as to obtain all the information and explanations which we considered necessary in order to provide us with sufficient evidence to give reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or other irregularity or error. *However, the evidence available to us was limited because we were unable to observe the counting of physical stock having a carrying amount of £X and send confirmation letters to trade debtors having an amount of £Y due to limitations placed on the scope of our work by the company. As a result we have been unable to obtain sufficient appropriate audit evidence concerning both stock and trade debtors. Because of the significance of these items, we have been unable to form a view on the financial statements.*

In forming our opinion we also evaluated the overall adequacy of the presentation of information in the financial statements.

Opinion*: disclaimer on view given by financial statements*

Because of the possible effect of the limitation in evidence available to us, we are unable to form an opinion as to whether the financial statements: … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above).

In respect solely of the limitation on our work referred to above:

- *we have not obtained all the information and explanations that we considered necessary for the purpose of our audit; and*
- *we were unable to determine whether proper accounting records have been maintained.*

Disagreement

5.3 The auditor may disagree with management about matters such as:

- the acceptability of accounting policies
- the application of those policies
- the adequacy of disclosures

5.4 An explanatory paragraph should be added *in the opinion section* covering:

(a) description of the disagreement
(b) quantification of the effect on the financial statements.

Example 5

Qualified opinion: disagreement on accounting policies – inappropriate accounting method

> ***Qualified*** **opinion** ***arising from disagreement about accounting treatment***
>
> *Included in the debtors shown on the balance sheet is an amount of £Y due from a company which has ceased trading. XYZ plc has no security for this debt. In our opinion the company is unlikely to receive any payment and full provision of £Y should have been made. Accordingly debtors should be reduced by £Y, deferred taxes should be reduced by £X and profit for the year and retained earnings should be reduced by £Z.*
>
> *Except for the financial effect of not making the provision referred to in the preceding paragraph,* in our opinion the financial statements: … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above).

Example 6

Qualified opinion: disagreement on accounting policies – inadequate disclosure

> ***Qualified*** **opinion** ***arising from disagreement as to the adequacy of a disclosure in the financial statements***
>
> *On 15 January 20X2, the company issued debentures in the amount of £X for the purpose of financing plant expansion. The debenture agreement restricts the payment of future cash dividends to earnings after 31 December 20X1. In our opinion, disclosure of this information is required by [state relevant accounting standards].*
>
> *Except for the omission of the information included in the preceding paragraph,* in our opinion the financial statements: … (remaining words are the same as illustrated in the opinion paragraph – Example 1 above).

Example 7

Adverse opinion

> ***Adverse* opinion**
>
> *As more fully explained in note to the financial statements no provision has been made for losses expected to arise on certain long-term contracts currently in progress, as the directors consider that such losses should be offset against amounts recoverable on other long-term contracts. In our opinion, provision should be made for foreseeable losses on individual contracts as required by [specify accounting standards] …… If losses had been so recognised the effect would have been to reduce the carrying amount of contract work in progress by £X, deferred taxes payable by £Y, and the profit for the year and retained earnings at 31 December 20X1 by £Z.*
>
> *In view of the effect of the failure to provide for the losses referred to above,* in our opinion the financial statements *do not* give a true and fair view, in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of the company's affairs as at 31 December 20X1 and of its profit [loss] for the year then ended; and
>
> *In all other respects, in our opinion* the financial statements have been properly prepared in accordance with the Companies Act 1985.

Lecture example 2

Exam standard for 10 marks

You are an audit partner. Your firm carries out the audit of Santa, a listed company. Because the company is listed, you have been asked to perform a second partner review of the audit file for the year ended 31 December 20X3 before the audit opinion is finalised. Reported profit before tax is £2.35 million and total assets are £9.5 million.

You have read the following note from the audit file.

'Debt: Rudolph

There is a debt outstanding from Rudolph, a limited liability company from January 20X3 in respect of a vehicle developed by Santa to Rudolph's own specification. Rudolph has disputed the quality of the vehicle and also does not agree that it was made completely to the specification. The company has submitted the dispute with Santa to arbitration, in accordance with their contractual agreement. Rudolph was a major customer up until the time of the dispute, often accounting for 50% of sales ledger total. It has not placed any orders with Santa in 20X3 or 20X4, preferring a French supplier who is Santa's only real competitor in the European market.

The directors of Santa are confident that at arbitration Rudolph will be required to pay the full bill, which is in the region of £1 million. They state that the quality of the machine is irrefutable and that any amendments to the specification were only safety improvements. The arbitral decision, which is not subject to appeal, is expected after the date of the AGM. Given their confidence, the directors of Santa have refused to refer to the dispute in the financial statements.

Given that the outcome of this arbitration is by no means certain, the potential overstatement of the debt is material and the permanent loss of Rudolph's custom could affect the going concern opinion, the following modification to the auditor's report is proposed:

Disagreement on Accounting Policies – Inappropriate Accounting Method – Adverse opinion

No allowance has currently been made for the impairment of an outstanding debt from Rudolph in respect of a dispute over a contract which has currently been submitted to arbitration, which, in our opinion is not in accordance with Financial Reporting Standards. An allowance of £1 million should be made in respect of this debt. Accordingly, debtors, profit for the period and retained earnings should be reduced by £1 million. Also, due to its significance, this allowance should have been disclosed separately in accordance with FRS 3 *Reporting financial performance*.

In view of the effect of the failure to provide for the losses referred to above, in our opinion the financial statements do not give a true and fair view in accordance with United Kingdom Generally Accepted Accounting Practice, of the state of Rudolph Company's affairs as at 31 December 20X3 and of its profit for the year then ended.'

Required

Comment on the suitability of the proposed audit opinion and any other relevant matters. Your comments should include an indication of what form the auditor's report should take.

Solution

6 IAPS 1014: Reporting by auditors on compliance with International Financial Reporting Standards

6.1 IAPS 1014 supplements ISA 700 *The Independent Auditor's Report on a Complete Set of General Purpose Financial Statements* in cases where financial statements are prepared under IFRSs.

It covers opinions of financial statements asserted to be prepared:

- solely in accordance with IFRSs
- in accordance with IFRSs and a national financial reporting framework
- in accordance a national financial reporting framework with disclosure of the extent of compliance with IFRSs.

6.2 Additionally, the APB has produced a Bulletin (2005/3) of questions and answers (*Guidance for Auditors on First-time Application of IFRSs in the United Kingdom and Republic of Ireland*) to assist auditors reporting on an entity's first IFRS financial statements.

Financial statements prepared solely in accordance with IFRSs

6.3 For an unqualified opinion to be expressed, the financial statements must be fully IFRS compliant. The IAPS gives example of situations where this is not the case, e.g. where a note states that the financial statements are prepared in accordance with IFRS, but then goes on to specify certain material departures.

6.4 A qualified/adverse or disclaimer of opinion would be necessary if the financial statements contain any material departure from IFRS.

Financial statements prepared in accordance with IFRS and a national reporting framework

6.5 For financial statements to have been prepared in accordance with more than one financial reporting framework, they must comply with each of the indicated frameworks individually.

A set of financial statements prepared in accordance with one framework containing a note or supplementary statement reconciling the financial statements to the other is not sufficient.

In practice, simultaneous compliance with both IFRSs and a national financial reporting framework is unlikely unless the country has adopted IFRSs as its national framework.

6.6 The auditor considers each framework separately. It is therefore possible to express an unqualified opinion on compliance with one framework and a qualified/adverse opinion on compliance with the other.

Additionally, it may be possible for non-compliance with one financial reporting framework to cause failure to comply with the other financial reporting framework, in which case a modified opinion would be issued on compliance with both frameworks.

6.7 **Illustrative modified auditor's opinion** (eg a UK listed company reporting under IFRSs and another country's national financial reporting framework)

> *Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and International Financial Reporting Standards. As discussed in Note Y to the financial statements, the Company has investment properties in the amount of £X that are carried at cost less accumulated depreciation. This accounting is required by [relevant national financial reporting framework] and permitted by International Financial Reporting Standards. The fair value of these investment properties of £X has not been disclosed. Such disclosure is not required by [relevant national financial reporting framework], but is required by International Financial Reporting Standards.*
>
> In our opinion, the financial statements give a true and fair view, in accordance with [title of national financial reporting framework with reference to the country of origin], of the state of the company's affairs as at 31 December 20X1 and of its profit for the year then ended, **and**, *except for the financial effect on the financial statements of the matter referred to in the preceding paragraph*, in our opinion, the financial statements give a true and fair view, in accordance with IFRSs as adopted for use in the European Union, of the state of the company's affairs as at 31 December 20X1 and of its profit for the year then ended.

Financial statements prepared in accordance with a national financial reporting framework with disclosure of the extent of compliance with IFRS

6.8 Financial statements prepared in accordance with a national financial reporting framework may disclose the extent to which they comply with IFRSs.

A note containing disclosure about compliance with IFRS is treated no differently to any other note as it contains management assertions on which the auditor can obtain sufficient appropriate evidence.

6.9 A qualified or adverse opinion is expressed if the auditor concludes that the note contains misleading information such that the financial statements fail to comply with the entity's national financial reporting framework, e.g. because it contains materially inaccurate information or incomplete information that is material and pervasive to the financial statements.

6.10 *Illustrative modified auditor's opinion:*

> Note X to the financial statements indicates that the financial statements have been prepared in accordance with [relevant national financial reporting framework] and are substantially in accordance with International Financial Reporting Standards (IFRSs) except that they do not comply with IAS 39, *Financial Instruments: Recognition and Measurement*. Because of the effect on the Company's financial statements of non-compliance with IAS 39 is material and pervasive, the reference to compliance with IFRSs is misleading.
>
> *Except for the inclusion of the reference to compliance with IFRSs,* in our opinion, the financial statements give a true and fair view, in accordance with [title of national financial reporting framework with reference to the country of origin], of the state of the company's affairs as at 31 December 20X1 and of its profit for the year then ended.

6.11 If the auditor concludes that the note containing disclosure about compliance with IFRS is not misleading, in certain circumstances, an emphasis of matter paragraph may be added to highlight it.

This is not a substitute for issuing a qualified or adverse opinion on compliance with the national financial reporting framework when disclosures as to compliance with IFRS are misleading such that they fail to comply with that framework.

7 Chapter summary

- Auditors' reports are the only tangible output produced by the auditor; it is therefore very important that the opinion expressed is appropriate in the circumstances.
- It is very important that you are able to understand the **different type and degrees of modifications** that can be made to the standard audit report.
- In situations where there is a **significant uncertainty** affecting the financial statements but this has been **adequately disclosed** in the accounts the auditor may consider including an **emphasis of matter paragraph** after an **unqualified** opinion.
- In situations where the auditors consider the directors **accounting treatment or disclosures** are **inappropriate or inadequate** a **disagreement** modification will be issued, depending on the magnitude of the problem this will be either a material (**except for…**) or pervasive (**adverse**) modification.
- In situations where the auditors have been **unable to gather sufficient appropriate evidence** in respect of items in the financial statements a **limitation on scope** modification will be issued, depending on the magnitude of the problem this will be either a material (**except for…**) or pervasive (**disclaimer**) modification.

Additional Notes

8 Reporting on the Internet

Introduction

8.1 In January 2001, the APB released Bulletin 2001/1, entitled *the Electronic Publication of Auditors' Reports* covering the issues involved and audit work to be carried out when a company releases its financial statements on its website.

8.2 The Bulletin notes that the legal environment governing the dissemination of corporate information by electronic means has yet to be fully established. The auditors' duty of care is not extended by virtue of the release of the audit report in an electronic format. However, the uncertainty regarding legal requirements is compounded by the availability of website information in many different countries due to the accessibility of the world wide web. All of these countries may have different requirements for the preparation and dissemination of financial statements.

8.3 The Bulletin states that if the directors' responsibility statement does not refer to this, or if the auditors otherwise consider it appropriate, they should insert a note at the end of the electronic version of the audit report to the effect that 'legislation in the United Kingdom governing the preparation and dissemination of financial statements may differ from legislation in other jurisdictions'.

8.4 The Bulletin also states that providing assurance on the maintenance and integrity of a company's website by reviewing (and perhaps testing) the company's security and control arrangements are outside the audit, but may be agreed with management at as a separate engagement.

8.5 Checking information presented electronically

Where the website is to contain the annual financial statements, auditors should:

(a) review the process by which the financial statements are posted onto the website and are derived from the hard copy accounts;

(b) check that the electronic version is identical to the hard copy accounts; and

(c) check that the electronic format does not distort the information, for example by highlighting certain areas.

The Audit report

8.6 Auditors must ensure that the wording of the electronic report is suitable and:

(a) adequately identifies which information has been audited, and which has been reviewed/read by the auditors (as page numbers are perhaps not suitable, the statements should be named instead);

(b) identifies the nationality of the accounting and auditing standards applied; and

(c) limits the auditors' association with any other information distributed with the annual report. This is an issue as website users may find it hard to distinguish between financial information that the auditors have audited, or just read and that which has not been examined. This is exacerbated by the use of hyperlinks. Auditors should ensure that they are satisfied that information is adequately distinguished. Where it is not, changes to the presentation should be requested. Where these are not made, the auditors will not consent to the electronic release of the audit report. If the report is then used anyway, legal advice is required, with resignation a further alternative.

8.7 **Controls over changes to information**

Inaccurate information may be posted by company employees in error, or deliberately, or by external third parties. As noted above, the directors should routinely review the electronic information. Auditors are not required to review the controls in place, nor to carry out ongoing reviews of the audited financial statements after they have been issued in electronic form. The directors should state their responsibility for this is the statement of directors' responsibilities.

9 Reports on summarised financial statements

Introduction

9.1 Listed companies may in certain circumstances send summary financial statements to their shareholders instead of full statutory financial statements. The summary financial statements must be derived from the annual accounts.

9.2 The auditor is required to give an opinion as to whether the summary financial statements are consistent with the annual accounts and directors' report and comply with the relevant sections of the Companies Act.

9.3 The auditor must also state whether the report on the annual accounts was qualified or unqualified.

9.4 There is no requirement to form an opinion on the truth and fairness of the summary financial statements.

Scope and timing of work

9.5 Usually the work performed on the full financial statements, coupled with a review of the summary financial statements, will be sufficient to enable the auditor to make the required statements.

9.6 The work on the summary financial statements should normally be carried out at the same time as the completion of the audit of the annual accounts.

Inconsistency

9.7 Inconsistency may result where:

(a) the information in the summary financial statements has been inaccurately extracted from the annual financial statements

(b) headings have been used which are incompatible with the statutory headings in the full accounts

(c) information has been included which in the auditor's opinion has been summarised in a manner that is not consistent with the annual financial statements.

(d) information has been omitted which the auditor believes should be included in the summary financial statements.

9.8 Any inconsistencies should be discussed with the management. They should be asked to remove the inconsistency by amending the summarised financial statements.

Examples of auditors' statements

9.9 **Unqualified**

An example of an unqualified statement is as follows:

> Auditor's statement to the members of ……………………
>
> In our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

9.10 **Qualified**

A qualified statement will arise where there is an inconsistency between the summarised financial statements and the annual statements or all information required by the Act has not been given.

(a) **Information not disclosed**

> Auditor's statement to the members of ……………………
>
> The summary financial statements do not disclose net interest payable of £6 million as required by the Companies (Summary Financial Statements) Regulations 1990.
>
> Except for the non disclosure of net interest payable, in our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

(b) **Inconsistency with the annual financial statements**

> Auditor's statement to the members of ……………………
>
> The summary financial statements include in the figure for turnover the share of turnover of associated companies attributable to the company's interests which amounts to £50 million. In the annual financial statements this amount is not included in the total turnover shown in the profit and loss account.
>
> Except for the matter referred to above, in our opinion the summary financial statements above/overleaf are consistent with the annual financial statements and the Directors' Report of XYZ plc for the year ended 31 December 20X1 and comply with the requirements of Section 251 of the Companies Act 1985 and the regulations made thereunder.

10 Distributions by companies

Issue

10.1 The Companies Act 1985 imposes a responsibility upon auditors who have qualified their audit opinion to state in writing whether the qualification is material in determining the legality of the distribution.

Disagreement qualifications

10.2 With a disagreement it is possible to quantify the value of the misstatement in the financial statements.

10.3 For example, the auditor may have concluded that sales are overstated by £500,000. He merely has to adjust the distributable profits by this amount to determine their legality.

Limitation in scope

10.4 The problem with a limitation in scope is that the effect of the qualification is not quantifiable. However, the auditor may be able to determine parameters of the possible effect.

END OF CHAPTER

Home study chapter - Current issues

18

Syllabus Guide Detailed Outcomes

Having studied this chapter you will be able to:

- Discuss the relative merits and the consequences of different standpoints taken in current debates and express opinions supported by reasoned arguments.

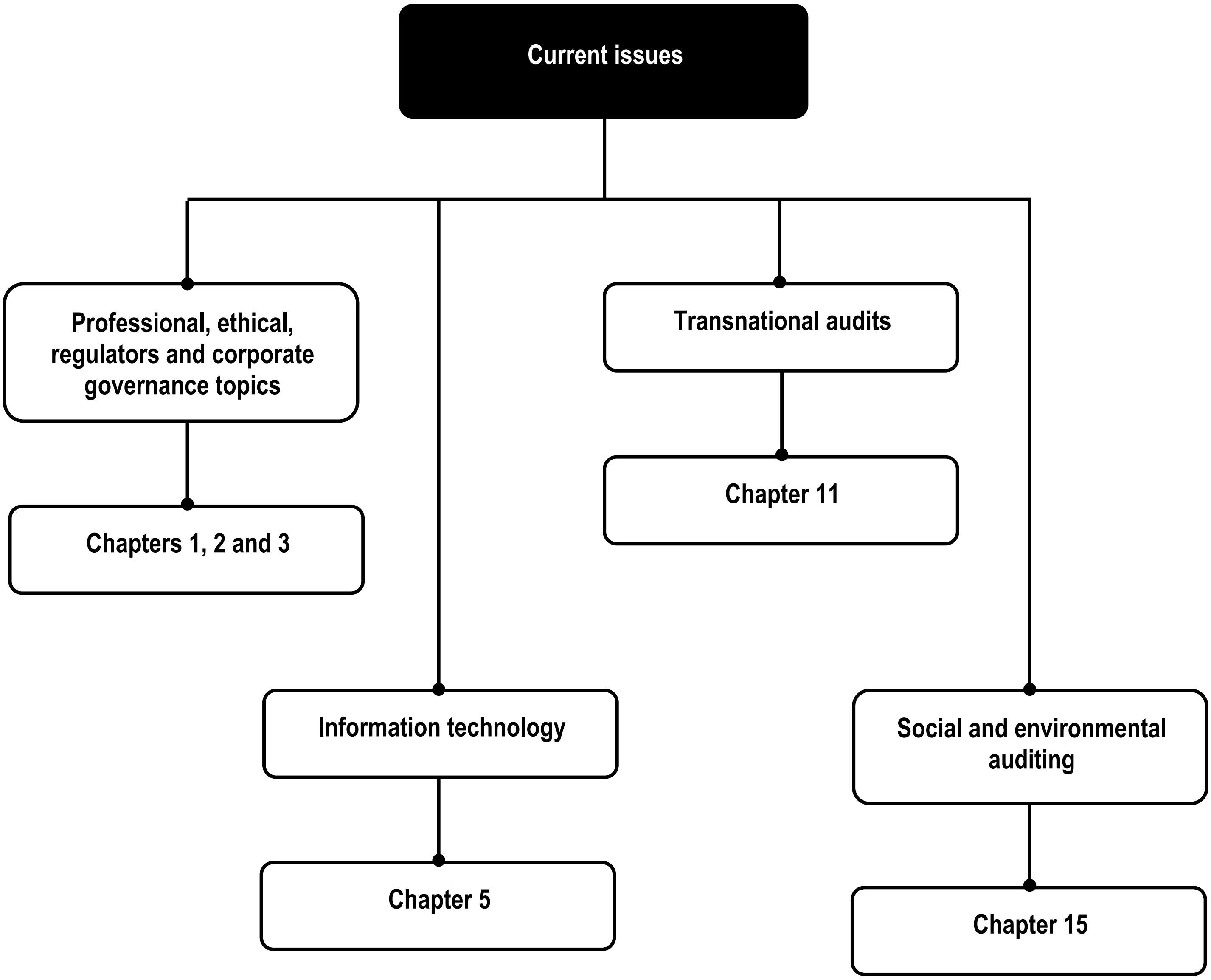
Exam Context

The examiner for P7 has stated that current issues can appear for a small number of marks in any question in the exam.

Business Context

It is important for all ACCA trainers, members and afflicters to b aware of current issues affecting the profession.

Overview


Current issues
Professional, ethical, regulators and corporate governance topics
Chapters 1, 2 and 3
Transnational audits
Chapter 11
Information technology
Chapter 5
Social and environmental auditing
Chapter 15

1 Current issues

1.1 These notes combined with the study text have covered the current issues that you need to be aware of for P7.

Chapter 18

1.2 In addition to this knowledge you should read relevant articles in the student accountant magazine and stay up to date with current developments by reading a quality newspaper and the business press.

END OF CHAPTER

Answers to Lecture Examples

Chapter 1

Answer to Lecture Example 1

- The reputation of the audit profession has, in recent years suffered due to high profile audit failures (e.g. Enron, Parmalat and Worldcom).
- The existence of auditing standards and other regulations should protect/enhance the reputation of the profession amongst all stakeholders by ensuring a consistently high level of work across all firms.
- Businesses have become more complex and global, and firms have expanded their range of services beyond traditional assurance and tax advice. This has led to a great deal of re-examination of regulatory and standard-setting structures both nationally and internationally in recent years.

Answer to Lecture Example 2

- In many countries the legal requirements are onerous and the penalties for non-compliance are severe (for example, in the UK auditors risk long prison sentences if they commit an offence).
- Money laundering is widely defined and it is not always obvious that an offence has been committed.
- Without the guidance in issue accountants may be used unwittingly to launder criminal funds.
- In many countries the law creates a conflict between the ethical duty of confidentiality to the client and the legal duty to report money laundering offences. The guidance helps to clarify the members' professional duty to report offences.

Chapter 2

Answer to Lecture Example 1

Self-interest threat

This would arise in situations where the audit firm or a member of the engagement team has some financial or other interest in the audit client. For example:

- Providing a loan to a client.
- Earning fees on a contingent basis, i.e. profit related.
- Owning shares in a client.
- Undue dependence on fees from a client.

Self-review threat

The self-review threat occurs when a previous judgement needs to be re-evaluated by members responsible for that judgement. The situation tends to arise when the auditor has provided other services to a client. Key examples would be:

- The auditor providing a specialist valuation (e.g. pension liabilities).
- The audit firm providing internal audit services and subsequently relying on the work for the external audit.
- Reporting on the operation of financial systems after being involved in their design or implementation.

Advocacy threat

The advocacy threat occurs when members promote a position or opinion to the point that subsequent objectivity may be compromised. Specific examples would be:

- Acting as an advocate on behalf of an assurance client in litigation or disputes with third parties.
- Promoting shares in a listed entity when that entity is a financial statement audit client.

Familiarity threat

The familiarity threat occurs when, because of a close relationship, members become too sympathetic to the interest of others. Circumstances which would create a familiarity threat would include:

- Long association with a client.
- Acceptance of gifts or preferential treatment unless the value is clearly insignificant.
- Over-familiarity with the management of the organisation such that judgement could be compromised.

Intimidation threat

The intimidation threat occurs when members are deterred from acting objectively by threats, actual or perceived. Such a threat will occur in the following circumstances:

- The threat of dismissal or replacement of the member, or a close or immediate family member, over a disagreement about the application of an accounting principle or the way in which financial and performance information is to be reported.
- A dominant personality attempting to influence the decision making process or controlling relations with auditors.
- Being threatened with litigation.
- Being pressured to reduce inappropriately the extent of work performed in order to reduce fees.

Answer to Lecture Example 2

Inherited shares

A 'self-interest threat' has arisen as the manager has a direct financial interest in his client.

In wishing the share price to increase there could be an incentive to overlook unrecorded liabilities and losses discovered during the conduct of the audit.

Although the manager may have independence of mind and be known to act with the utmost integrity, the public will not perceive the manager as independent.

This inadvertent violation of an independence principle does not impair the independence of the audit practice or the audit team providing:

- The firm's established policies and procedures resulted in the audit manager having reported promptly his inheritance of the shares;
- The firm promptly advises the manager that the shares should be disposed of;
- The manager disposes of them at the earliest practical date, or is removed from the engagement.

However, the manager does not intend to dispose of the shares quickly as he is waiting for the share price to recover.

Although the professional ethics independence statement requires the manager to be removed from the audit team, the firm may require stricter safeguards and prohibit all professional staff from holding direct financial interests.

If the audit manager has done any work on this audit since he inherited the shares, the work should be re-reviewed by another professional accountant.

This threat is so significant that the manager should be removed from the audit team unless he disposes of the shares before he undertakes any further tasks relating to the audit of the client.

Godfather

There is a risk that the personal relationship with the client will result in a familiarity threat.

The **relevant factors** are:

- The partner has been involved with the client for many years and has a personal relationship with client staff
- The company is not a listed or public interest company
- It is an audit assignment

The risk arising here is **significant**, but as the client is not listed, it is not insurmountable. However, it would be a good idea to implement some safeguards to mitigate against the risk. A second partner should provide a **hot review** of the audit. The partner could be rotated away from the client for a period, which is a requirement anyway under ACCA rules after five years (IFAC seven years).

Answer to Lecture Example 3

Advantages of an ethical framework over a rules based system

A framework of guidance places the onus on the auditor to actively consider independence for every given situation, rather than just agreeing a checklist of forbidden items. It also requires him to demonstrate that a responsible conclusion has been reached about ethical issues.

The framework prevents auditors interpreting legalistic requirements narrowly to get around the ethical requirements. There is an element to which rules engender decision, whereas principles encourage compliance.

A framework allows for the variations that are found in every individual situation. Each situation is likely to be different.

A framework can accommodate a rapidly changing environment, such as the one that auditors are constantly in.

However, a framework can contain prohibitions (eg loans) where these are necessary if safeguards are not feasible.

Chapter 3

Answer to Lecture Example 1

(a) There were a number of interesting developments in the area of auditors' liability to third parties in the 1980s and 1990s. The most significant recent case decision is the Caparo case (1990).

Prior to the Caparo case, the position was that auditors' liability depended on a qualified test of reasonable foresight, that is to say, liability depended on a principle whereby negligent accountants owed a duty of care to those who can be foreseen as likely to sustain damage if carelessness exists, but with the important qualification that any prospective plaintiff, to succeed in his action, must establish that it was reasonable in the circumstances for him to rely on the audited accounts.

However, the Caparo case narrowed those who can successfully sue the auditors for negligence to the company or the shareholders as a group. It is unlikely that an individual shareholder will be able to successfully sue an auditor. However, the case has not yet been tested in the UK courts.

(i) *The possibility of demonstrating negligence*

It is worth noting the comments of the UK's Auditing Practices Committee (now the Auditing Practices Board) in the preface to the auditing standards and guidelines on the relationship of standards and guidelines to the law:

'Members are advised that a court of law may, when considering the adequacy of the work of an auditor, take into account any pronouncements or publications which it thinks may be indicative of good practice. Auditing standards and guidelines are likely to be so regarded.' The Littlejohn case demonstrated this principle: following auditing standards and documenting the approach is a good defence against possible third party action.

In the case of Moorland, the auditor seems to have laid himself open to a possible charge of negligence in that they did not attend to observe the company's physical inventory counting procedures as recommended by ISA 501 *Audit Evidence – Additional Considerations for Specific Items*. Much would depend on whether or not the auditor could satisfy the court as to whether there were good practical reasons for non-attendance and the other audit work which they carried out in relation to inventories provided sufficient, relevant and reliable audit evidence on which to base the audit opinion.

(ii) *The fact that the inventories figure in the financial statements apparently* '*made sense*'

This seems to suggest that the main audit evidence on which the auditor based his opinion, in relation to the inventories figure, was the result on his analytical review work in this area. As the auditor seems, through pressure of work, to have neglected to attend the inventory count, then one would expect him to have carried out more extensive analytical review procedures than would perhaps normally have been the case for that client. If it appeared that the auditor had only carried out a minimal amount of review tests, then he would be very likely to be open to a charge of negligence.

(iii) *The fact that the auditor was not informed that the financial statements and auditor's report were to be used to obtain additional finance*

If the person who provided the unsecured long-term loan to Moorland were to be able to recover damages against the auditor, then the court would need to be satisfied, on the evidence before it, that:

(1) The auditor had been negligent; and

(2) The third party had suffered loss in consequence of that negligence on the part of the auditor; and

(3) The auditor should reasonably have foreseen that the third party might wish to place reliance on the audited accounts.

As a result of the Caparo case, it would appear that the third party would not succeed in an action against the company: the plaintiff would need to prove that the auditor knew that the financial statements would be used specifically to obtain finance from this third party, which is not the case here.

However, this can only be decided by the courts.

(b) From the above it may be seen that the issue of auditor's liability will always be dependent on the facts of an individual case. However, there are steps that any firm of auditors/accountants should take to minimise the risk of successful litigation against them on the part of clients and/or third parties. Such steps would include:

(i) Adhering at all times to International Standards on Auditing relevant to the client

(ii) Adequate training of all audit staff to ensure that they are fully aware of how the audit procedures considered necessary by the firm are to be carried out

(iii) Ensuring that there are adequate review procedures which are constantly applied within the firm to see that laid-down standards are being properly applied in practice

Answer to Lecture Example 2

The advantages of settling auditor liability cases out of court are:

1 There will be a saving in legal fees.
2 The time of partners and senior staff will not be taken up with preparing a legal defence.
3 The claimant may be willing to settle for a lower amount.
4 There should be less damage to the firm's reputation.

The disadvantages are:

1 The settlement may leave the question of the firm's ultimate responsibility unclear. As well as casting doubts over the firms reputation, the case may also fail to provide clear guidance for other firms in similar situations.

2 Settlement also increases the uncertainty about the circumstances in which audit firms are responsible to third parties.

3 The possibility of achieving a settlement without the need for expensive litigation may encourage some claimants to sue.

4 The firm's insurance premiums may rise because they are perceived to be a higher risk.

Chapter 4

Answer to Lecture Example 1

- To provide reasonable assurance that the firm and its personnel comply with professional standards and regulatory and legal requirements (ISQC 1).
- To ensure that reports issued by the firm or engagement partners are appropriate in the circumstances (ISQC 1).
- To protect the reputation of the firm.
- To protect the reputation of the profession.
- To reduce the risk of legal action against the firm for negligence.

Answer to Lecture Example 2

(a) Guidelines for evaluating applicants
(b) Professional education requirements, e.g. passing ACCA exams before promotion
(c) Establishing a system of continuing professional development and training within the firm
(d) Keeping staff informed of developments in technical standards and internal policies
(e) Coaching by more experienced staff, e.g. other members of the engagement team
(f) Evaluation procedures for performance of personnel.

Answer to Lecture Example 3

(a) Understanding and practical experience of engagements of a similar nature and complexity
(b) Understanding of applicable professional standards and regulatory and legal requirements
(c) Appropriate technical knowledge, including knowledge of relevant information technology
(d) Knowledge of relevant industries in which the client operates
(e) Ability to apply professional judgement
(f) Understanding of the firm's control policies and procedures
(g) Any possible independence problems.

Answer to Lecture Example 4

- Steve's role as Marketing partner, managing the growth of the business is in direct conflict with his role as Quality partner – should be allocated to one of the other partners.
- The approach to quality control updates is inadequate to meet ISQC 1's HR requirements, a more formalised programme is needed. Training should be conducted at a time when staff are not likely to be on holiday (or on alternative dates).
- Ongoing monitoring of compliance with the firm's quality control, professional and ethical procedures is required. The partner cannot argue that the firm is too small if working under IAASB standards. Indeed an engagement quality control review for the firm's two listed clients is required by ISA 220 *before* the auditor's report can be issued.
- New joiners should be trained in the firm's principles and methodology. The firm cannot rely on the degree. It is not sufficient to provide staff with standards on a CD-Rom. Typically, a staff manual would be produced, backed up by training and updates.
- The appraisal criteria are not consistent with quality control objectives, for example, a 'quality' audit may overrun due to investigation of emerging issues.
- The review process is inadequate to ensure quality. Areas undertaken by the AIC not highlighted as important would not be reviewed by anyone. Typically, a manager review would cover the AIC's work and a second review of work undertaken by more junior staff.
- Documentation is key to quality. Audit evidence required to support the file should not be destroyed.
- Allocation of audits to partners based on location does not foster quality. Industry units may not be practical in a small firm, but the retail and financial clients could be divided between the partners to develop specialisms (and foster efficiency). This is a particular concern for the financial services clients which are subject to complex regulation, which could open up CWMM to liability if not abreast of the requirements.
- Facilities should be available for technical consultation (beyond simply ethical issues) both within and outside the firm. A facility for second opinions should be put into place between the partners. Consultation would be better allocated to a technical manager (or group of staff) to make them more accessible to audit team members.
- Additionally, ethical compliance should not be left to members of staff. At least annual written confirmation of independence is required from professional staff by ISQC 1.
- Data can be obtained from the Internet, but staff should be provided with guidance as to where to source data from, to ensure accuracy and consistency of approach.

Chapter 5

Answer to Lecture Example 1

- The client may perceive the audit fee to be too high or poor value for money.
- The "fit" between the auditor and the client may no longer be appropriate. For example, a company experiencing rapid growth may become too large and complex relative to the capabilities of its auditors.
- The audit firm may not seek re-election or resign. This could be for a number of reasons, for example the auditor may have independence issues with the client or the auditor may have doubts about the integrity of the client staff. There may also be an insurmountable conflict of interest with another client.
- The reason could be due to a breakdown in the working relationship between the auditor and the client; this is especially likely with small clients who value a fairly close relationship with their auditors.

Answer to Lecture Example 2

The following work would be performed in order to assess the risk attaching to a prospective client.

- Perform a company search to ascertain shareholders, directors, security granted and whether or not annual returns are filed on a timely basis.
- Consult as credit reference agency to review solvency and consider whether the firm's fees are likely to be paid promptly.
- Review the most recent published accounts for solvency, adequacy of disclosure and to determine whether or not the accounting policies adopted are acceptable to the firm.
- Examine background information to identify industry specific problems, issues, legislation and trends.

Less 'technical' methods such as looking at local newspapers or finding out about the company's location and reputation in that area may also be productive.

The firm may make use of contacts with knowledge of the company to assess its reputation and that of its owners and managers. Useful sources of information may include trade associations and local chambers of commerce.

Answer to Lecture Example 3

Advertising

Albion and Baggie have clearly broken the ethical guidance on 'Advertising, Publicity and Obtaining Professional Work' by discrediting the services offered by another firm.

The leaflet drop itself is acceptable as long as it abides by advertising rules and technically so is the fixed fee. However, fixed fees are not generally wise as the auditor is unable to assess the amount of work required until discussion with the client has taken place since:

– Fixed fees may reduce service and quality, if insufficient time can be devoted to the audit.
– Losses may be made if problems occur that can not be covered by increasing fees.

Outstanding fee income

The outstanding fee income is similar to making a loan to a client.

The following diagram summarises why making a loan to someone is perceived to be a threat to independence (i.e. a threat to not doing a thorough job/not modifying the auditor's report when necessary).

Auditor wants money/fee paid

↓

Potential modification of auditor's report (with implications that client may be unable to pay as funding by banks and creditors may be withdrawn if the report is modified, leading to cash flow problems)

↓

Client may not pay

Obviously it is impossible to have no outstanding fee income. Clients will not pay up simply because they are causing their auditors to break ethical guidance. Auditors should try to minimise the level of outstanding fees by good credit control and so on.

There is nothing to stop a firm starting the next year's audit when the previous year's fees have not yet paid, however this would only compound the above problem, therefore payment is advised.

Rolling balls

The lottery management company tendering for same contract as Virgo would constitute a conflict of interest, as this is a major contract and they are competitors.

The appointment could be accepted providing:

– Both parties are informed that you are acting for the other;

– Both parties are in agreement that this situation is acceptable;

– Different audit teams should be used on each audit, information should not be transferred between teams (Chinese walls); and

– Review carried out by different audit engagement partners.

Fee income

ACCA guidance is that the maximum fee income from one client should not exceed 15% of gross recurring practice income, this is reduced to 10% if the company is a listed or other public interest client.

These are not absolute criteria, i.e. an auditor would need to be careful about perceived independence problems if getting close to these figures.

Rolling Balls is a potential new client and the fee represents 10% of gross recurring practice income. Two issues arise:

(a) It is a lottery company, hence public interest; therefore, the ACCA limit is reduced to 10%
(b) Other services required (presumably on regular basis) are likely to push the fee up higher.

As the fee is close to limit it is necessary to take extra precautions.

Additional services

In addition to the fee limit issue the auditor should consider:

– The amount of fee generated from this client compared to audit fee (i.e. would Albion & Baggie be inclined to not modify the auditor's report in order to 'please' the client and retain lucrative other services?)

– Whether Albion & Baggie have adequate resources and expertise required to perform the additional services (i.e. do they know enough about lottery regulations?). The fundamental principle of competence is the key issue here.

Family connections

The issue here is closely connected parties.

The risk is that the auditor may not be willing to issue a modified auditor's report to someone he is closely attached to, either in business or personally.

The issue is perceived independence – whether the public would perceive that the auditor has done a 'proper audit' on the accounts of a closely connected party or whether there would be the temptation to let a few errors 'slip under the carpet'.

Following the ACCA rules, there appears to no problem regarding Sophie, who is closely connected to the practice, provided the loan from the financial institution is on normal commercial terms.

Maggie cannot be manager on the audit of Nibbles until two years has elapsed since leaving the company, otherwise she may be auditing her own work.

As Maggie is an adult and is not to be involved in the audit, Sid's shares at present do not present a problem as closely connected has a narrower definition when referring to interests in shares, i.e:

– Partner of the firm and his/her spouse/minor children/company >20% interest
– Staff member on audit and his/her spouse/minor children/ company >20% interest

Should Maggie subsequently be involved on the audit, then Sid should dispose of his shares.

Chapter 6

Answer to Lecture Example 1

- **Logistics** – Assignment of staff to the audit; consider the clients locations and arrange visits where appropriate or consider using staff from other offices/countries if possible; also Johnson is a plc so it is important to consider what reporting deadlines the client is working towards.
- **Time budgets** – The audit of a large multinational will generate a significant fee but is at risk of going over budget; it is therefore important at the planning stage to prepare and communicate a time budget to the audit team and monitor this throughout the engagement.
- **Reporting** – The audit manager should consider what other reports the client may require over and above the statutory audit report. A large manufacturer such as Johnson is likely to produce a social and environmental report as part of the annual report; the audit manager should ascertain whether they require assurance on these issues on this report.
- **Client interface** – Consideration should be given to the method and timing of communication with the client management and/or audit committee at certain stages of the audit.
- **Preliminary materiality** – Materiality should be assessed and calculated at the planning stage (although it is likely to be based on draft figures).
- **Risk assessment** – The key aspect of the planning stage of an audit is the performance of a risk assessment. This will ensure that the work performed is focused on the important areas of the accounts.

Answer to Lecture Example 2

(a) As the timing of the redundancies is towards the year-end, it is important that the timing of the announcement is ascertained, if it is made before the year-end then a provision should be made for any redundancy costs not paid as at 31st December. If the announcement is made post year-end then the costs would not be recognised until next year.

The disclosure of the costs should be considered as it may be possible to treat them as an exceptional item if they meet the definition in the accounting standards (IAS 1 / FRS 3).

The unexpected loss of this major contract gives rise to a potential going concern problem. Since only 10% of the American staff have been lost as a result it is unlikely that this in itself would be enough to affect the going concern status of the entire business. This should however form part of the overall assessment of going concern. Consideration should be given as to the reasons for the improvement in the security situation and whether similar improvements may occur in other markets.

(b) Close attention will need to be paid to the software development costs to ensure that they meet the criteria laid out in IAS 38 / SSAP 13 and have been correctly capitalised and disclosed.

It will be important to ensure that the training costs for the new software have not been included in the amounts capitalised. These do not represent an intangible asset and so should be recognised as an expense when incurred.

Answer to Lecture Example 3

	SCENARIO	*BUSINESS RISK*	*AUDIT RISK*
(i)	CD Planet operates a chain of retail outlets selling chart CDs.	• Overstocking of CDs resulting in inventories of ex-chart CDs • Excessive mark down and reductions in order to sell ex-chart inventories • Impact on revenues, profits and cash flows	• Identification of obsolete inventories • Valuation of inventories – NRV < cost
(ii)	Mucha Pasta operates several Italian restaurants and is subject to comprehensive and stringent Health and Safety food hygiene legislation.	• Breach of legislation could lead to fines, closure, bad press and costly improvement expenses • Potential impact on revenues due to impact on reputation/closure • Financial impact due to fines, legal actions and required improvements	• Provisions/contingent liability disclosure for legal action • Impact on going concern • Appropriateness of the capitalisation of improvements
(iii)	XYZ, based in the Eurozone, trades extensively in the USA and invoices sales in US$.	• Company is exposed to exchange rate risk • Potential impact on profits and cash flows	• Correct retranslation of year end receivables • Correct treatment of initial sale and receivable • Correct calculation, treatment and disclosure of exchange differences • Compliance with IAS 21 (FRS 23)

Answer to Lecture Example 4

Financial risk

Foreign currency risk: Many of Melon's supplies are from India and hence cost would depend on exchange rate with the Indian rupee. Also franchisees pay 60% of local retail price to Melon, which passes currency risk to Melon where the franchisees are located outside the Eurozone (e.g. in the UK).

Cash flow/financing risk: The Group bears an ongoing cash flow risk with respect to the shop fittings provided to franchisees which are not paid for until later. Given that most shop fittings will be for new franchisees this is coupled with the business risk that those franchisees may fail.

Leased vs owned properties: Leased properties allows the Group the flexibility to open, close or move shops, but also subjects the Group to the risks of the rental market and the potential loss of prime retail sites when the rental agreements are up for renewal. Owned properties are more secure, but are less flexible when the retail centre of a town shifts location over time.

Operational risk

Fashion: The market in which Melon operates is a fast-moving one. Success depends on being at the cutting edge of latest fashions. Given that the clothes are ordered six months in advance, it is essential that Melon's research and buying department calculations are based on accurate information. Miscalculations of the market could result in large amounts of unsaleable inventories to customers or indeed to franchisees. Further, goods unsold by the franchisees can be returned to Melon increasing its risk.

Tutorial note: The question asks for the *business* risks facing Melon, so to discuss whether the inventories are overvalued at the year end would not be appropriate as that is an audit risk.

Quality: All clothing is manufactured by third parties. Controls are necessary to ensure that the quality of goods is adequate across suppliers and consistent between suppliers and over time.

Competitors: There are many players in the fashion market which is becoming more globalised. What, in the past may have been a stable national position could quickly turn sour if a new, but established foreign player enters the market. This needs to be regularly monitored.

Supply issues: Unexpected supply problems could occur for Melon, a foreign investor in India, as a result of local activists criticising the use of cheaper developing world workers.

Compliance risk

Operations in various different markets pose risks due to different regulatory and reporting requirements which must be researched and complied with.

Chapter 7

Answer to Lecture Example 1

- Review prior year working papers for names of known related parties
- Review shareholder records to determine the names of the principal shareholders
- Review minutes of meetings of shareholders and those charged with governance and other relevant statutory records e.g. register of directors' interests
- Review the entity's procedures for identification of related parties
- Ask management to help identify related parties and enquire about relationships between key management personnel and other entities
- Obtain a letter of representation confirming who are related parties
- Look through major customers and suppliers and see if there are any connections through board members or other group companies.

Chapter 8

Answer to Lecture Example 1

- Review procedures management has established to ensure that subsequent events are identified.
- Read minutes of board meetings, shareholder meetings and audit committees that have taken place since the year-end.
- Obtain and review the latest available interim financial statements and/or management accounts, budgets and other related management reports.
- Enquire of the entity's legal counsel concerning litigation and claims.
- Enquire of management as to whether any subsequent events have occurred which might affect the financial statements.

Chapter 9

Answer to Lecture Example 1

Factors to consider before accepting standard costs as an appropriate basis for the estimation of cost:

- How often are the standard costs updated?
- Do significant price variances arise?
- Have the standard costs been acceptable in the past?
- What controls are there over the amendment of standard cost data?

Answer to Lecture Example 2

(i) **Matters to consider**

Whether the contract has been correctly treated in the accounts, given that the contract is loss making ($100m-72m-48m = loss of $20m) it is mandatory for the full amount of the loss to be recognised immediately against current year profits.

Whether the contract price is correct and recoverable from the customer. The contract is expected to be loss making which may indicate difficulties regarding the construction. We should consider the possibility of a reduction in the contract price or other penalties due to unforeseen delays and difficulties that may occur.

Whether the costs incurred to date are complete and accurate.

Whether the expected future costs of $48m are complete. There is a risk that these costs are intentionally understated as a method of reducing the impact of the loss on this year's profit.

Whether the stage of completion (60%) is correct and has been verified by an independent source. This figure affects the revenue and costs recognised in the income statement. It appears that the Finance Director is giving us this information rather than an independent and qualified surveyor. We would need to consider the reliability of the Finance Director's assessment and consider using the work of an expert to confirm the stage of completion.

(ii) **Evidence to find**

Draft financial statements reviewed to ensure the accounting treatment and disclosures are correct, particularly that the full loss of $20m has been recognised this year.

Copy of the signed contract confirming the contract price of $100m. Check the date of the contract to ensure the work straddles the year-end. Review for details of the timing of payments on account which should be traced to bank statements. Inspect for any penalty clauses for late completion.

Copies of correspondence with the customer reviewed for evidence of disputes or any indications of problems regarding the recoverability of amounts owed.

Sample of costs incurred to date agreed to invoice and timesheets; also review costs not included to ensure they have been correctly omitted. If overheads have been included these should be reviewed to ensure they are correctly calculated and have been appropriately allocated to the contract.

Schedule of $48m expected costs to complete the contract assessed for reasonableness by enquiring of knowledgeable staff as to basis of estimates. Consider accuracy of estimates in prior years and compare expected costs to actual costs incurred in the post balance sheet period.

Discussion with Finance Director regarding the stage of completion to gain understanding of how the 60% figure was arrived at. If it is on the basis of an external surveyor's report obtain a copy and assess the quality of the work. If the Finance Director has made an estimate of the stage of completion consider the need to engage a third party expert to confirm the stage of completion.

Answer to Lecture Example 3

(i) **Matters to consider**

Whether Holly Ltd really owns 1% of the share capital and benefits from it.

Whether the purchase price and transaction costs have been correctly stated and accounted for.

Whether the financial instrument has been appropriately classified per the requirements of the relevant accounting standards.

Whether the year-end valuation is accurate.

Whether the increase in value of the investment has been correctly treated in the financial statements.

(ii) **Evidence to find**

Copies of the share certificates in Holly Ltd’s name.

Inspection of Buddy plc’s statutory share records to verify Holly Ltd owns 1%.

Inspection of bank statements and cash book to verify the payment of the purchase price ($2 × 50,000= $100,000) and the transaction costs (1% × $100,000= $1,000).

Third party confirmation of Buddy plc's share price on the date of purchase (e.g. agree $2 per share cost to the quoted price in the *Financial Times* on purchase date).

Enquire of directors regarding the correct classification of the investment per the accounting standards: the shares have no maturity date and do not represent a loan. The choice is therefore between whether the shares are held for trading (speculative) purposes or whether the intention is to hold them for the long term in which case they represent an available-for-sale financial asset.

The information in the question appears to imply that there is no intention to use this investment as a speculative instrument and therefore it should be classified as an available-for-sale investment. This should be discussed and confirmed with the directors and post-year events monitored to identify any change in strategy regarding the investment.

Confirmation to third party of share price ($2.25) at the year-end.

Recalculation of increase in fair value of the investment:

Increase in value (50,000 × 2.25) - $101,000 = $11,500

The financial statements should be inspected to ensure that the fair value increase has been correctly treated. As an available for sale investment, any increase in the fair value of the asset should be recognised in reserves with the net movement being recycled to the income statement when the shares are sold.

Chapter 10

Answer to Lecture Example 1

(i) **Matters to consider**

Materiality: At 15% of profit before tax and 3.8% of total assets the deferred tax provision is material to both the income statement and the balance sheet.

Whether the correct tax rate has been used. The accounting standards require that deferred tax is calculated at a rate that is 'substantively enacted' and expected to apply when the deferred tax is to be settled.

Whether the deferred tax provision has been calculated correctly based on accurate temporary/timing differences relating to the plant and equipment.

Whether the deferred tax provision and charge are complete.

Whether the deferred tax provision and income statement charge have been properly presented and are supported by the appropriate notes.

(ii) **Evidence to find**

Schedule of temporary/timing differences relating to the plant and equipment agreed to plant and equipment schedules and tax computations.

Agreement of tax rate used (30%) to 'substantially enacted' rate of tax (note the rate used should be the rate substantively enacted not merely 'announced').

Enquire of directors and review plant and equipment schedules and tax computation for evidence of temporary/timing differences not provided for.

Recalculation of provision:	
Plant and equipment NBV:	\$3.6m
Tax written down value:	\$2.1m
Temporary difference	\$1.5m
Total temporary differences	\$1.5m* 30% = \$450,000

Review of disclosure in the notes to the financial statements to ensure the appropriate disclosures are made in accordance with accounting standards, primarily being disclosure of the items forming the deferred tax provision, the movement on the liability and the major components of income tax expense.

Answer to Lecture Example 2

(i) **Matters to consider**

Whether the lease has been classified correctly as a finance lease. A close inspection of the terms of the lease document should reveal which party bears the risks and rewards of ownership. If Beckham does not, the lease should be reclassified as an operating lease.

Materiality: \$9,000 represents 10.7% of profits whereas the interest charged is \$9,000 x 5.747 x 8% = \$4,138 is only 4.9% of profits. However, if the lease should be classified as an operating lease rather than a finance one, the difference charged to profits would be \$9,000 – \$4,138 – \$4,048 depreciation ((\$9,000 x 5.747 + \$9,000)/15), a difference of \$814 which at 0.01% of profits is immaterial.

The effect on the balance sheet, however, would be the removal of an asset of \$56,675 ((\$9,000 x 5.747 + \$9,000) x 14/15) and a liability of \$55,861 (\$9,000 x 5.747 x 1.08), which at 4.0% and 3.9% of total assets respectively are material.

Whether the asset is being depreciated over an appropriate period. The depreciation period is normally the shorter of useful life and lease term (i.e. nine years here). However, if it is reasonably certain that Beckham will retain ownership or use of the asset for the asset's useful life, 15 years may be appropriate.

Whether the interest rate implicit in the lease has been correctly calculated. This can be checked by using a market value for the asset to calculate the internal rate of return.

Whether the disclosures are correct for a finance lease (analysis of present value of minimum lease payments in the categories <1 year, 2-5 years, >5 years) or operating lease (analysis of future lease commitments in the same categories as above).

(ii) **Evidence to find**

The lease agreement with relevant sections demonstrating the type of lease highlighted.

A recalculation of the interest rate implicit in the lease.

Evidence of existence of the leased asset.

Documentation of any discussion with management regarding the use of the asset and period of use (plus potential management representation).

Recalculation of the disclosures in the accounts referenced to the financial statements.

Recalculation of depreciation charge and carrying value of the leased asset referenced to the financial statements (or workings making up the total figures).

Schedule of adjustments should the lease need to be classified as an operating lease.

Chapter 11

Answer to Lecture Example 1

- The independence requirements regarding the entity and the subsidiary and inform the firm that we will require written representations as to compliance with them.
- The use that is to be made of their work and report.
- Areas that we consider require special consideration (e.g. high risk or material areas)
- The accounting, auditing and reporting requirements and inform the firm that we will require written representations as to compliance with them.
- It is likely we will discuss the production of a questionnaire or checklist that the other auditor will be required to complete to detail the audit work performed.

Answer to Lecture Example 2

The following work would be performed in the fair values.

(i) **Inventories (international)**

The fair value for finished goods and work in progress should be based on selling price less costs to complete/costs of disposal less a reasonable profit margin. Raw materials are valued at current replacement costs. I will check replacement cost to suppliers' list prices on a sample basis. Selling price will be checked to sales invoices or price lists, disposal costs to budgets or subsequent/past payments and profit margins to management accounts and budgets.

Stocks (UK)

The fair value should be based on the lower of replacement cost and NRV. I will check replacement cost to suppliers' list prices on a sample basis, selling price will be checked to sales invoices or price lists.

(ii) **Payables / debtors**

The level of payables should be compared with previous years. It may be necessary to circularise payables to ensure that they are not understated. They should be held at present value if material. This can be recalculated using market interest rates at the time of the acquisition appropriate to the entity.

(iii) **Land & buildings**

If an independent valuation has been obtained, check the basis of valuation, which should be open market value. If the valuation is based on similar properties in the area discuss the basis with the directors. Consider obtaining a representation from the directors on the basis of the valuation.

Answer to Lecture Example 3

Possible discussion points

Audit firms

Advantages

- Geographic coverage
  – national
  – international
- Economies of scale
- Economies of scope
- Synergies

Disadvantages

- Concepts of integration
- Management culture
- Information systems
- Duplication
- Monopoly and mergers (antitrust) investigations

Clients

Advantages

- Global coverage
- Better service
- Reduced cost

Disadvantages

- Limitation of choice
- Conflicts of interests

Chapter 12

Answer to Lecture Example 1

- Obtain an understanding of the entity's business activities, the industry in which it operates and the system for recording financial information and preparing financial statements from prior year audit files and discussion with management.
- Enquire regarding any
  - changes to the entity's accounting principles and practices;
  - changes in the entity's procedures for recording financial information and preparing financial statements;
  - other relevant changes (e.g. a change in ownership).
- Enquire of management the current status of any prior year audit issues or management report points that would impact the financial statements.
- Obtain the trial balance and determine whether it agrees with the general ledger and financial statements.
- Obtain supporting schedules of each trial balance item and determine whether the total agrees with the trial balance.
- Perform analytical procedures to identify relationships and individual items that appear unusual and compare to prior year audited financial information and, if available, budgets and forecasts.
- Obtain explanations from management for any unusual fluctuations or inconsistencies in the financial statements.
- Consider the need for similar accounting adjustments to those identified in previous audits.
- Read the minutes of meetings of shareholders, the board of directors and other appropriate committees in order to identify matters that could be important to the review.

- Read the financial statements to consider whether the financial statements appear to conform with the basis of accounting indicated.
- Enquire
  - whether all financial information has been recorded completely, promptly and after the necessary authorisation;
  - about the existence of transactions with related parties and whether they have been disclosed;
  - about contingencies and commitments.
- Consider obtaining written representations from management.
- Enquire about events subsequent to the date of the financial statements that may require adjustment or disclosure in the financial statements.

Answer to Lecture Example 2

Practitioner: Auditor.

Responsible party: Audit client management.

Intended users: Shareholders (primary users).

Subject matter: The entity's balance sheet, statements of income and cash flows.

Suitable criteria: Financial Reporting Standards.

Sufficient appropriate evidence: Evidence of audit procedures – tests of controls, substantive procedures, etc.

Assurance report: Positive assurance: the financial statements give/do not give a true and fair view.

Answer to Lecture Example 3

(1) This is an assurance engagement as all the necessary elements are met. By providing an opinion on the client's responses the auditor is providing assurance.

(2) Preparation of the tax computation alone is not assurance unless the accountant also expresses a conclusion, but normally the engagement letter specifies that the responsibility for the tax computation rests with management.

(3) If the accountant draws a conclusion on whether the new image has been effectively implemented in identified areas, this would be an assurance engagement, probably providing limited assurance.

(4) Advisory services are not assurance per ISAE 3000.

(5) A due diligence report rarely gives an opinion and is therefore not assurance. Normally it is a report of factual findings based on the area of study and is hence an example of an agreed-upon procedures engagement.

(6) An internal control review provides assurance on the design and/or effectiveness of operation of internal controls.

Answer to Lecture Example 4

Risks	Mitigation
Old planes	
– Older planes will cost more to run due to higher repair costs	– Lease airplanes rather than buy second-hand planes.
– They may fail causing disruption to business and possible injury to passengers. This could lead to fines and loss of licences.	
– Customers want new planes and will not fly with RT.	
– The old planes do not comply with new environmental regulations. This could damage RT's image. The company will also incur large cost to update system and potential fines and loss of flight slots if they fail to comply. Potentially prevent RT from servicing routes.	– Lease new planes. – Investigate alternative methods of compliance, better or new fuels to reduce pollution.
Airport locations	
– Neither of the airports are in the city, reducing tourist and business travel. Not convenient for users.	– Strategic alliance with bus/train operator. Offer discounted or free tickets on purchase of flight.
– All airports are north of London. Not good for customers in the south. Very poor national coverage.	– Open new facilities in other parts of the country to improve national coverage.
Public relations	
– RT operates in the airline industry which is very competitive. Bad press would be very damaging. RT would incur large switching costs as customers move to the competition.	– Appoint PR managers to give all press releases. – Advertising campaign to move focus away from LR.
– Seating policy alienates passengers. Fear they will not get a seat and use alternative carrier.	– Change ticket policy. Only sell one ticket per seat, combine with new marketing campaign.
– Role of LR, she may be a fantastic business woman but she is not good at customer relations.	– Ensure LR takes a back seat. Use the new PR manager for all press contact.
New booking system	
– The system may put off users who like to talk to sales staff. Some customers may not have Internet access.	– Maintain a parallel phone system. Use discounts for all Internet bookings to encourage its use.
– Failure to pay tax may be illegal. At the least could force RT to pay tax after a test case. As RT reduced price there may not be the money to pay the tax, causing going concern problems.	– Test system with tax authorities. Take legal advice. – Do not pass on full discount to customers. Ensure liquid resources are available to pay tax in the future.

Risks	Mitigation
Staff	
– High staff turnover very costly, recruitment cost and loss of knowledge.	– Introduce staff incentive schemes. Free flights or bonuses.
– Temporary staff who don't speak English well will not provide a good face of RT to the passengers, leading to loss of customer goodwill.	– Steward and check-in staff given English classes. Always have an English speaking supervisor on hand. – Use more full-time staff where possible.
– Staff may not be trained sufficiently to safeguard passengers in the event of a crash or terrorist attack.	– Increase staff training.
– Terrorists may breach security and hijack planes.	– Liaise more closely with airport operator over security arrangements.
– Low wages to foreign staff potentially illegal and demotivational to staff.	– Ensure pay minimum wage. Review wage, ensure they are fair.
New long haul routes	
– The long haul market, different business to short haul. RT has no experience of long haul market. What is the strategy? – price, differentiation etc.	– Strategic link with tour operator or hotels to generate business. – Continue using same economy strategy.
– Large cost already incurred on licences. Must still find new funding for planes.	– New funding rights issue.
– Long haul, increased risk of terrorism.	
– Very competitive market.	
Military airbases	
– Customers may not want to fly to remote bases with poor facilities.	– Undertake market research. – Advertising/marketing campaign.
– Difficult for transfers to hotels etc as mentioned above.	– Provide courtesy bus.

Answer to Lecture Example 5

Non-financial performance measures (any five of these)

- Customer rejects or returns vs sales
- Customer satisfaction
- Wastage
- Staff morale
- Machine down time
- Documents processed per employee

Answer to Lecture Example 6

Businesses are exposed to the following risks if their systems are unreliable:

- Assets are misappropriated or tampered with.
- Systems are damaged and shut down.
- Data is tampered with and unauthorised amendments made.
- Confidential data is stolen.

Chapter 13

Answer to Lecture Example 1

Prospective financial information can include financial statements or one or more elements of financial statements and may be prepared:

(a) as an internal management tool, for example, to assist in evaluating a possible capital investment; or

(b) for distribution to third parties in, for example:

  (i) A prospectus to provide potential investors with information about future expectations.

  (ii) An annual report to provide information to shareholders, regulatory bodies and other interested parties.

  (iii) A document for the information of lenders which may include, for example, cash flow forecasts.

Answer to Lecture Example 2

The following work would be performed.

General procedures

(1) Meet with Paul to determine the process for preparing the forecast information.

(2) Identify and document internal controls over the process. Consider the role played by the internal audit department.

(3) Obtain backing schedules for the information, cast and ensure they are numerically accurate.

(4) Review the accounting policies used and ensure they are consistent with previous periods.

(5) Discuss the need to produce a full income statement taking account of the proposed tax, interest and dividend payment.

(6) Produce a letter of engagement.

(7) Obtain management representation with regard to the completeness and accuracy of information and assumptions used. Also this should contain a statement that it is management's responsibility to produce the information.

Income statement

(1) I would compare the forecast sales for the year with those in the previous audited financial statements. Challenge Paul's assumption that revenue will increase by 17%.

(2) Agree the increase to contracts, review the management accounts for the start of the year, do they show an increase in the revenue?

(3) Consider the likelihood of such an increase in revenue by reviewing the performance of similar companies in the same sector and reviewing the wider economic climate.

(4) Obtain a detailed analysis of revenue and cost, perform a detailed analytical review and discuss the unusual movements with Paul or other relevant directors of Prism.

(5) Compare the gross profit margin with that achieved in the past. The forecast shows an increase of 5% – how has this been achieved? Is it a realistic expectation?

(6) I would compare the level of expenses with those in prior year. Certain expenses should be fixed and remain static. Others will vary according to sales levels. Any significant fluctuations would be investigated further.

(7) Review the expected profit on disposal of investment to supporting documentation and recalculate it.

Balance sheet

(1) I will check the value of non-current assets to the most recent audited accounts. Possible impairment of assets will be discussed with the directors.

(2) I would recalculate depreciation for each period and check the accounting policies against those used in previous financial statements.

(3) I would calculate the age of inventories, receivables and payables and compare them with past financial statements. Any significant variations would be investigated further.

(4) Discuss with management the possibility of obtaining equity finance.

(5) Calculate key ratios and compare them year on year such as ROCE, asset turnover, current asset and quick asset ratios. Review any current bank agreement check that bank covenants are not breached.

(6) Discuss the need to include any provisions for contingencies, such as warranties.

(7) I would agree the cash figure and the level of overdraft and loans to agreements with the banks and financial institutions.

Chapter 14

Answer to Lecture Example 1

(a) *Integrity*

SL Ltd has been a victim of fraud perpetrated by at least one of its own staff. It appears that this is isolated to one, junior, member of staff. Despite this, prior to accepting the engagement we should consider the risk that the fraud was assisted by more senior members of staff or that there is a weak control environment which could call into question the integrity of some or all of the senior staff at SL Ltd. If we feel there is a significant risk of our own integrity being compromised we should not accept the engagement.

Objectivity

Should this case come to court in the future there is a very real chance staff from our firm could be called as an expert witness. We would need to consider our relationship with the client and whether that would restrict our ability to provide testimony to the court in an objective manner. An expert witness should seek to provide evidence independently regardless of the interests of their client.

Professional competence and due care

As with any engagement we should consider our ability to perform the engagement with the required level of expertise and competence. Our firm has a forensic department (albeit a small one) so it is likely that we have performed similar engagements in the past. We should note however that SL Ltd is a construction company and we would need to carefully consider whether we have sufficient knowledge of the business and the industry to perform a meaningful investigation.

Confidentiality

This engagement will carry a duty of confidentiality to the client; this will be overridden should we be called to court as an expert witness and we should inform the client of this in the engagement letter. Additionally this is likely to be a sensitive investigation and we should discuss the levels of secrecy required whilst we are at the client's premises.

Professional behaviour

There is a chance that this case could enter the public domain in a court case that could be relatively high profile. We should be careful to conduct ourselves in a professional manner and do nothing which brings our firm or the profession into disrepute particularly if we are called as an expert witness.

(b) *Procedures*

- Enquire of the Purchasing Manager as to the contracts/jobs for which Sam Seel dealt with the invoices.
- Perform an analytical review on purchases for contracts/jobs that Sam wasn't involved in to identify any unusual trends that may imply the fraud is more widespread.
- Inspect **all** (materiality is not relevant) invoices that Sam dealt with below $1,000. Be alert for invoices to suppliers not on the company's approved list or purchase ledger for the previous year (Sam was only employed for nine months). Unusual suppliers should be contacted to confirm their existence; where the supplier cannot be verified the invoice should be listed as being fraudulent.
- Perform an analytical review of all invoices dealt with by Sam in excess of $1,000. Consider any unusual trends in purchasing costs, margins and so on compared to the prior year. Unexplained fluctuations could indicate more extensive fraud and collusion with senior staff.
- Depending on the results of this analytical review, select a sample of invoices greater than $1,000 and ensure the existence of the suppliers as above.

Chapter 15

Answer to Lecture Example 1

- The growth in the importance of "the environment" as a political and economic issue.
- This has led to the growth of so called "ethical" consumers, investors and employees. These key groups are now very selective as to from whom they purchase goods, in which companies they invest and for whom they work.
- As a result of this businesses are keen to be seen to be engaging with the key stakeholder groups and demonstrating a commitment to ethical social and environmental behaviour.
- From an alternative perspective there has been, in many countries, a growth in the volume of domestic and supra-national legislation regulating the behaviour of businesses in these areas.

Answer to Lecture Example 2

(a) Perceived benefits of assurance work on environmental/social reports include the following.

- The assurance report adds credibility to the data reported
- Reassures investors by promoting transparency (and may improve stock market price)
- Prestige of having the information audited
- Competitive advantage over those whose reports are not audited
- Identifies areas of weakness which can be addressed
- It may be a requirement for trading with some companies/countries or governments
- Environmental performance is taken more seriously which in turn will improve performance and reduce costs.

(b)
- Note of the objectives of the review.
- Opinion (if the engagement was agreed upon procedures rather than assurance there will be no opinion given)
- Basis on which the opinion has been reached
- Work performed
- Limitations (if any) to the work performed
- Limitations (if any) to the opinion given

Note There is no specific guidance on the contents of an assurance report on environmental issues; the above points represent the minimum you should expect to see included.

Chapter 16

Answer to Lecture Example 1

	External Audit	Internal Audit
Objectives	Provide independent opinion on the truth and fairness of the accounts Ensure compliance with local legislation	Wide ranging and ultimately up to the management of the entity
Reports to…	Shareholders	Management/directors
Status	External and required to be independent of the entity	Employed by / contracted to the company (outsourcing). No independence requirement
Qualifications	Must be a qualified member of a recognised supervisory body	No formal qualifications required

Answer to Lecture Example 2

The **advantages** of outsourcing are as follows:

- It frees up the time of staff.
- It allows the company to take advantage of specialist expertise rather than investing in these facilities itself and under-utilising them.
- Services may be performed more quickly and to a higher standard.
- It may be cheaper, once time savings and opportunity costs are taken into account.

However there are a number of **disadvantages**:

- There is no guarantee that the service will be performed to the organisation's satisfaction.
- It may be more expensive than providing the service in-house.
- By performing services itself the organisation retains or develops skills that may be needed in the future and will otherwise be lost.
- Commercially sensitive data may get into the wrong hands.
- There may be opposition from employees if outsourcing involves redundancies.
- With respect to internal auditing, outsourcing would appear to go against the spirit of corporate governance requirements which regards regular monitoring of key controls by internal audit as an integral part of the company's system of controls.

Chapter 17 (UK & Int)

Answer to Lecture Example 1

Pros:

1 A short report should encourage the user to read it.
2 A standard format ensures that all the necessary information is included.
3 Time spent drafting the report is reduced leading to reduced audit fees.
4 Common language should facilitate user understanding.

Cons:

1 They cannot be tailored to specific circumstances.

2 A standard format year after year may result in users not reading the report. They may believe that they already know its contents.

3 The technical distinction between the different types of modification may not be appreciated by the user.

Answer to Lecture Example 2

Allowance for bad debt

Receivables (creditors) for the year is potentially overstated by $1 million, depending on the outcome of arbitral proceedings. The amount is material, being 43% of profit and 11% of total assets, and any settlement by which the price is reduced by more than 10% would be material to the income statement (P&L) (W1).

The outcome of the arbitration does not appear certain, despite the directors' feelings on the subject. It is clear that they did make amendments to the specification, albeit for what they saw as the right reasons, and therefore, as auditor we must be aware of the possibility that this price will be materially reduced, rendering the reported debt overstated.

In these circumstances, an allowance for the impairment of the debt should be made to some extent. We should take advice from the company's legal advisers as to whether they estimate the price will be reduced at arbitration, and if so, by how much.

If Santa's directors refuse to make any necessary allowance in the financial statements, the auditor's report should be modified on the grounds of disagreement with this lack of allowance as has been suggested on the audit file. However, this modification would be a qualified ('except for') rather than an adverse opinion as suggested on the audit file, as while it would be material, it does not appear to be pervasive to the financial statements, but rather confined to one item.

IAS 1 disclosure/FRS 3 disclosure

If a material allowance against this debt is required, as discussed above, separate disclosure will be required in respect of it in the notes in accordance with IAS 1/FRS 3. Again, if the directors fail to amend the financial statements to reflect this disclosure, the auditor's report should be modified on the grounds of disagreement with this lack of disclosure. Again, this is not pervasive to the financial statements, so a qualified ('except for') modification, rather than the suggested adverse opinion, would be appropriate.

Going concern

While the outcome of the arbitration might not in itself affect the going concern basis of the company, irretrievable loss of a major customer (half of the company's revenue (turnover)) could have seriously detrimental effects.

Hopefully the audit team has considered the going concern position of the company and this is all documented on file and, if necessary, disclosed in the financial statements. If sufficient disclosure has not been made, the auditor's report might also have to be modified on this issue.

There could be sufficient uncertainty about the company's future to warrant a significant uncertainty emphasis of matter paragraph in the auditor's report where the auditor would set out the fact that such an uncertainty existed. If sufficient disclosure had been made about this uncertainty, the auditor would draw attention to this disclosure in the auditor's report and state that the opinion was not qualified in that respect. If insufficient disclosure were given, as stated above, the auditor would make the disclosure in the auditor's report and modify the auditor's report on the grounds of lack of disclosure.

Events after the balance sheet date

The arbitral decision is not expected until after the AGM, when the financial statements will have been issued to members. However, although the IAS 10/FRS 21 *Events After the Balance Sheet Date* period for adjustments finishes when the financial statements are authorised for issue, the auditor's duty in respect of subsequent events continues under ISA 560 *Subsequent Events*. An early decision before the financial statements are authorised for issue would directly impact the financial statements and might require further amendment and a change in the audit opinion. A decision after that date may require the financial statements to be reissued and the auditor may need to seek legal advice as to possible actions if the directors refuse to do so.

(W1) Profit before tax = $2.35 million. Materiality = (say) 5% of PBT.

5% x $2.35m = $117,500 which is approximately 10% of contract price ($1,000,000)

Chapter 18

No Lecture Examples

END OF ANSWERS TO LECTURE EXAMPLES

Question and Answer bank

Index to Question and Answer bank

			Page	
			Questions	Answers
1	Aventura International	(Study Text Question 2)	20.3	20.9
2	CS Sales	(Study Text Question 5)	20.3	20.12
3	Griffin	(Study Text Question 14)	20.4	20.14
4	Annabella	(Study Text Question 18)	20.5	20.18
5	Verity	(Study Text Question 23)	20.5	20.21
6	Maple	(Study Text Question 26)	20.6	20.24
7	Locksley	(Study Text Question 12)	20.7	20.25

Questions

1 Aventura International

Aventura International, a listed company, manufactures and wholesales a wide variety of products including fashion clothes and audio-video equipment. The company is audited by Voest, a firm of Chartered Certified Accountants, and the audit manager is Darius Harken. The following matters have arisen during the audit of the group's financial statements for the year to 31 December 2007 which is nearing completion:

(1) During the annual inventory count of fashion clothes at the company's principal warehouse, the audit staff attending the count were invited to purchase any items of clothing or equipment at 30% of their recommended retail prices.

(2) The chief executive of Aventura International, Armando Thyolo, owns a private jet. Armando invoices the company, on a monthly basis, for that proportion of the operating costs which reflects business use. One of these invoices shows that Darius Harken was flown to Florida in March 2007 and flown back two weeks later. Neither Aventura nor Voest have any offices or associates in Florida.

(3) Last week Armando announced his engagement to be married to his personal assistant, Kirsten Fennimore. Before joining Aventura in September 2007, Kirsten had been Voest's accountant in charge of the audit of Aventura.

Required

Discuss the ethical issues raised and the actions which might be taken by the auditor in relation to these matters.

Note. Assume it is 6 December 2007. **(15 marks)**

2 CD Sales

CD Sales, a limited liability company, was a growth orientated company that was dominated by its managing director, Mr A Long. The company sold quality music systems direct to the public. A large number of sales persons were employed on a commission only basis. The music systems were sent to the sales agents who then sold them direct to the public using telephone sales techniques. The music systems were supplied to the sales agents on a sale or return basis and CD Sales recognised the sale of the equipment when it was received by the sales agents. Any returns of the music systems were treated as re-purchases in the period concerned.

The company enjoyed a tremendous growth record. The main reasons for this apparent expansion were as follows.

(a) Mr A Long falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the company's revenue.

(b) At the year-end, Mr Long despatched nearly all of his inventories of music systems to the sales agents and re-purchased those that they wished to return after the year-end.

(c) 20% of the cost of sales were capitalised. This was achieved by the falsification of purchase invoices with the co-operation of the supplier company. Suppliers furnished the company with invoices for non-current assets but supplied music systems.

(d) The directors of the company enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries. The directors did not query the unusually rapid growth of the company, and were unaware of the fraud perpetrated by Mr A Long.

Mr A Long spent large sums of money in creating false records and bribing accomplices in order to conceal the fraud from the auditor. He insisted that the auditor should sign a 'confidentiality' agreement which effectively precluded the auditor from corroborating sales with independent third parties, and from examining the service contracts of the directors. This agreement had the effect of preventing the auditor from discussing the affairs of the company with the sales agents.

The fraud was discovered when a disgruntled director wrote an anonymous letter to the Stock Exchange concerning the reasons for CD Sales's growth. The auditor was subsequently sued by a major bank that had granted a loan to CD Sales on the basis of interim accounts. These accounts had been reviewed by the auditor and a review report issued.

Required

(a) Explain the key audit tests which would normally ensure that such a fraud as that perpetrated by Mr A Long would be detected. **(7 marks)**

(b) Discuss the implications of the signing of the 'confidentiality' agreement by the auditor. **(4 marks)**

(c) Explain how the 'review report' issued by the auditor on the interim financial statements differs in terms of its level of assurance from the auditor's report on the year-end financial statements. **(4 marks)**

(d) Discuss where you feel that the auditor is guilty of professional negligence in not detecting the fraud. **(5 marks)**

(Total = 20 marks)

3 Griffin

Griffin Co, a listed company, manufactures football kit. It has contracts with a number of league football teams. It also produces 'unbranded' football wear, which it sells to a number of wholesalers.

The profit before tax for the year is $1.2m (2006 $3.5m). You are the manager responsible for the audit for the year end 30 June 2007. Today you have visited the client's premises to review the audit team's work to date. The audit senior has drafted the following 'points for the attention of the manager':

(1) Griffin is seeking to enter the market in women's leisure clothes. In light of that fact, during the year it purchased 30% of the share capital of Bees Co, a company that manufactures sporty leisurewear at a cost of $750,000. **(7 marks)**

(2) During the year a major competitor emerged in the branded football kit market. Two of the contracts with nationwide clubs which came up during the year have not been renewed. A number of key personnel have been headhunted by the competitor. **(6 marks)**

(3) A legal requirement to adjust the seats at which machinists sit was passed in December 2006. The legislation required the seats to be adjusted by April 2007. Griffin has not yet carried out any adjustment. Also in April 2007, the government increased the national minimum wage. 5% of Griffin's employees receive less than the minimum wage. **(7 marks)**

Required

(a) Comment on the matters you would consider.

(b) State the evidence you would expect to find during your review of the working papers and financial statements of Griffin Co.

(Total = 20 marks)

4 Annabella

Annabella Co has been an audit client of your firm for 13 years. It is a business which manufactures soft furnishings. It also has a shop, from which it sells its own soft furnishings, and other manufacturers' soft furnishings and small items of furniture.

On the first day of the year ending 30 June 2007, Annabella Co undertook a major reconstruction of its operations. It set up two subsidiary companies. Anna Co and Bella Co. It then transferred its trade to those companies. Anna Co took the manufacturing trade and Bella Co took the retail trade. On the same day, Annabella Co entered into a joint venture with its former chief designer. The joint venture, Annabella Designs Co, will provide designs for the soft furnishings manufactured by Anna Co and will also operate an interior design service, which will be advertised strongly by Bella Co.

Annabella Co is 100% owned by James Dancer. Annabella Co will charge Anna Co, Bella Co and Annabella Designs Co management charges.

The former chief designer, now a 50% shareholder in Annabella Designs Co is Annabel Dancer, James' only daughter. They make decisions about Annabella Designs jointly, and have agreed that the audit of Annabella Designs Co shall be carried out by David Turner and Co. David Turner is a friend of Annabel.

Required

(a) Identify and explain the audit planning issues in the above scenario. **(17 marks)**

(b) Describe the principal audit procedures on a consolidation. **(8 marks)**

(Total = 25 marks)

5 Verity

Verity, a limited liability company, has a credit facility with Cranley Bank of $6 million. The facility is due to expire on 31 December 20X1. The overdraft in the recently audited balance sheet at 30 September 20X1 is $5.5 million. The directors of Verity have started negotiations with their bankers for a renewal of the facility and to increase the amount to $9 million. To support this request the bank has asked Verity to provide a business plan for the coming 12 months consisting of a cash flow forecast supported by a forecast income statement and balance sheet. The management of Verity has produced a cash flow forecast for the period 1 October 20X1 to 30 September 20X2 and, at the request of the bank, has asked the auditor to examine and report on it.

The audit manager, who has recently completed Verity's audit, has been asked to make a preliminary examination of the cash flow forecast and supporting material and she has noted the following observations.

(a) The cash flows from sales are based on the assumption of an overall increase in sales of 24% compared to the previous financial year. Analysis shows that this is based on an increase in selling price of 5% and an increase in the volume of sales of 18%. Just over a quarter of all Verity's sales are made to foreign customers.

(b) The cost of sales in the recently audited income statement to 30 September 20X1 was 80% of sales revenue, giving a gross profit of 20%. In the forecast income statement for the year to 30 September 20X2 the cost of sales has fallen to 72%, giving a gross profit of 28%. Manufacturing costs are made up of approximately one third each of materials, labour and production overheads.

(c) The trade receivables collection period used in the cash flow forecast to 30 September 20X2 is 61 days. In the year to 30 September 20X1 this period averaged 93 days. Management has stated that it is its intention to inform all customers of a new standard 60 day credit period. In addition an early settlement discount of 1% will apply to customers who settle their account within 30 days of the statement.

Conversely the credit period for trade payables has been extended from an average of 45 days in the current year to 90 days in the forecast.

(d) The cash flow forecast showed that the maximum credit required during the period would rise to nearly $9 million in August 20X2.

Required

(a) Describe the general matters an auditor should consider before accepting an engagement as a reporting accountant on forecast financial information. **(5 marks)**

(b) Detail the procedures that the reporting accountant should undertake in relation to the cash flow forecast of Verity for the year to 30 September 20X2. **(8 marks)**

(c) The negotiations with Cranley Bank resulted in a renewal of Verity's existing credit facility of $6 million, but the bank would not agree to increase it to $9 million. As a result of this Verity issued a circular to its existing shareholders inviting them to subscribe for a new $3 million issue of debentures. The purpose of the circular was to show the intended use and the future benefits from the debenture issue. It was supported by the same forecast financial information, including the accountant's report, that had been provided to Cranley Bank. However the directors of Verity had removed all references to its original purpose and restricted distribution.

The trading results of the first half of the year to 30 September 20X2 showed that the forecast information was proving to be over optimistic and that Verity was beginning to experience cash flow difficulties.

Discuss the basis on which a reporting accountant should form an opinion on forecast information, and consider whether the reporting accountants of Verity may be liable to:

(i) Cranley Bank; and
(ii) The investors who subscribe for the new debentures. **(7 marks)**

(Total = 20 marks)

Note. You are to assume that the accountant's report had expressed an unqualified opinion on the cash flow statement.

6 Maple

(a) Explain the auditor’s responsibility in respect of fraud and error. **(5 marks)**

(b) Maple, a limited liability company, designs and manufactures high quality wooden furniture. The audit is nearing completion and you are in the process of reviewing the audit file in your capacity as audit manager.

Draft accounts for the year ended 30 September 20X5 show a profit before tax of $100,000 and total assets of $4,562,500.

The following matters are brought to your attention.

(i) The inventories figure of $675,000 includes $80,000 which has been valued based on the directors’ estimate. This is due to the loss of the inventory counting sheets for the Sherwood depot. The audit team were unable to find any other means of validating these inventories.

(ii) During the year Maple made a loan to a director, Colin Wood, for $5,000. This is not disclosed in the accounts as the directors believe that the transaction is a personal issue.

(iii) Trade receivables that total $525,000 include $47,000 due from Beech. This customer went into liquidation on 3 November 20X5. The audit senior has concluded that Maple is unlikely to recover the debt based on information provided by the liquidator.

The directors have refused to adjust the accounts.

The audit senior has drafted the auditor's report, extracts of which are as follows:

'*Modified opinion*

The inventories balance includes an amount of $80,000 based on the directors' estimate. This is because the inventory counting sheets for the Sherwood depot were lost and we were unable to find any other suitable means of confirming the inventory value. Also, included in receivables is an amount of $47,000 due from a company which is in liquidation. We believe that this amount should have been fully provided against as it is unlikely that they will receive any payment in respect of this amount.

Except for the financial effects of the matters referred to in the preceding paragraph, in our opinion, the financial statements give a true and fair view, in accordance with Generally Accepted Accounting Practice, of the state of the company's affairs as at 30 September 20X5 and of its profit for the year then ended.'

The audit senior has also attached a note for you explaining that he has made no reference to the director's loan on the basis that the amount involved is not material.

Required

Comment on the suitability of this report. Your answer should include an assessment of the materiality of each of the three outstanding issues. **(10 marks)**

(Total = 15 marks)

7 Locksley

The following is the draft balance sheet of Locksley Co for the year ended 31 January 20X3.

LOCKSLEY CO

BALANCE SHEET AS AT 31 JANUARY 20X3

	20X3	*20X2*
	$	$
Non-current assets		
Development expenditure	59,810	–
Tangible assets	99,400	73,000
Investments	85,100	101,400
	244,310	174,400
Current assets		
Inventory	58,190	63,010
Receivables	184,630	156,720
Cash at bank and in hand	9,970	62,620
	252,790	282,350
Payables: amounts falling due within one year	276,510	215,900
Net current (liabilities)/assets	(23,720)	66,450
Total assets less current liabilities	220,590	240,850
Payables: amounts falling due after more than one year		
Provisions for liabilities and charges	53,100	46,320
Deferred taxation	3,080	2,520
	164,410	192,010
Capital and reserves		
Share capital	89,700	89,700
Share premium account	11,300	11,300
Revaluation reserve	19,750	9,750
Retained earnings	43,660	81,260
	164,410	192,010

Locksley Co produces garden furniture and has incurred expenditure during the year ended 31 January 20X3 on the development of mouldings for a new range of plastic garden furniture. The directors wish to carry forward the development expenditure indefinitely as they feel that the company will benefit from the new moulding for many years. The product range is being developed because profits have been declining over the last few years owing to the uncompetitiveness of the products made by the company. The company has sold many of its non-current assets during the year and purchased new machinery which will enable the company's productivity to increase. The directors decided not to fund the above expenditure using outside finance but to generate the necessary resources internally by taking extended credit from its suppliers and utilising its liquid funds held at the bank. The company also sold part of its investments, which are made up of stocks and shares of public limited companies.

One of the reasons for this method of financing the expenditure was that the company already has a loan of $45,000 outstanding which has been included in the figure for 'payables: amounts falling due after more than one year'. This loan is secured on the non-current assets of the company and is repayable over ten years. The sale of non-current assets and investments did not yield as much as was expected and a small loss on sale of $1,200 has been included in the income statement as part of the amounts shown for 'other expenses'.

The company had the non-current assets revalued by a professional valuer, at the year-end. The gain on revaluation of non-current assets has been credited by the company to the revaluation reserve.

The directors felt that the shareholders should share in the gain on the revaluation of the non-current assets and increased the proposed dividend accordingly. Over 90% of the shares of the company are held by the directors.

Required

(a) Describe the audit work to be performed to verify the value attributed to the development expenditure in the balance sheet of Locksley Co. **(6 marks)**

(b) Describe the audit procedures which should be carried out to verify the gain arising on the revaluation of non-current assets. **(6 marks)**

(c) Explain to the directors why development expenditure should not be carried forward indefinitely in the financial statements, and describe the circumstances in which the costs maybe deferred to the future. **(8 marks)**

(d) Describe the implications for the company and the auditors of the directors' decision to generate internally the funds required for the development of the business. **(5 marks)**

(Total = 25 marks)

END OF QUESTION BANK

Answers

1 Aventura International

Marking scheme

	Marks
Ethical issues and actions to be taken	
Generally 1 mark a point	
Action ideas	
• Enquire (ask)/discuss/review/inspect/accept/decline	
• Safeguards	
Reason ideas	
• Ethical rules	
• Risk – actual/perceived	
For each matter	
Max 4 marks for issues	
Max 4 marks for actions	
Max 6 marks for any one matter × 3	Max 15

Ethical situations arising in connection with the audit of Aventura International

(1) **Offer of goods**

At the inventory count, the auditors attending were invited to purchase inventory at 30% of RRP, that is, at a 70% discount.

ACCA's guidance on accepting goods states that such benefits should only be accepted on 'normal commercial terms' or at a 'modest benefit'. What constitutes modest benefit will be a matter of judgement for the auditor.

Benefit

It is possible that this offer does approximate to offers made to staff at Aventura, as clothes commonly retail at prices with a substantial mark-up on cost. It would not be unreasonable for a clothes retailer to give staff a 'cost' benefit. The auditor should determine whether such a benefit is made available to staff. If it is not made to staff it should not be accepted by the auditor.

The term 'modest benefit' should be considered both in terms of materiality to the auditor and the company. The offer is not material to Aventura, for whom clothes retail is only one division. However, the offer of unlimited fashion at a 70% discount is extremely likely to be material to junior audit staff (who are the grade most likely to be allocated to the inventory count). In this context, the benefit is **not** clearly insignificant.

Timing

It would be inappropriate to take up the offer at the inventory count, not least because this would constitute movement of inventory during the count, which would be wrong.

Also, the junior staff members should not accept such goods without having discussed the matter with the audit partner (it is assumed in this answer that this is the first time such an offer has been made).

Lastly, if mistakes were to be made on the inventory count, the audit might be open to charges of negligence if it appeared its staff members indulged in a shopping trip when they should have been auditing.

Action to be taken

The staff members should not have taken up the offer at the inventory count.

The audit partner should discuss the matter with management, ascertain whether a similar benefit is offered to staff and decide whether he feels it is appropriate for his staff to take up the offer. It may be inappropriate as Aventura might become perceived to be a 'reward' job by audit staff. Alternatively, it might be appropriate if the audit firm imposed a financial limit to the benefits their staff could accept.

(2) **Hospitality**

An invoice to the company for business use of the Chief Executive's jet shows that the audit manager was flown to Florida and back for a stay of two weeks.

Issues arising

(a) If the invoice was ostensibly for 'business use', what was the business? (Neither the client nor the auditor have offices in Florida.)

(b) If the invoice was not for business, the Chief Executive is wrong to invoice it to the company. Is this common practice?

(c) If it was for business, the cost of the auditor's flight should not have been charged directly to the company, but the audit firm, who could then have re-charged it. Was Darius Harken working for the weeks in question, or is it recorded as holiday in the audit firm's records?

(d) Does the invoice actually represent a significant example of hospitality being accepted by the audit manager?

(e) Did the audit manager travel alone, with family, or even with the Chief Executive? Does this indicate that the audit manager has a close personal relationship with the Chief Executive?

Hospitality/close personal relationship

It is possible that points (d) and (e) above may be indicated by the invoice.

In terms of accepting hospitality, ACCA's guidance is the same as was discussed above in relation to accepting goods. It is unlikely that paying for an auditor's flight would be considered on normal commercial terms, because it would be traditional for the audit firm simply to recharge the cost of a business trip. Taking steps such as these would help to reduce the suggestion that something inappropriate has occurred, if the trip was genuinely business related.

If the trip was for pleasure (a) it should not have been charged to the company, which raises several auditing issues in its own right and (b) it does not come within the definition of 'modest commercial benefit'.

In terms of close business or personal relationships, ACCA's guidance states that these might adversely affect, or appear to affect, the objectivity of the auditor. It seems likely that in this instance, if the Chief Executive and the audit manager have been on holiday together, or at least a business 'jolly', then as a minimum, objectivity will **appear** to be threatened.

Action to be taken

(a) The audit firm should check their personnel records and see whether Darius Harken was working or holidaying at the relevant time.

(b) If the trip was business-related, the audit partner should check why the cost has been invoiced to the company by the Chief Executive and not by the audit firm.

(c) If the trip was personal, then the audit manager appears to have threatened the objectivity of the audit, and indeed, given that the trip appears to have been taken around the time the prior year audit was taking place, that audit is also adversely affected.

(d) The prior year audit files should be subjected to a cold review and the audit manager should be replaced on this year's audit, which should also be subject to a quality control review.

(e) All invoices rendered to the company in respect of the jet should be scrutinised by the audit team, for further evidence of personal expenses being charged to the company.

(3) **The impending marriage of the Chief Executive**

The Chief Executive's assistant is the former accountant in charge of the audit of Aventura, who is likely to have been involved with the audit of the previous year-end. She has just announced her engagement to the Chief Executive.

Issues arising

(a) Current year audit – there is a risk of loss of independence as the Chief Executive's assistant is aware of audit method.

(b) Prior year audit – there is a suggestion that the accountant in charge of the audit may have been in a personal relationship with the Chief Executive which may have adversely affected her objectivity.

Movement of audit staff

ACCA does not cover the issue of audit staff moving between the employments of the audit firm and audit clients. However, it is clear that this might adversely affect objectivity, so members involved in such activity should bear in mind the general guidance on objectivity.

IFAC suggests a number of safeguards in this situation, such as:

- Considering the appropriateness of modifying the plan for the engagement
- Assigning the audit team to someone of sufficient experience in relation to the person who has left
- Involving an additional accountant not previously associated with the audit to review

Action to be taken

Although the accountant in charge was not the most senior staff member on the audit, it would have been prudent to modify the audit plan before this year's audit. However, this does not appear to have been done, and the audit is nearing completion.

Therefore, it is important that Voest implement the third bullet point above, and conduct a quality control review of this audit.

In relation to the suspicion that Ms Fennimore's objectivity may have been affected last year, it might also be a good idea to conduct a similar review of last year's audit work, evidence obtained and conclusions drawn. However, as the work should have been reviewed by an audit manager and partner after Ms Fennimore's involvement, the risk of a problem on last year's audit appears to be slight.

2 CD Sales

(a) There are various key audit procedures which would have uncovered the fraud perpetrated by Mr A Long. Note that the first two tests would bring to the attention of the auditor the substantial inherent and control risk surrounding the accounts of CD Sales, thus increasing their perceived audit risk, and putting them on their guard.

Analytical review

The auditor should perform analytical procedures in order to compare the company's results with those of other companies in the same business sector. In particular, the auditor should look at sales growth rates and gross profit margins, but also inventory holding levels, non-current assets and return on capital. This should indicate that the company's results are unusual for the sector, to a great extent.

Review of service contracts

The auditor should examine the directors' service contracts. It is unusual for *all* directors to be paid such substantial bonuses, although the payment of bonuses of some sort to directors is common business practice. It is the size of the bonuses in proportion to the directors' base salaries which is the problem here. It increases both the inherent and control risk for the auditor because it reduces the directors' objectivity about the performance of the company. Audit risk is thus increased.

Testing of sales, purchases and inventories

(i) The main audit test to obtain audit evidence for sales would be to require direct confirmations from the sales agents. These confirmations would also provide evidence for the balance owed to CD Sales at the year-end and the inventories held by the agent at the year-end. Replies to such confirmations should be sent direct to the auditor who would agree the details therein to the company's records or reconcile any differences. Where replies are not received alternative procedures would be carried out which might include visits to the agents themselves to examine their records.

(ii) A selection of agents should, in any case, be visited at the year-end to confirm the inventories held on sale or return by physical verification. The auditor should count such inventories and consider obsolescence, damage etc.

(iii) Fictitious agents might be discovered by either of tests (iii) and (iv), but a further specific procedure would be to check authorisation of and contracts with all the sales agents. Correspondence could also be reviewed from throughout the year.

(iv) The practice of 'selling' all the inventory to the agents and them repurchasing it after the year-end should be detected by sales and purchases cut-off tests around the year-end. All transactions involving inventory items returned after the year-end should be examined.

Testing of non-current assets

Non-current asset testing should help to identify inventory purchases which have been invoiced as non-current assets.

(i) Samples of additions to non-current assets can be checked to the non-current asset register and to the asset itself.

(ii) Physical verification will ensure that an asset is being used for the purpose specified, and this should be relatively straightforward to check as the computers will each have individual identification codes.

(iii) Where the assets cannot be found, then it may be possible to trace the asset to inventories, perhaps via the selling agents' confirmations, or to sales already made.

Related parties review

The level of collusion with suppliers makes detection of fraud difficult, but the auditor may be put on guard if he discovers that the suppliers are related parties to CD Sales. A related party review would normally take place as part of an audit.

(b) The type of 'confidentiality agreement' signed by the auditor of CD Sales has reduced the scope of the audit to such an extent that it has become almost meaningless.

While it is understandable that companies would wish to protect sensitive commercial information, the auditor has the right to any information he feels is necessary in the performance of his duties. This agreement clearly circumvents that right. Moreover, such information would still be protected if released to the auditor, because the auditor is under a duty of confidentiality to the client.

In reducing the scope of the audit to this extent, the agreement prevents the auditor obtaining sufficient appropriate evidence to support an audit opinion. The auditor's report should therefore be modified on the grounds of limitation on scope, possibly to the extent of a full disclaimer.

In failing to issue such a modification, the auditor may well have acted negligently and even unlawfully in signing such an agreement.

(c) A review of interim accounts is very different from an audit of year-end financial statements. In an auditor's report a positive assurance is given on the truth and fairness of the financial statements. The level of audit work will be commensurate with the level of the assurance given, that is it will be stringent, testing the systems producing the accounts and the year-end figures themselves using a variety of appropriate procedures.

In the case of a review of interim financial statements, the auditor gives only negative assurance, that he has not found any indication that the interim accounts are materially misstated. The level of audit work will be much less penetrating, varied and detailed than in a full audit. The main audit tools used to obtain evidence will be analytical procedures and direct enquiries of the company's directors.

(d) It is not the duty of the auditor to prevent or detect fraud. The auditor should, however, conduct the audit in such a way as to expect to detect any material misstatements in the financial statements, whether caused by fraud or error. At the planning stage, the auditor should assess the risk that fraud is occurring both at the financial statement and the assertion level and plan his procedures accordingly. Where fraud is suspected or likely, the auditor should carry out additional procedures in order to confirm or deny this suspicion.

Even if a fraud is uncovered after an audit, the auditor will have a defence against a negligence claim if it can be shown that auditing standards were followed and that no indication that a fraud was taking place was received at any time.

Application of principles to this case

In this particular case, Mr A Long has taken a great deal of trouble to cover up his fraudulent activities, using accomplices, bribing people, cooking up fictitious documents etc. When such a high level fraud is carried out, the auditor might find it extremely difficult to uncover the true situation or even to realise anything was amiss. The auditor is also entitled to accept the truth of representations made to him and documents shown to him which purport to come from third parties.

On the other hand, the auditor should have a degree of professional scepticism. The auditor should be aware of the risks pertaining to the company and should recognise that controls can be overridden by collusion or by management actions. The suspicions of the auditor should have been aroused by the rapid growth rate of the company and fairly standard audit procedures on cut-off and non-current assets should have raised matters which required explanation.

Where the auditor has been most culpable, however, is in signing the confidentiality agreement. This restricted the scope of the audit to such an extent that the auditor should have known that there was insufficient evidence to support their opinion. The auditor will therefore find it difficult to defend a negligence claim.

3 Griffin

Tutorial note. This question requires a good accounting knowledge as well as good auditing knowledge. You must anticipate that there will be at least one question on the paper that has such a requirement. It is essential for auditors to understand accounting problems and the audit issues that such matters raise.

It is also important that you show the examiner that you have used the details given to you to consider matters such as materiality. Whether an issue is material or not is critical to an audit manager, who will not want to waste audit time considering matters which are not material. Use the details given to you as much as you can. For example, in (1), the details about profits and cost of investment help you to make a sensible comment about the chances that the 'group' created by the investment in the associate will be large enough to require some sort of group accounts, or in this case, additional disclosures for the associate. Note that **consolidated** financial statements are **not** required –as there is no subsidiary involved.

Lastly, it is perfectly legitimate for you to include current issues in your answer if they seem relevant, and you will receive credit for them if they are relevant and you use them well. For example it is reasonable in the answer to (2) where it touches on going concern to mention that if a lot of Griffin's revenue comes from league clubs, the company may be facing financial difficulties as an on-going results of problems with television revenues. You are training to be an accountant, you should be aware of current financial issues.

1 **Investment in Bees Co**

(a) *Matters to consider*

Inclusion in Griffin's accounts

Bees Co may meet the criteria to be accounted for as an associate under IAS 28. This states that an associate is an entity (other than a subsidiary) in which another entity (the investor) has a participating interest and over whose operating and financial policies the investor exercises a significant influence.

A company holding 20% or more of the voting rights in a company is presumed to exercise a significant influence. The auditors must check whether the shares held are **voting shares**.

Assuming that the entity is an associate, it should be included in Griffin's accounts as a fixed asset investment at cost, assuming that cost does not overstate the value of the asset. It is unclear whether the investment is material to Griffin's balance sheet.

'Group accounts' here does **not** mean a consolidation is required.

Requirement for group accounts?

Griffin and Bees may represent a 'group' for which group financial statements are required, even though as there is no subsidiary involved, consolidated financial statements are not required.

If group accounts are required, a further set of accounts with the associated equity accounted is required. Alternatively, Griffin's accounts could contain additional disclosure of what the accounts would look like if Bees had been equity accounted.

The 'Griffin Group' would be exempt from group accounts if the group was small or medium sized. Pre-tax profit of \$1.2 million and the cost of the investment to Griffin of

$750,000 both indicate that the group is not small The auditor needs to consider whether group accounts are required.

Other auditors

If group accounts are required, our firm would be the principal auditors and would need to liase with the auditors of Bees Co (the other auditors.)

Related party transactions

There may be related party transactions requiring disclosure under IAS 24.

Dividends

Griffin may have received, or be due, dividend income from Bees Co which will require disclosure in the financial statements.

(b) *Audit evidence required*

The investment in Bees Co should be verified to a **share certificate**. In order to determine whether the shares are voting or not, the auditors should obtain and review the **register of members** at Bees Co, which is open to the public for a fee.

The cost of the investment should be verified to purchase documentation, and the payment should be agreed to bank statements.

The auditors must **review the financial statements** or the most up to date financial information available **of Bees Co** to ensure that the cost figure used for the investment is still reasonable and that all dividends have been accounted for correctly in Griffin's financial statements. This information may be passed on by the other auditors.

The **sales and purchase ledgers** and the **bank statements** should be **scrutinised** to assess whether there are any related party transactions in the normal course of business. This should also be **discussed with the directors**.

2 **Competitor**

(a) *Matters to consider*

Going concern

The entrance into the market of a major competitor, the failure of the clubs to renew their contracts and the loss of personnel to the competitor may raise issues relating to going concern. The auditors must assess whether the non-renewal of contracts was anticipated, and whether historic practice shows that such contracts are often swapped. They must also discover whether the directors have assessed the impact of the competitor on their business and consider whether these assessments have covered all the issues, and what the implications for the future of Griffin are.

Further indicators of going concern issues could be the large drop in profit, the plan to diversify (does this indicate the old market is shrinking?) and the football league clubs facing current financial problems, some of whom may be customers of Griffin. However, there appears to have been sufficient cash available to make a substantial investment in Bees Co, which may indicate that going concern is not an issue. The auditor needs to check these matters.

Receivables

If the income from contracts with the League clubs has not been replaced, both revenue and receivables should have fallen on last year. We should check that this is the case.

Non-current asset impairment?

The entrance of a major competitor to the market could be considered under IAS 36 as a potential indicator of non-current asset impairment. The auditors need to consider whether non-current assets have been impaired, and whether the directors have considered if non-current assets have been impaired.

(b) *Audit evidence required*

The auditors need to gain evidence about going concern issues. They should review the cash flow statement and the financial statements generally and **assess the cash position** of the company. They should consider how the investment in Bees Co has been financed. They should review **arrangements with the bank** and ensure that Griffin has sufficient cash to operate.

The auditors must **discuss** (and document) the loss of the contracts and the new competitor with the directors, particularly the sales director. They should **review budgets and sales projections** and ensure that these factors have been taken into account in them. They should review the current order book for signs that the budgets are unrealistic.

The reasons for the plans to diversify into women's leisure wear must be discussed (and documented) with the directors. There must be evidence on file that the auditors have investigated the issue of going concern and satisfied themselves either that the entity will continue in the foreseeable future, or that the directors have made sufficient disclosures in the financial statements that the situation is explained to the users of the financial statements.

The auditors should **review any correspondence** relating to the non-renewal of contracts to ensure that the contract has not been renewed. If no such information is available, the former customers should be included as part of the **receivables' circularisation** to ensure that no money is owed by them at the end of the year. There must be evidence on file that the level of receivables has been analysed in the light of known facts about customers and loss thereof. The auditors should also have reviewed discussions in the press about the financial viability of any clubs that are customers to assess the **recoverability of current debt**.

The auditors should identify whether the directors have carried out an **impairment review** and should review it to see if it is reasonable if they have done so. If no impairment review has been carried out, the auditors should consider whether one is required and discuss this with the directors. They may want to obtain **written representation** from the directors that no impairment review is required.

3 *Legal requirements*

(a) *Matters to consider*

IAS 37

The provisions of IAS 37 must be considered in relation to the requirement to amend machinist's working conditions and the increase in the national minimum wage.

IAS 37 states that a provision is required if

- An enterprise has a present obligation as a result of a past event
- It is probable that an outflow of resources embodying economic benefits will be required to settle the obligation, and
- A reliable estimate can be made of the amount of the obligation

Three situations arise for Griffin:

(i) **Cost of adjustments**. As the adjustments have not yet been made, there is no present obligation to pay for them. The obligation to make the adjustments does not create a financial obligation to pay for them until a contract has been formed for the adjustments. No provision is therefore required for the cost of adjustment.

(ii) **Possibility of penalty**. As Griffin has not made the adjustments before the required date, it is possible that they are now subject to a penalty under the legislation. If this were to be in the form of a fine, this would result in the transfer of economic benefit. However, as it is only possible that such a penalty would occur (ie, no order has yet been made) no provision for fines would be required. However, the matter should be disclosed as a contingent liability, were it material.

(iii) **Liability to employees**. Some employees are not being paid the national minimum wage. If this is material, the auditor must consider whether there is a present obligation to pay those wages. However, as the shortfall is for 5% of employees and for two months of the year, it is extremely unlikely that this matter is material to the financial statements. Secondly, the auditor must consider whether any employees are taking action over the health and safety issue which has arisen over the seat adjustment.

ISA 250

Both issues arising here indicate that the entity is not complying with the laws and regulations concerning health and safety and to the national minimum wage.

Two considerations for the auditor result:

(i) Material effect on the financial statements? The auditors must consider whether examples of non-compliance will affect the financial statements in a material way. Given the considerations linked to IAS 37 above, it appears that this is not the case in this situation.

You are unlikely to be *au fait* with NMW law. Remember the requirement to report is in extreme cases, such as terrorism and drug-trafficking. Express a measured opinion.

(ii) Reporting on non-compliance. When the auditors become aware of non-compliance with laws and regulations, they must discuss them with management. There may also be a requirement to report non-compliance to a third party, such as a regulator. In this instance, it is extremely unlikely that there is such a requirement.

(b) *Audit evidence required*

The auditor must identify whether a contract has been entered into to make the adjustments to the seats. This might become obvious from a review of board minutes, or discussions with directors.

The auditor should also review the minutes to establish whether any fines have been levied. There should also be correspondence on the legislation requirements to review, or correspondence from the company solicitor.

In terms of the national minimum wage, the auditors should review the payroll to assess the extent of the problem.

It may be necessary to contact the solicitors to establish whether any legal action has been threatened by employees over either the health and safety issues or the wage issues outlined. If so, the auditors might have to rely on the solicitor's expert opinion as to whether the claims were actionable and the possible outcomes.

4 Annabella

Tutorial note. Part (a) is a very general requirement for a large number of marks. This can be daunting, but as this would be a compulsory question in the exam, don't let that put you off. Start thinking through standard lists of planning matters and see if any of them apply in this situation. (Don't include them in your answer if they don't apply, you won't get any marks for them.) Then read through the scenario again slowly (it is only short), looking for points that raise question marks or that indicate issues the auditor will need to consider.

You should be able to identify key issues in the scenario from key words. For example, '*set up two subsidiary companies*' = group audit, '*transferred its trade*' = IFRS 5, all the intercompany dealings should point you towards IAS 24. Remember also that as soon as Annabella Co sets up a group, you have several audits to consider: all the individual company accounts, and the consolidated ones. Don't talk about consolidation to the exclusion of the individual audits. Lastly, talk of group audits should always make you ask 'are there any other auditors?' and in this situation, there is the friend of the director.

Remember, it is not enough to identify that IFRS 5 (say) may be an issue. You must explain what the specific impacts are going to be. This is true of all the points you raise.

Part (b) should be much more straightforward than part (a). It requires you to repeat things you have learnt, rather than apply anything. You might have wanted to tackle this part first. However, as always, remember not to spend too long on the easier part that provides fewer marks. You need to get a good number of marks in part (a) to pass the question.

(a) **Planning issues**

Engagement letters

The audit firm needs to ensure that **every entity** that it audits is **covered in an engagement letter** so that there is no confusion over the audit that is undertaken. Annabella Co requires a **new engagement letter** itself because of the **radical overhaul** of its business and the impact that that will have on its own audit.

Impact on Annabella Co's individual accounts

(i) **Accounting for the investment in subsidiaries**. The auditors need to establish what the credit accounting entries were in Annabella Co's financial statements. If the trade and assets have been transferred, Annabella's **balance sheet is likely to be substantially different** from the previous year. As the firm were probably involved in the reconstruction and may have advised the journals, this information should be available at the firm.

(ii) **Profit on sale**. The auditors need to establish whether a profit on sale was made on the transfer of assets to the subsidiaries, as this may require special disclosure under IAS 8.

(iii) **Other items requiring special disclosure**. The auditors should consider whether any **costs of reconstruction** (for example, **legal fees or accountancy fees**) represent exceptional costs under the requirements of IAS 8. If this is the case, these would also require special disclosure.

(iv) **Discontinued operations**. Disclosures should have been made in the previous year's accounts for discontinued operations under IFRS 5. This should be checked in the **comparatives** for this year.

(v) **Accounting for the investment in a joint venture**. In the individual financial statements of Annabella, this should be **accounted at cost**. The auditors will need to check that the joint venture does **qualify** as a joint venture for accounting purposes under the requirements of **IAS 31**.

New subsidiaries

The audit firm will have to ensure that **financial statements** are being drafted for the new subsidiaries and that these are **to be audited**. They will have to determine an **audit approach** for these new audits. It is likely that they will be able to make use of **analytical evidence** from the previous business of Annabella, so while these will be first year audits, in many ways they will **not be a risky as first year audits can be**.

Related party transactions

In the individual company accounts there are going to be a number of related party transactions which **require disclosure** under IAS 24 . <90% subsidiaries are not required to make disclosures. If Annabella's parent accounts are published within the group accounts, the parent does not have to make disclosures either.

	Anna	**Bella**	**Annabella Designs**
Annabella	Transfer of assets and trade. Management charges.	Transfer of assets and trade. Management charges.	Management charges. Any transfer of assets and trade?
Anna		Trading on commercial terms?	Trading on normal commercial terms?
Bella			Advertising? Trading at all?

The relationships between the companies and directors and the ultimate controlling party will all require disclosure in the accounts. When the accounts are consolidated, intercompany trading will drop out, but the controlling party will still require disclosure.

Consolidation

(i) **Required?** The audit firm must determine whether the group will be required to publish group accounts. This will depend upon its **size**. If it qualifies as a small group, it may be exempt.

(ii) **Audited**. If the company is required to produce group accounts, then the consolidated accounts must be audited.

(iii) **Other auditors**. See below.

(iv) **Accounting**. The subsidiaries will require consolidating into the results of the group. The joint investment should be included in the group accounts under the gross equity method. Intercompany transactions will have to be stripped out.

(v) **Drafting**. The audit firm should determine who is to draft any required group accounts, in case the client would like them to. This would have to be included in the engagement letter and would also impact upon new fee quotes for the group.

Arrangements with the other auditors

(i) **Evaluation**. The firm is the principal auditor for the group, so it will need to evaluate the second audit firm (David Turner and Co) to assess **to what degree it is happy to rely on the audit of Annabella Designs**. It will need to satisfy itself particularly that the audit is going to be **objective** and independent, due to the personal relationship between the audit partner and the director of the firm. The firm may feel that the relationship is too close, the audit will not be objective, in which case they would have to discuss this matter with the directors of Annabella.

(ii) **Procedures**. If the auditors are happy that the audit will be objective and they are satisfied with the qualifications, resources and reputation of the other auditors, they will then have to **discuss the procedures and audit approach** with the other auditors.

(iii) **Timing**. The principal auditors will also need to outline the **deadlines** that they are working to, so the **time requirement** for the audit of Annabella Designs Ltd to be completed.

Costs and time budgets

As the group is new, it is **difficult to determine the time** that will be taken to complete the audit of the group, and this may **impact upon the fee**. The engagement partner should **discuss the fee level with the directors** and **possibly arrange** a margin by which it might rise, as it becomes apparent how long the audit will take.

The auditors will also require **good time budgets** upon which **to base future audits and billings**. The audit plan should require that **very detailed time records** are maintained, in particular, outlining time spent in the main because the audit of the group was **new** and on the **restructuring**.

(b) **Audit of a consolidation**

Step 1 Compare the audited accounts of each subsidiary/associate to the consolidation schedules to ensure figures have been transposed correctly.

Step 2 Review the adjustments made on consolidation to ensure they are appropriate and comparable with the previous year. This will involve:

- **Recording** the **dates** and **costs** of **acquisitions** of subsidiaries and the assets acquired
- **Calculating goodwill** and **pre-acquisition reserves** arising on consolidation
- **Preparing** an overall **reconciliation** of movements on reserves and minority interests

Step 3 For business combinations, determine:

- Whether acquisition or merger accounting has been appropriately used
- The appropriateness of the date used as the date for acquisition
- The treatment of the results of investments acquired during the year
- If acquisition accounting has been used, that the fair value of acquired assets and liabilities is reasonable (to ascertainable market value by use of an expert)
- Goodwill has been calculated correctly and if amortised, period of amortisation is reasonable

Step 4 For disposals:

- Agree the **date** used as the date for disposal to sales documentation
- Review management accounts to ascertain whether the **results** of the **investment** have been **included** up to the date of disposal, and whether figures used are reasonable

Step 5 Consider whether previous treatment of existing subsidiaries or associates is still correct (consider level of influence, degree of control)

Step 6 Verify the arithmetical accuracy of the consolidation workings by recalculating them

Step 7 Review the consolidated accounts for compliance with the law and standards and other relevant regulations. Care will need to be taken where:

- Group companies do not have coterminous accounting periods.
- Subsidiaries are not consolidated.
- Accounting policies of group members differ because foreign subsidiaries operate under different rules.

Other important areas include:

- Treatment of participating interests and associates
- Treatment of goodwill and intangible assets
- Foreign currency translation
- Treatment of loss-making subsidiaries
- Treatment of restrictions on distribution of profits of a subsidiary

Step 8 **Review** the **consolidated accounts** to confirm that they give a true and fair view in the circumstances.

5 Verity

(a) The factors that will affect the accountants' decision on whether to accept appointment are as follows.

(i) **Previous experience of client**

The accountants should draw on their knowledge of the client as gained during the audit. In particular they will be interested in the willingness of the client to provide information, the integrity and knowledge of the directors, and the reliability of the forecasts prepared for financial accounting purposes, for example for assessment of going concern or deferred tax.

(ii) **How prepared**

The accountants will need to consider how the forecast is being prepared, in particular:

(1) How the forecast was compiled, and the staff who compiled it.

(2) The extent to which the forecast is based on assumptions consistent with past events. The details given suggest that a more optimistic view is being taken than is warranted by the company's record in recent years.

(3) Whether the forecast represents management's best estimate of achievable results, or whether it represents hopeful targets or is based on certain hypothetical events taking place.

(4) How the forecast takes account of factors which may invalidate the assumptions made.

(5) The level of detail available supporting the forecast.

(iii) **Terms of report**

The accountants will need to consider the exact terms within which they are reporting, as this could have a bearing on their liability. This is discussed further in (c) below.

(iv) **Users**

The accountants should consider carefully the use to which the report will be put, and its audience.

(b) A major concern of the reporting accountant will be the assumptions on which the report is based. The level of evidence required will depend on the terms of the accountants' report, but some evidence will be required on the major assumptions made in the forecast.

(i) **Sales**. It might be expected that the price increase would result in some lost sales, so extra sales will be needed from other customers to make up for the sales lost as well as achieving the planned increase. The auditor will need to focus on the plans to achieve that increase. Increases might be a result of a change in the sales mix or new products or customers; if these changes have already occurred, the accountants should consider what effect they have already had. Increased marketing and promotional activity may also be necessary, and this would need to occur rapidly in order to achieve the desired effect. This activity will probably be reflected in increased costs, and the accountants will need to check that these have been included in the forecast.

(ii) **Cost of sales**. The accountants will need to consider whether economies have been planned to improve margins, whether these economies are likely to be achieved, and whether there will be consequential other costs that need to be reflected in the plan. For example reduction in the labour force is likely to mean redundancy costs, investment in more up-to-date plant and equipment to mean capital investment costs.

(iii) **Trade receivables**. The accountants should consider whether the decrease in settlement period is likely to be achieved. They should consider whether emphasising new credit limits and prompt settlement discounts will help achieve the required target, and also the effectiveness of any other measures the company takes, for example tighter checks on new customers and more rigorous pursuit of slow payers. In particular the accountants will need to review the position of foreign customers, as they may be less flexible in reducing settlement periods. The accountants should also check that the consequences of the prompt settlement discount, a reduction in amounts received, have been reflected in the forecast. For foreign customers, the accountants should also check any exchange rate effects have been reflected in the forecast.

(iv) **Trade payables**. The accountants should check that the increase in payable days will not breach terms of business with suppliers, leading to possible supply problems or withdrawal of credit terms and demands for immediate cash payments. They should also check that the forecast reflects other possible consequences of the increase, for example a loss of early settlement discounts.

(v) **Maximum finance**. The accountants should check whether the estimated increase in finance is reasonable or whether other sources will be required, either because the $9 million is an under-estimate or because other existing sources of finance will need to be repaid. The accountants should check that the consequences of the increase, particularly an increased interest burden, have been reflected. They should consider also whether the forecast shows that the company will be able to make the repayments comfortably, or whether the forecast margins are tight.

The accountants should also check that the forecast is internally consistent, for example that increased sales correspond with increased purchases, and reflects all non-trading cash flows. Consistency with forecasts made for other purposes, for example management accounting budgets, should also be checked.

(c) Liability will depend partly on the following general factors.

Extent of assurance

In this assignment accountants are focusing on uncertain future events, as opposed to an audit, where the report is based on a verification of data relating to past events. Therefore the level of assurance that can be given on this type of report is lower.

The exact level of assurance will depend on the form of the opinion given. Reporting under ISAE 3400 *The examination of prospective financial information* would require the accountants to report whether the forecast has been properly compiled on the basis of the stated assumptions and is presented in accordance with the relevant financial reporting framework. The report would state that nothing has come to the accountants' attention to suggest that the assumptions do not provide a reasonable basis for the prospective financial information. The accountants may go further, and make a positive report on the assumptions or less probably give a report on the achievability of the forecasts. If the report gives more positive assurance, this may increase the expectations of the report's readers as to the assurance given.

Other report issues

Whatever the exact terms of their opinion, the accountants should mention other matters in their report that will clarify for users what the accountants have done and hence what they are offering:

(i) The accountants should state why and for whom the report is being prepared.

(ii) Reference should be made to the work done, and whether the work has been done in accordance with ISAE 3400.

(iii) The report should state that the directors are responsible for the assumptions made.

(iv) The accountants may be able to include specific disclaimers on the assumptions made and achievability of the forecasts. Even if they do not, they should make a statement about the uncertainty of the forecast, and the possibility that the actual outcomes will differ from what is predicted.

Cranley Bank

The accountants were on notice that the forecast was being prepared for the purposes of the bank, and thus the degree of the proximity that the law relating to professional liability requires has been established. If a claim arises, the courts will consider whether the forecast was properly prepared and based on reasonable assumptions that took account of the information that should have been known at the time of the forecast. If it was not, the court would then consider whether the accountants should have drawn the conclusion that they did or allowed themselves to provide some degree of implicit assurance on the forecast because of their association with it.

Certainly some of the assumptions made would appear to be doubtful and the bank may have a case against the accountants. However if the company fails to meet the forecast, it may well be difficult to assess how much this was due to factors that could have been predicted, and how much it was due to factors that could not have been forecast when the forecast was made.

The debenture holders

The accountants will probably not be liable to the debenture holders, The accountants stated in their report that it was prepared solely for the bank. The fact that the directors omitted this statement makes no difference to the accountants' liability, although it may render the directors liable. In addition had the report been prepared for the purposes of obtaining debenture finance it would have been prepared on different assumptions.

6 Maple

(a) **Auditor's responsibility in respect of fraud and error**

ISA 240 *The auditor's responsibility to consider fraud in an audit of financial statements* states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance and the management of an entity. It is not the auditor's function to prevent fraud or error although the fact that an audit is carried out may act as a deterrent.

In respect of detection, ISA 240 states that the auditor should assess the risk of material misstatement due to fraud at both the financial statement and assertion level and determine overall responses to address the assessed risks. This might include changing the nature, timing and extent of audit procedures, eg more inspection, more work conducted during the year rather than at the year end and larger sample sizes.

The approach to error under ISA 315 Understanding the entity and its environment and assessing the risks of material misstatement and ISA 330 The auditor's procedures in response to assessed risks is broadly similar to the approach outlined for fraud above.

In practical terms the likelihood of detecting errors will be much higher than that of detecting fraud as deliberate attempts are normally made to conceal fraud including collusion and falsification of records.

In either case an audit is subject to an unavoidable risk that some material misstatements will not be detected.

If the auditor identifies an instance of fraud or error, he should document his findings and report them to the appropriate level of management and possibly to those charged with governance of the entity depending on their significance.

The auditor also needs to consider the potential impact on the audit opinion. If the fraud or error has a material effect on the financial statements the auditor's report may need to be modified. The nature of the modification would depend on the specific circumstances.

The auditor may need to consider whether there is a legal duty to report the occurrence of fraud or material error to regulatory or enforcement authorities.

(b) **Auditor's report**

Inventories in Sherwood

An exact calculation of the required adjustment to inventories cannot be performed as it is not possible to tell the extent to which the directors' valuation is incorrect. However the inventories figure of $80,000 overall is material to both the profit and total assets figure.

The issue here is a limitation on scope which is material (assuming that the audit manager agrees that no other procedures can be performed). In the draft auditor's report this has not been dealt with correctly. It appears that it has been dealt with as a disagreement.

The explanation of the problem has been correctly dealt with in the explanatory paragraph itself. The opinion paragraph should have acknowledged the limitation as follows:

'Except for the financial effects of such adjustments, if any, as might have been determined to be necessary had we been able to satisfy ourselves as to the validity of the inventories figure, in our opinion the financial statements……'

Director's loan

The audit senior has made no reference to the loan on the basis that $5,000 is not material to the financial statements. Whilst this is true from a quantitative perspective, in this case the director's loan is material due to the sensitive nature of the balance. IAS 24 *Related party disclosures* requires disclosure of transactions with key management personnel.

If the directors of Maple still refuse to provide the necessary information the details of the loan should be included in the auditor's report. In addition the opinion would be modified (qualified – 'except for') on the grounds of a material disagreement for non compliance with legislation/IFRS.

Bad debt

If the debt in respect of Beech were written-off this would result in a reduction in profits of 47% and assets of 8.4%. On this basis it would have a material effect on the financial statements. Whilst material, the matter is isolated to the receivables balance and does not affect the truth and fairness of the financial statements overall. The audit senior has modified the audit opinion on the grounds of material disagreement with the decision not to provide against the debt. This is the correct treatment and the report has been correctly drafted in respect of this issue.

7 Locksley

Tutorial note. The audit of these assets is relatively straightforward, but it relies on your knowledge of the relevant accounting standards. You should cover every aspect of the audit of these items, perhaps by considering the balance sheet and then the income statement effects.

(a) The relevant audit tests are as follows.

(i) The auditors should **obtain** from the client a **breakdown** of the figure for development expenditure which makes it possible to trace the amounts spent to the nominal ledger and the final accounts.

(ii) **Tests of controls** should be performed to ensure that a system exists for controlling the authorising and recording of development expenditure, and that the system is operating adequately. (This work may be covered where practicable by the audit tests performed on the company's purchases and payroll systems.)

(iii) Individual amounts should be **vouched** by reference to **supporting documentation**. The relevant documentation will vary according to the type of expenditure, but tests might include the following.

(1) Agree purchases to requisitions, orders, goods received notes, invoices, cash book and bank statement.

(2) Agree labour costs to the payroll and to supporting evidence, such as time sheets or job cards.

(3) If overheads have been included in the development figure, ensure that they have been calculated on a basis consistent with that used generally by the company.

The auditors will wish to set a materiality level for testing individual items; this will have to be established when the breakdown of the total figure is known. For instance, it may be possible to restrict testing considerably if one or two large invoices represent the bulk of the relevant expenditure.

(iv) The **arithmetical accuracy** of the schedule of expenditure should be **checked**.

(v) The auditors should **ensure** that there has been **no double-counting**, that is, that development items capitalised have not also been charged as an expense in the income statement.

(vi) Finally, the auditors should carry out a **review of the development figure** in order to be satisfied that it is reasonable and consistent with what else is known about the company and its business.

(b) The following audit procedures may be performed to verify the revaluation gain arising on non-current assets.

   (i) Ensure that the **valuer** appears to be **appropriately qualified** and **independent** of the company. If these conditions are not fulfilled, the auditors will need to consider their possible impact on the results of the valuation.

   (ii) By reference to the instructions given to the valuer and the valuer's report, ensure that the **valuation** has been **performed on a basis reasonable and consistent** with previous valuations.

   (iii) Check that **profits or losses on individual non-current assets** have been **correctly calculated** by reference to the non-current asset register and the detailed analysis of the revaluation.

   (iv) **Check the arithmetical accuracy** of the compilation of the **revaluation schedule** and of the **calculation of asset profits and losses**.

(c) IAS 38 lays down the basis on which development costs may be carried forward. They may be carried forward only if, and to the extent that, they represent an **asset** which is likely to generate income for the company in the future. It would contravene the prudence concept to carry forward expenditure which is not reasonably expected to generate future income.

According to IAS 38, development expenditure should be written-off in the year it is incurred, unless it meets all the following criteria:

- The technical feasibility of completing the intangible asset so it will be available for use or sale can be demonstrated
- The entity can demonstrate its intention to complete the intangible asset and use or sell it
- The entity can demonstrate its ability to use or sell the asset
- The entity can show how the asset will generate probable future economic benefits
- The availability of adequate technical, financial and other resources to complete the development and to use or sell the asset can be shown
- The entity can measure reliably the expenditure attributable to the asset during its development

If, taking a prudent view of the available evidence, these conditions are met, development costs may be deferred and amortised over the period expected to benefit.

(d) The decision to finance development internally has resulted in a large increase in payables and a decrease in cash and bank balances. This may lead to liquidity problems, especially since the company will still need funds to finance the new product. These funds will have to be generated either by the sale of further investments, the raising of a loan from the directors or an outside investor, or by the issue of shares. If **funding** is **not available**, the **development expenditure** should be **written-off** on the basis that it will not be possible to complete the project. This would eliminate the retained earnings reserve and would create doubts about the company's status as a going concern.

The auditors should discuss with the directors their plans for obtaining **additional finance**, and request that they produce cash flow forecasts in support of these. If the auditors do not obtain satisfactory evidence of the company's ability to obtain finance, it may be necessary to qualify the audit report on the grounds of going concern problems which have not been fully disclosed.

END OF ANSWER BANK

Appendix A: Pilot paper questions

SECTION A: This question is compulsory and MUST be attempted

1 You are an audit manager in Ribi & Co, a firm of Chartered Certified Accountants. One of your audit clients Beeski Co provides satellite broadcasting services in a rapidly growing market.

In November 2005 Beeski purchased Xstatic Co, a competitor group of companies. Significant revenue, cost and capital expenditure synergies are expected as the operations of Beeski and Xstatic are being combined into one group of companies.

The following financial and operating information consolidates the results of the enlarged Beeski group:

	Year end 30 September	
	2006 (Estimated)	*2005(Actual)*
	\$m	\$m
Revenue	6,827	4,404
Cost of sales	(3,109)	(1,991)
Distribution costs and administrative expenses	(2,866)	(1,700)
Research and development costs	(25)	(22)
Depreciation and amortisation	(927)	(661)
Interest expense	(266)	(202)
Loss before taxation	(366)	(172)
Customers	14·9m	7·6m
Average revenue per customer (ARPC)	\$437	\$556

In August 2006 Beeski purchased MTbox Co, a large cable communications provider in India, where your firm has no representation. The financial statements of MTbox for the year ending 30 September 2006 will continue to be audited by a local firm of Chartered Certified Accountants. MTbox's activities have not been reflected in the above estimated results of the group. Beeski is committed to introducing its corporate image into India.

In order to sustain growth, significant costs are expected to be incurred as operations are expanded, networks upgraded and new products and services introduced.

Required

(a) Identify and describe the principal business risks for the Beeski group. **(9 marks)**

(b) Explain what effect the acquisitions will have on the planning of Ribi & Co's audit of the consolidated financial statements of Beeski Co for the year ending 30 September 2006. **(10 marks)**

(c) Explain the role of 'support letters' (also called 'comfort letters') as evidence in the audit of financial statements. **(6 marks)**

(d) Discuss how 'horizontal groups' (ie non-consolidated entities under common control) affect the scope of an audit and the audit work undertaken. **(5 marks)**

(Total = 30 marks)

2 You have been asked to carry out an investigation by the management of Xzibit Co. One of the company's subsidiaries, Efex Engineering Co, has been making losses for the past year. Xzibit's management is concerned about the accuracy of Efex Engineering's most recent quarter's management accounts.

The summarised income statements for the last three quarters are as follows:

Quarter to	*30 June 2006*	*31 March 2006*	*31 December 2005*
	$'000	$'000	$'000
Revenue	429	334	343
Opening inventory	180	163	203
Materials	318	251	200
Direct wages	62	54	74
	560	468	477
Less: Closing inventory	(162)	(180)	(163)
Cost of goods sold	398	288	314
Gross profit	31	46	29
Less: Overheads	(63)	(75)	(82)
Net loss	(32)	(29)	(53)
Gross profit (%)	7·2%	13·8%	8·5%
Materials (% of revenue)	78·3%	70·0%	70·0%
Labour (% of revenue)	14·5%	16·2%	21·6%

Xzibit's management board believes that the high material consumption as a percentage of revenue for the quarter to 30 June 2006 is due to one or more of the following factors:

(1) Under-counting or under-valuation of closing inventory;
(2) Excessive consumption or wastage of materials;
(3) Material being stolen by employees or other individuals.

Efex Engineering has a small number of large customers and manufactures its products to each customer's specification. The selling price of the product is determined by:

(1) Estimating the cost of materials;
(2) Estimating the labour cost;
(3) Adding a mark-up to cover overheads and provide a normal profit.

The estimated costs are not compared with actual costs. Although it is possible to analyse purchase invoices for materials between customers' orders this analysis has not been done.

A physical inventory count is carried out at the end of each quarter. Items of inventory are entered on stocksheets and valued manually. The company does not maintain perpetual inventory records and a full physical count is to be carried out at the financial year end, 30 September 2006.

The direct labour cost included in the inventory valuation is small and should be assumed to be constant at the end of each quarter. Historically, the cost of materials consumed has been about 70% of revenue.

The management accounts to 31 March 2006 are to be assumed to be correct.

Required

(a) Define 'forensic auditing' and describe its application to fraud investigations. **(5 marks)**

(b) Identify and describe the matters that you should consider and the procedures you should carry out in order to plan an investigation of Efex Engineering Co's losses. **(10 marks)**

(c) (i) Explain the matters you should consider to determine whether closing inventory at 30 June 2006 is undervalued; and

(ii) Describe the tests you should plan to perform to quantify the amount of any undervaluation. **(8 marks)**

(d) (i) Identify and explain the possible reasons for the apparent high materials consumption in the quarter ended 30 June 2006; and

(ii) Describe the tests you should plan to perform to determine whether materials consumption, as shown in the management accounts, is correct. **(7 marks)**

(Total = 30 marks)

Section B – TWO questions ONLY to be attempted

3 You are a manager in Ingot & Co, a firm of Chartered Certified Accountants, with specific responsibility for the quality of audits. Ingot was appointed auditor of Argenta Co, a provider of waste management services, in July 2006. You have just visited the audit team at Argenta's head office. The audit team is comprised of an accountant in charge (AIC), an audit senior and two trainees.

Argenta's draft accounts for the year ended 30 June 2006 show revenue of \$11·6 million (2005 – \$8·1 million) and total assets of \$3·6 million (2005 – \$2·5 million). During your visit, a review of the audit working papers revealed the following:

(a) On the audit planning checklist, the audit senior has crossed through the analytical procedures section and written

'not applicable – new client'. The audit planning checklist has not been signed off as having been reviewed. **(4 marks)**

(b) The AIC last visited Argenta's office when the final audit commenced two weeks ago on 1 August. The senior has since completed the audit of tangible non-current assets (including property and service equipment) which amount to \$0·6 million as at 30 June 2006 (2005 – \$0·6 million). The AIC spends most of his time working from Ingot's office and is currently allocated to three other assignments as well as Argenta's audit. **(4 marks)**

(c) At 30 June 2006 trade receivables amounted to \$2·1 million (2005 – \$0·9 million). One of the trainees has just finished sending out first requests for direct confirmation of customers' balances as at the balance sheet date. **(4 marks)**

(d) The other trainee has been assigned to the audit of the consumable supplies that comprise inventory amounting to \$88,000 (2005 – \$53,000). The trainee has carried out tests of controls over the perpetual inventory records and confirmed the 'roll-back' of a sample of current quantities to book quantities as at the year end. **(3 marks)**

(e) The AIC has noted the following matter for your attention. The financial statements to 30 June 2005 disclosed, as unquantifiable, a contingent liability for pending litigation. However, the AIC has seen a letter confirming that the matter was settled out of court for \$0.45 million on 14 September 2005. The auditor's report on the financial statements for the year ended 30 June 2005 was unmodified and signed on 19 September 2005. The AIC believes that Argenta's management is not aware of the error and has not brought it to their attention. **(5 marks)**

Required

Identify and comment on the implications of these findings for Ingot & Co's quality control policies and procedures.

Note. The mark allocation is shown against each of the five issues.

(Total = 20 marks)

4 You are the manager responsible for four audit clients of Axis & Co, a firm of Chartered Certified Accountants. The year end in each case is 30 June 2006.

You are currently reviewing the audit working paper files and the audit seniors' recommendations for the auditors' reports. Details are as follows:

(a) Mantis Co is a subsidiary of Cube Co. Serious going concern problems have been noted during this year's audit. Mantis will be unable to trade for the foreseeable future unless it continues to receive financial support from the parent company. Mantis has received a letter of support ('comfort letter') from Cube Co.

The audit senior has suggested that, due to the seriousness of the situation, the audit opinion must at least be qualified 'except for'. **(5 marks)**

(b) Lorenze Co has changed its accounting policy for goodwill during the year from amortisation over its estimated useful life to annual impairment testing. No disclosure of this change has been given in the financial statements. The carrying amount of goodwill in the balance sheet as at 30 June 2006 is the same as at 30 June 2005 as management's impairment test show that it is not impaired.

The audit senior has concluded that a qualification is not required but suggests that attention can be drawn to the change by way of an emphasis of matter paragraph. **(6 marks)**

(c) The directors' report of Abrupt Co states that investment property rental forms a major part of revenue. However, a note to the financial statements shows that property rental represents only 1·6% of total revenue for the year. The audit senior is satisfied that the revenue figures are correct.

The audit senior has noted that an unqualified opinion should be given as the audit opinion does not extend to the directors' report. **(4 marks)**

(d) Audit work on the after-date bank transactions of Jingle Co has identified a transfer of cash from Bell Co. The audit senior assigned to the audit of Jingle has documented that Jingle's finance director explained that Bell commenced trading on 7 July 2006, after being set up as a wholly-owned foreign subsidiary of Jingle.

The audit senior has noted that although no other evidence has been obtained an unmodified opinion is appropriate because the matter does not impact on the current year's financial statements. **(5 marks)**

Required

For each situation, comment on the suitability or otherwise of the audit senior's proposals for the auditors' reports. Where you disagree, indicate what audit modification (if any) should be given instead.

Note. The mark allocation is shown against each of the four issues.

(Total = 20 marks)

5 (a) Comment on the need for ethical guidance for accountants on money laundering. **(5 marks)**

(b) You are senior manager in Dedza & Co, a firm of Chartered Certified Accountants. Recently, you have been assigned specific responsibility for undertaking annual reviews of existing clients. The following situations have arisen in connection with three clients:

(i) Dedza was appointed auditor and tax advisor to Kora Co last year and has recently issued an unmodified opinion on the financial statements for the year ended 31 March 2006. To your surprise, the tax authority has just launched an investigation into the affairs of Kora on suspicion of underdeclaring income. **(7 marks)**

(ii) The chief executive of Xalam Co, an exporter of specialist equipment, has asked for advice on the accounting treatment and disclosure of payments being made for security consultancy services. The payments, which aim to ensure that consignments are not impounded in the destination country of a major customer, may be material to the financial statements for the year ending 31 December 2006. Xalam does not treat these payments as tax deductible. **(4 marks)**

(iii) Your firm has provided financial advice to the Pholey family for many years and this has sometimes involved your firm in carrying out transactions on their behalf. The eldest son, Esau, is to take up a position as a senior government official to a foreign country next month. **(4 marks)**

Required

Identify and comment on the ethical and other professional issues raised by each of these matters and state what action, if any, Dedza & Co should now take.

Note. The mark allocation is shown against each of the three situations.

(Total = 20 marks)

END OF APPENDIX A