**Initial audit engagement**

Generally up to 1½ marks for each point discussed, including:

- Communicate with the previous auditor, review their working papers

It is important, given that this is an initial audit engagement, that we carry out specific audit procedures to minimise risk. We should start by contacting the previous auditor to request access to the working papers for the financial year ended 31st May 14. This will enable us to more efficiently plan the audit by highlighting any potential problems in the opening balances or in understanding the appropriateness of accounting policies applied.

- Consider whether any previous auditor reports were modified

In addition to the above it will be important as part of our initial risk assessment to enquire as to whether any of the previous Audit Reports have been modified. A previous modification will indicate increased risk of misstatement and we would need to ensure the problem was rectified.

- Consider any matters which were raised when professional clearance was obtained

As part of the client acceptance process, professional clearance should have been sought from Crilly & Co. Any matters which were brought to our firm’s attention when professional clearance was obtained should be considered for their potential impact on the audit strategy.

- Consider matters discussed with management during our firm’s appointment

- Need to develop thorough business understanding

- Risk of misstatement in opening balances/previously applied accounting policies

- Firm’s quality control procedures for new audit clients

- Need to use experienced audit team to reduce detection risk

Maximum marks 6
Evaluation of audit risk

Generally up to 1½ marks for each point discussed, and 1 mark for each calculation of materiality.

– Management bias due to recent stock market listing – pressure on results

There is an inherent risk in the fact that the stock market listing during the year which will mean that management will want to show good results. The fact that profit before tax has increased by 48.1% would also indicate that there is a potential over-statement.

– Management bias due to owner’s shareholding – incentive to overstate profit

There is a related risk of overstatement due to Dougal Doyle and his family members retaining a 30% equity interest in Ted Co, which is an incentive for inflated profit so that a high level of dividend can be paid.

– Management lacks knowledge and experience of the reporting requirements for listed entities

There is also a risk that management lacks knowledge of the reporting requirements specific to listed entities, for example, in relation to the calculation and disclosure of earnings per share which is discussed later in these briefing notes.

– Weak corporate governance, potential for Dougal to dominate the board

It appears that governance structures are not strong, for example, there are too few non-executive directors, and therefore Dougal Doyle is in a position to be able to dominate the board and to influence the preparation of the financial statements. This increases the risk of material misstatement due to management bias.

– Revenue recognition – should the revenue be deferred

Deferred licence income makes up 13.4% of total assets making it material. It may be that management control along with the risk and rewards have passed to the buyer and that the revenue should not be deferred at all leading to a potentially large understatement of revenue and profit.
- Revenue recognition – whether deferred income recognised over an appropriate period
- E-commerce (allow up to 3 marks for discussion of several risks factors)
- Foreign exchange transactions – risk of using incorrect exchange rate
- Forward currency contracts – risk derivatives not recognised or measured incorrectly
- Portfolio of investments – risk fair value accounting not applied
- New team dealing with complex issues of treasury management
- EPS – incorrectly calculated (allow 3 marks for detailed discussion)
- EPS – risk of incomplete disclosure
- Rapid growth – control risk due to volume of transactions
- Profit margins – risk expenses misclassified (1 mark for each margin correctly calculated
- Development costs – risk of over-capitalisation of development costs
- Inventory – year-end counts already taken place, difficulties in attending inventory counts
- Opening balances (give mark here if not given in (a) above)

Maximum marks 17
Recently, a small treasury management function was established to manage the company's foreign currency transactions, which include forward exchange currency contracts. The treasury management function also deals with short-term investments. In January 2015, cash of $8 million was invested in a portfolio of equity shares held in listed companies, which is to be held in the short term as a speculative investment. The shares are recognised as a financial asset at cost of $8 million in the draft statement of financial position. The fair value of the shares at 31 May 2015 is $6 million.

Audit procedures on the portfolio of short-term investments

Inspect stock market listings to agree the fair value of the shares held as investments at 31 May 2015.

Confirm the original cost of the investment to cash book and bank statements.

Enquire with management as to the accounting treatment and confirm that an adjustment will be made to recognise the shares at fair value.

Inspect the notes to the financial statements to ensure that disclosure is sufficient to comply with the requirements of IFRS 9.

Enquire with the treasury management function as to whether there have been any disposals of the original shares held and reinvestment of proceeds into the portfolio.

Inspect board minutes to confirm the authorisation and approval of the amount invested.

Inspect documentation relating to the scope and procedures of the new treasury management function, for example, to understand how the performance of investments is monitored.

For any investments from which dividends have been received, confirm the number of shares held to supporting documentation such as dividend received certificates or vouchers.
Audit procedures on earnings per share

Enquire with management as to the requirements of IAS 33 and request that management recalculates the EPS in accordance with those requirements.

Inspect board minutes to confirm the authorisation of the issue of share capital, the number of shares and the price at which they were issued.

Inspect any other supporting documentation for the share issue, such as a share issue prospectus or documentation submitted to the relevant regulatory body.

Confirm that the share issue complies with the company's legal documentation (e.g. the memorandum and articles of association).

Recalculate the weighted average number of shares for the year to 31 May 2015.

Recalculate EPS using the profit as disclosed in the statement of profit or loss and the weighted average number of shares.

Discuss with management the existence of any factors which may impact on the calculation and disclosure of a diluted EPS figure, for example, convertible bonds.

Inspect the notes to the financial statements in respect of EPS to confirm that disclosure is complete and accurate and complies with IAS 33.

Note: Earnings per share has been calculated as follows:

<table>
<thead>
<tr>
<th></th>
<th>$'000</th>
</tr>
</thead>
<tbody>
<tr>
<td>Profit before tax</td>
<td>8,000</td>
</tr>
<tr>
<td>Add: Depreciation</td>
<td>1,100</td>
</tr>
<tr>
<td>Amortisation</td>
<td>6,000</td>
</tr>
<tr>
<td>Adjusted profit before tax</td>
<td>15,100</td>
</tr>
<tr>
<td>Adjusted profit before tax</td>
<td>15,100,000</td>
</tr>
<tr>
<td>Number of equity shares at 31 May 2015</td>
<td>16,850,000</td>
</tr>
</tbody>
</table>

= 89.6 cents per share
Evaluation of business risks

Generally up to 1 1/2 marks for each business risk evaluated. In addition, 1 mark for relevant trends calculated and used as part of the risk evaluation.

Regulatory risk – licensing of products
A significant regulatory risk relates to the highly regulated nature of the industry. If any of Connolly Co’s products fail to be licensed for development and sale, it would mean that costs already incurred are wasted. Research and development costs are significant. For example, in 2014 the cash outflow in relation to research and development amounted to 7-5% of revenue, and the failure to obtain the necessary licences is a major threat to the company’s business objectives.

Regulatory risk – patent infringement
In developing new products and improving existing products, Connolly Co must be careful not to breach any competitor’s existing patent. If this were to happen, significant legal costs could be incurred in defending the company’s legal position. Time and effort must be spent monitoring product developments to ensure legal compliance with existing patents.

Regulatory risk – advertising
The company risks running inappropriate advertising campaigns, and failing to comply with local variations in regulatory requirements. For example, if television campaigns to promote products occurred in countries where this is not allowed, the company could face fines and reputational damage, with consequences for cash flow and revenue streams.

- Skilled workforce
- Risk of diversification
- Cash flow issues – negative trend/cash management issues
- Cash flow issues – reliance on further bank finance
- Cash flow issues – timing of cash flows
- Court case – bad publicity and further scrutiny
- Risk of overtrading

Maximum marks 11
Risks of material misstatement

Up to 2 marks for each risk identified and explained – 4 risks only. Also allow up to 1 mark for appropriate and correct materiality calculations.

Management bias
Connolly Co’s management is attempting to raise finance, and the bank will use its financial statements as part of their lending decision. There is therefore pressure on management to present a favourable position. This may lead to bias in how balances and transactions are measured and presented. For example, there is a risk that earnings management techniques are used to overstate revenue and understate expenses in order to maximise the profit recognised.

We will need to be aware of this throughout the audit and particularly recognise the risk in areas where management has used judgement such as estimating a provision.

Development costs – recognition
Research costs must be expensed and strict criteria must be applied to development expenditure to determine whether it should be capitalised and recognised as an intangible asset. There is a risk that the expenditure on the drug affected by side-effects has been capitalised when the development is unlikely to be completed meaning the intangible asset associated would be overstated.

Development costs – amortisation
Amortisation should be carried out on a systematic basis over the lifetime of the intangible asset. If there has been a change such as a competitor entering that market or other conditions changing it may be that the basis has changed and amortisation increased.

The risk if this does not happen is that assets are overstated and expenses are understated.

Patent costs
The cost of acquiring patents for products should be capitalised and recognised as an intangible asset as the patent provides protection over the economic benefit to be derived. If patent costs have been expensed rather than capitalised, this would understate assets and overstate expenses. Once recognised, patents should be amortised over the period of their duration, and non-amortisation will overstate assets and understate expenses.

Court case – provision or contingent liability

Segmental reporting

Maximum marks 8
Another success in 2014 was the acquisition of the ‘Cold Comfort’ brand from a rival company. Products to alleviate the symptoms of coughs and colds are sold under this brand. The brand cost $5 million and is being amortised over an estimated useful life of 15 years.

Audit procedures on the Cold Comfort brand

Inspect board minutes for evidence of discussion of the purchase of the acquired brand, and for its approval.

Agree the cost of $5 million to the company’s cash book and bank statement.

Obtain the purchase agreement and confirm the rights of Connolly Co in respect of the brand.

Enquire with management as to the estimated useful life of the brand of 15 years and obtain an understanding of how 15 years has been determined as appropriate.

If the 15-year useful life is a period stipulated in the purchase document, confirm to the terms of the agreement.

If the 15-year useful life is based on the life expectancy of the product, obtain an understanding of the basis for this, for example, by inspecting a cash flow forecast of sales of the product.

Inspect any market research or customer satisfaction surveys to confirm the existence of a revenue stream.

Consider whether there are any indicators of potential impairment at the year end by obtaining pre-year-end sales information and reviewing terms of contracts to supply the products to pharmacies.

Recalculate the amortisation expense for the year and agree the charge to the financial statements, and confirm adequacy of disclosure in the notes to the financial statements.
Ethical matters

Generally up to 1 mark for each point discussed:

Loan guarantee is a financial self-interest threat
First, the bank has asked our firm to provide a guarantee in respect of the bank loan which may be advanced to our client. The provision of such a guarantee represents a financial interest in an audit client, and creates a self-interest threat because the audit firm has an interest in the financial position of the client, causing loss of objectivity when auditing the financial statements.

The loan is material and guarantee should not be given
The loan is 5% of the total assets of Connolly and that combined with their financial difficulties make it material.

If an audit firm guarantees a material loan to an audit client, the self-interest threat created would be so significant that no safeguards could reduce the threat to an acceptable level.

The advice on systems would be a non-audit service
Threat of assuming management responsibility
Self-review threat created
The second threat relates to Connolly Co’s request for our firm to provide advice on the new accounting and management information systems to be implemented next year. If the advice were given, it would constitute the provision of a non-assurance service to an audit client and is a significant self-review threat.

The auditor would be required to assess the system during the audit and would therefore be less objective, in addition they would be assuming the responsibility of management creating a significant threat.

Service can only be provided if systems unrelated to financial reporting
In this case the advice relating to accounting systems must not be given

In the case of an audit client which is a public interest entity, the Code states that an audit firm shall not provide services involving the design or implementation of IT systems which form a significant part of the internal control over financial reporting or which generate information which is significant to the client’s accounting records or financial statements on which the firm will express an opinion.

Advisable not to provide the advice on management information systems
Discuss both matters with management/those charged with governance

Maximum marks 7
Audit risk evaluation

Up to 2 marks for each audit risk evaluated
Up to 1 mark for each relevant calculation/trend and 1⁄2 mark for relevant materiality calculations

New audit client

The fact that this is Group is a new client will increase detection risk as we do not have previous knowledge. We will therefore need to be careful to gain sufficient understanding to enable us to adequately audit their activities.

We need to obtain an understanding of each of the subsidiaries and they are all significant components of the Group, with Ross Co, Lynott Co and Beard Co’s assets representing respectively 20%, 22.3% and 26% of Group assets.

Brand name – indefinite useful life and lack of amortisation

The Adams brand is correctly capitalised as a purchased intangible but at its original cost. There is risk attached to the policy of non-amortisation of the brand. IAS 38 Intangible Assets states that an intangible asset with a finite useful life is amortised, and an intangible asset with an indefinite useful life is not.

The brand is material at 7.4% of Group Assets and there is a risk that it is overstated so we will need to understand the basis for the assessment of its indefinite life.

Equity accounting – measurement of associate and possible impairment

A new associate has been acquired during the year, which gives rise to several risks. It is material at 11.2% of Group assets and the first risk is that it has not been treated correctly under Equity Accounting. The value in the SFP has increased by $0.5m presumably due to profit earned by the associate but there is a risk that this has been done incorrectly.

Disclosure of income from associate

The draft statement of profit or loss and other comprehensive income does not show income from the associate as a separate line item; it may have been omitted or netted against operating expenses, and the risk is inappropriate presentation of the income from investment.

Classification as an associate

There is also a risk that the new investment has been incorrectly classified as an associate. Under IAS 28 this should happen where the parent has ‘significant influence’ which is assumed at 20%. However there is a risk that the 25% holding does not confer ‘significant influence’ either through voting rights of other influence.

We will need to confirm through documentation etc. that the classification is appropriate.
Ross Co's revenue recognition
Ross Co should only recognise revenue when the sale of goods criteria from IAS 18 Revenue have been met. For example, revenue should only be recognised when the seller has transferred to the buyer the significant risks and rewards of ownership and the seller does not retain continuing managerial involvement.

The nature of the agreement between Ross Co and the department stores will need to be reviewed to understand the substance of the arrangement and the implications for Ross Co's revenue recognition policy. There is a risk that revenue is recognised at an inappropriate point, and may be over or understated.

Ross Co's inventory – control issues relating to multi-location of inventory
A risk arises in relation to inventory, which is held in each of the department stores. There is a risk that controls are not sufficiently strong in respect of the movement of inventory and counting procedures at the year end, as it will be hard for Ross Co to ensure that all locations are subject to robust inventory counting procedures. This control risk leads to potential over or understatement of inventory and cost of sales.

Lynott Co's new inventory control system
A new system introduced during the year can create control risk. With any new system, there are risks that controls may take time to develop or be properly understood, and risk of error in relation to inventories is relatively high.

Beard Co's investment property – measurement of the gain & incorrect classification
The investment properties are material to both Beard Co’s individual financial statements, representing 35.7% of its total assets, and also to the Group’s financial statements, representing 9.3% of Group assets.

IAS 40 states that investment properties held under the fair value model should be remeasured in profit or loss whereas we can see a gain of $2.5m relating to the increase in value of these properties but only $1m in other comprehensive income which in any case should be in profit or loss.

Possible error in comparative information and need for skepticism
The possible error discussed above in relation to the presentation of the investment property gain is also relevant to the comparative information, which may also be materially misstated. This increases the risk that other balances and transactions in the prior years have been incorrectly accounted for. The use of professional skepticism should be stressed during the audit, and further procedures planned on opening balances and comparative information.
Bonus scheme – inherent risk of overstatement of revenue
The bonus scheme gives rise to a risk of material misstatement at the financial statement level. Management will be biased towards accounting treatments which lead to overstatement of revenue, for example, the early recognition of revenue.

Trend calculations, comment on increase in both revenue and operating expenses
Revenue has increased by 11.5% on the prior year, which is a sizeable increase indicating potential overstatement. However, cost of sales and operating expenses have also increased, by 10.9% and 11% respectively, so the increase could be as a result of genuine business activity.

Elimination of management charges
The management charges imposed by the parent company on the subsidiaries represent inter-company transactions. In the individual financial statements of each subsidiary, there should be an accrual of $800,000 for the management charge payable in August 2014, and Adams Co's individual financial statements should include $2.4 million as a receivable. There is a risk that these payables and the corresponding receivable have not been accrued in the individual financial statements.

Inventories – movement in the year and potential overstatement
The draft consolidated statement of financial position shows that inventory has doubled in the year. Given that the Group is involved in retail, there could be issues to do with obsolescence of inventory, leading to potentially overstated inventory and overstatement of profit if any necessary write down is not recognised. This may be especially the case for the mass market fashion clothing made by Lynott Co. Inventory is material to the Group, representing 11.2% of Group assets.

Goodwill – none recognised
The draft consolidated statement of financial position does not recognise goodwill, which is unusual for a Group with three subsidiaries. It may be that no goodwill arose on the acquisitions, or that the goodwill has been fully written off by impairment. However, there is a risk of understatement of intangible assets at the Group level.

Maximum marks 18
Using the work of a component auditor

Up to 1½ marks for each matter explained:

Compliance with ethical requirements
The Group engagement team should ascertain whether the component auditor understands and will comply with the ethical requirements which are relevant to the group audit and, in particular, is independent.

When performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements which are relevant to the group audit. Given that Clapton & Co is based overseas, the ethical requirements in that location may be different, possibly less stringent, to those followed by the Group.

Professional competence
The component auditor’s professional competence should also be assessed, including whether the component auditor has the relevant industry specific skills and technical knowledge to adequately obtain evidence on the component. As Lynott Co reports under IFRS, there is less likelihood of Clapton & Co having a knowledge gap in terms of the Group’s applicable financial reporting framework than if the company used local accounting rules.

Sufficient involvement in component auditor’s work/resources
The group audit team should also gain an understanding of Clapton & Co’s resource base to ensure it can cope with the work required by the Group. There should also be evaluation of whether the group engagement team will be able to be involved in the work of the component auditor to the extent it is necessary to obtain sufficient appropriate audit evidence.

Existence of a regulated environment
Whether the component auditor operates in a regulatory environment which actively oversees auditors should be understood. The Group audit team should ascertain whether independent oversight bodies have been established in the jurisdiction in which Clapton & Co operates, to oversee the auditing profession and monitor the quality of audit.

Assess level of risk in the subsidiary audited by the component auditor
In addition to the matters required to be considered in accordance with ISA 600 discussed above, the risk of material misstatement in the subsidiary being audited by the component auditor must be fully assessed, as areas of high risk may require input from the Group audit team, and not be subject to audit solely by the component auditors. For areas of high risk, such as Lynott Co’s inventories, the Group audit team may consider providing instructions to the component auditor on the audit procedures to be performed.

Maximum marks 8
Procedures

Review the local ethical code (if any) followed by Clapton & Co, and compare with the IESBA Code of Ethics for Professional Accountants for any significant difference in requirements and principles.

Obtain confirmation from Clapton & Co of adherence to any local ethical code and the IESBA Code.

Establish through discussion or questionnaire whether Clapton & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body.

Obtain confirmations of membership from the professional body to which Clapton & Co belong, or the authorities by which it is licensed.

Discuss the audit methodology used by Clapton & Co in the audit of Lynott Co, and compare it to those used under ISAs (e.g. how the risk of material misstatement is assessed, how materiality is calculated, the type of sampling procedures used).

A questionnaire or checklist could be used to provide a summary of audit procedures used.

Ascertian the quality control policies and procedures used by Clapton & Co, both firm-wide and those applied to individual audit engagements.

Request any results of monitoring or inspection visits conducted by the regulatory authority under which Clapton & Co
June 15 Q2

The Adder Group (the Group) has been an audit client of your firm for several years. You have recently been assigned to act as audit manager, replacing a manager who has fallen ill, and the audit of the Group financial statements for the year ended 31 March 2015 is underway. The Group's activities include property management and the provision of large storage facilities in warehouses owned by the Group. The draft consolidated financial statements recognise total assets of $150 million, and profit before tax of $20 million.

Materiality

The leisure centre is material to the Statement of financial position as it makes up 18% of the total assets (35-8/150).

In addition the profit on disposal of $8m is highly material to the P/L as it makes up 40% of profit before tax.

Treatment

It appears that this arrangement is a sale and lease back under a finance lease due to the rental at the market rate + 2% as well as the option to repurchase at the market value at the end of the term.

The correct treatment therefore would be to defer the $8m profit and recognise it over the term of the lease which means that profit is materially overstated.

In addition the new fair value of $35m should be used to create an asset as the risk and reward of ownership of the leisure complex has been retained. The other side of this DR entry is a CR to create a lease liability for the finance lease.

At the moment therefore both assets and liabilities are materially understated.

From then on there would be a finance charge in the P/L for the interest treatment on the lease and the new asset would be depreciated over its useful economic life. If this is not done, expenses will be understated.

Evidence

Copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with the Group, and that the arrangement is a finance leaseback.

Confirmation of the fair value of the property complex, possibly using an auditor's expert to report.

Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements.

Required:

In respect of the issues described above:

Comment on the matters to be considered, and explain the audit evidence you should expect to find in your review of the audit working papers.

Note: The marks will be split equally between each part.

(16 marks)
The Adder Group (the Group) has been an audit client of your firm for several years. You have recently been assigned to act as audit manager, replacing a manager who has fallen ill, and the audit of the Group financial statements for the year ended 31 March 2015 is underway. The Group’s activities include property management and the provision of large storage facilities in warehouses owned by the Group. The draft consolidated financial statements recognise total assets of $150 million, and profit before tax of $20 million.

**Materiality**

(a) The audit engagement partner, Edmund Black, has asked you to review the audit working papers in relation to two audit issues which have been highlighted by the audit senior. Information on each of these issues is given below:

(i) In December 2014, a leisure centre complex was sold for proceeds equivalent to its fair value of $35 million, the related assets have been derecognised from the Group statement of financial position, and a profit on disposal of $8 million is included in the Group statement of profit or loss for the year. The remaining useful life of the leisure centre complex was 21 years at the date of disposal.

The Group is leasing back the leisure centre complex to use in its ongoing operations, paying a rental based on the market rate of interest plus 2%. At the end of the 20-year lease arrangement, the Group has the option to repurchase the leisure centre complex for its market value at that time.

(ii) In January 2015, the Group acquired 52% of the equity shares of Baldrick Co. This company has not been consolidated into the Group as a subsidiary, and is instead accounted for as an associate. The Group finance director’s reason for this accounting treatment is that Baldrick Co’s operations have not yet been integrated with those of the rest of the Group. Baldrick Co’s financial statements recognise total assets of $18 million and a loss for the year to 31 March 2015 of $5 million.

**Control**

The Group’s interest in Baldrick Co is material, as the company’s assets are equivalent to 12% of total Group assets, and its loss is equivalent to 25% of the Group’s profit.

**Treatment**

Typically control over a subsidiary is assumed with a 50% holding although there are limited circumstances such as shareholder agreements that may result in such a holding not resulting in control. These however are rare.

Baldrick Co not having been integrated into the Group’s activities is not a valid reason for its non-consolidation as a subsidiary.

A subsidiary requires full line-by-line consolidation whereas an associate has one line for the investment in Associate on the SFP and Income from Associate in P/L.

In this case the loss of ($5m x 3/12) $1.25m from the subsidiary should be brought into the group accounts rather than the equity method for an associate which would result in ($5m x 3/12 x 52%) $600,000 of a loss being recognised.

**Evidence**

Agreement of the cash paid to acquire Baldrick Co to cash book and bank statements.

Review of board minutes for discussion of the change in Group structure and for authorisation of the acquisition.

Review of legal documentation pertaining to the acquisition of Baldrick Co, to confirm the number of equity shares acquired, and the rights attached to the shareholding, e.g. the ability to appoint board members.

Inspection of other supporting documentation relating to the acquisition such as due diligence reports.
The storage of the chemicals raises concerns that the Group may not be complying with regulations such as health and safety legislation. The auditor needs to consider whether the entity's operations are conducted in accordance with applicable laws and regulations, in particular where non-compliance has an impact on the financial statements.

The auditor is required to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance.

Therefore the auditor should ensure a full knowledge and understanding of the laws and regulations relevant to the storage of items in the Group's warehouses is obtained, focusing on health and safety issues and the implications of non-compliance.

If non-compliance is identified or suspected, the auditor will need to obtain an understanding of the nature of the act, the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements.

Management may not be aware that the warehouse manager is allowing the storage of these potentially hazardous items and the auditor should ignore the warehouse manager's threats and communicate the suspected non-compliance as soon as possible due to its seriousness. If management ignore this then those charged with governance may be informed and ultimately the regulatory body.

The auditor needs to consider the potential implications for the financial statements. The non-compliance could lead to regulatory authorities imposing fines or penalties on the Group, which may need to be provided for in the financial statements.

There is also an ethical issue arising from the warehouse manager's aggressive attitude and threatening behaviour. This may indicate potential bribery or wilful ignorance of the issue and should be reported to those charged with governance.

The final issue is that the Group should review its policy of requiring limited documentation for contracts less than $10,000. This would seem to be inappropriate because it may lead to other instances of unknown items being stored in the Group's warehouses.
June 15 Q4

You are a senior manager in Bunk & Co, a global audit firm with offices in more than 30 countries. You are responsible for monitoring audit quality and ethical situations which arise in relation to audit clients. Wire Co is an audit client whose operations involve haulage and distribution. The audit report for the financial statements of Wire Co for the year ended 31 December 2014 was issued last week. You are conducting a review of the quality of that audit, and of any ethical issues which arose in relation to it. Relevant information obtained from a discussion with Lester Freeman, the audit engagement partner, is given below.

(a) Wire Co’s audit committee refused to agree to an increase in audit fees despite the company’s operations expanding into new locations. In response to this, the materiality level was increased during the audit, and some review procedures were not carried out. To reduce sample sizes used in tests of detail, the samples were selected based on judgement rather than statistical methods. In addition, only parts of the population being tested were sampled, for example, certain locations were not included in the sample of non-current assets selected for physical verification.

Required:

Comment on the quality control, ethical and professional issues raised in respect of the audit of Wire Co and the firm-wide policies of Bunk & Co, and recommend any actions to be taken by the audit firm.

The pressure on Bunk & Co. to match a fee that has been approved by the audit committee is an intimidation threat. The objectivity of the firm may well be compromised and the extent of the work performed will be reduced.

The matter should have been discussed with Wire Co’s audit committee, with the audit firm stressing that the new locations would lead to an increased scope of the audit, and therefore the fee should increase rather than remain the same. It should also be brought to the attention of Bunk & Co’s partner responsible for ethics.

The fee pressure has resulted in the materiality level being increased. This leads to a risk that insufficient audit evidence may have been obtained to support the audit opinion, with the risk heightened by the fact that some review procedures were not carried out.

Review procedures are an integral part of ISA 220 Quality Control for an Audit of Financial Statements, and are carried out to ensure the evidence used to support the audit opinion is sufficient and appropriate.

There are also quality control issues with the selection of samples to be used in tests of detail. Using judgement rather than statistical methods to select samples may reduce sample size and therefore increase sampling risk to an unacceptable level.

It also seems that some items in the populations were completely excluded from the sample. Not testing some of the locations for physical checks on non-current assets may mean that they are not checked at all for existence and could be overstated.

Given the pressure on fees which seems to be affecting the quality of audit work performed, Bunk & Co may wish to consider whether it is appropriate to continue with the audit engagement. The audit firm’s concerns should be communicated to those charged with governance of Wire Co, and the audit committee should be made aware of the implications of the fee pressure on the audit.
June 15 Q4

(b) Some of the audit work was performed by an overseas office of Bunk & Co in an ‘off-shoring’ arrangement. This practice is encouraged by Bunk & Co, whose managing partners see it as a way of improving audit efficiency. The overseas office performs the work at a lower cost, and it was largely low-risk, non-judgemental work included in this arrangement for the audit of Wire Co, for example, numerical checks on documentation. In addition, the overseas office read the minutes of board meetings to identify issues relevant to the audit. (5 marks)

Required:

Comment on the quality control, ethical and professional issues raised in respect of the audit of Wire Co and the firm-wide policies of Bunk & Co, and recommend any actions to be taken by the audit firm.

The off-shoring of audit work has become increasingly common in the audit profession in the last few years, with global audit firms using low-cost overseas audit offices or service centres to perform some audit procedures. There is no regulation to prohibit this practice, but quality control implications have been brought into question.

If the overseas office is performing only low-risk and non-judgemental work, the risk to audit quality is relatively low. However, it seems in the case of Wire Co’s audit other more subjective tasks were included in the off-shoring arrangement, such as the review of board minutes.

In order to properly assess the contents of the board minutes for audit implications, the work should be performed by an auditor with sufficient knowledge and understanding of the audit client to be able to identify matters which are significant in the context of that audit.

It is unlikely that an auditor in an overseas office with no direct understanding or experience of Wire Co would be able to identify relevant matters for the attention of the rest of the audit team.

If Bunk & Co wishes to continue the off-shoring of audit procedures, then controls must be put in place to ensure that only appropriate tasks are included in the arrangement, and that monitoring and review procedures are performed to give comfort on the quality of the work performed.
There is a clear threat to independence through Russell’s move to Bunk as an Audit partner, although this is lessened by him not being part of the audit team. However the information provided by Russell to the team may well constitute a threat.

In addition the holding of shares by Russell for the first six months of his employment with Bunk constitutes a clear self-interest threat to objectivity. The ethical code says any holding should be disposed of immediately in the case of an audit team member, or as soon as possible in the case of an individual who is not a member of the audit team. Given Russell’s seniority, and the fact that he seems to have closely advised the audit team on matters relating to Wire Co, he should have made the disposal immediately.

In the light of this the firm should review their procedures in relation to disclosure of such matters to see why this information did not come to light earlier to enable the shares to be sold.

Finally, the audit firm’s policy on cross-selling non-audit services raises a self-interest threat because the audit team member clearly has a financial interest in successful cross-selling, which may result in the selling of services which are inappropriate to the client, or which give rise to other ethical threats which exist when non-audit services are provided to audited entities.

The significance of the self-interest threat will depend on the proportion of the individual’s compensation or performance evaluation which is based on the sale of such services, the role of the individual on the audit team, and whether promotion decisions are influenced by the sale of such services.

The IESBA Code states that a key audit partner shall not be evaluated on or compensated based on that partner’s success in selling non-assurance services to the partner’s audit client. Therefore if Bunk & Co is to continue with this policy, care must be taken that partners’ performance are not evaluated based on their success in cross-selling to their audit clients.
Materiality

The goodwill arising on the acquisition of Teapot Co is material to the Group financial statements, representing 6\% of total assets, as is the loan at 13.3\%.

Treatment

The consideration paid should be included at fair value including any deferred or contingent consideration. There is a risk that the amount in the calculation is incorrect or incomplete.

The non-controlling interest has been measured at fair value. This is permitted by IFRS 3, and there is a risk that the fair value is determined incorrectly particularly if the entity is not listed and the fair value is estimated.

There is a risk that not all acquired assets and liabilities have been identified, or that they have not been appropriately measured at fair value, which would lead to over or understatement of goodwill and incomplete recording of assets and liabilities.

IAS 38 requires that goodwill is tested annually for impairment regardless of whether indicators of potential impairment exist. The goodwill in relation to Teapot Co is recognised at the same amount at the year end as it was at acquisition, indicating that no impairment has been recognised.

However, Group profit has declined by 30.3\% over the year, which in itself is an indicator of potential impairment of the Group's assets, so it is unlikely that no impairment exists unless the fall in revenue relates to parts of the Group's activities which are unrelated to Teapot Co.

The loan taken out to finance the acquisition should be accounted for under IFRS 9 Financial Instruments. It should be initially measured at fair value, and classified according to whether it is subsequently measured at amortised cost or at fair value. As the loan is not held for trading, it should be measured at amortised cost.

Assuming subsequent measurement is based on amortised cost, an effective interest rate should be calculated to allocate the premium to be paid on maturity over the 20-year life of the loan. There is a risk that the finance charge does not include an element relating to the premium, in which case both the finance charge and the liability are understated.

Dec 14 Q2

You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 2014. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognize profit for the year to 31 July 2014 of $23 million (2013 – $33 million) and total assets of $450 million (2013 – $455 million).

Information in respect of three issues has been highlighted for your attention during the file review.

(a) An 80\% equity shareholding in Teapot Co was acquired on 1 August 2013. Goodwill on the acquisition of $27 million was calculated at that date and remains recognised as an intangible asset at that value at the year end. The goodwill calculation performed by the Group's management is shown below:

<table>
<thead>
<tr>
<th>Description</th>
<th>Amount ($'000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Purchase consideration</td>
<td>75,000</td>
</tr>
<tr>
<td>Fair value of 20% non-controlling interest</td>
<td>13,000</td>
</tr>
<tr>
<td>Less: Fair value of Teapot Co's identifiable net assets at acquisition</td>
<td>88,000</td>
</tr>
<tr>
<td>Goodwill</td>
<td>27,000</td>
</tr>
</tbody>
</table>

In determining the fair value of identifiable net assets at acquisition, an upwards fair value adjustment of $300,000 was made to the book value of a property recognised in Teapot Co's financial statements at a carrying value of $600,000.

A loan of $60 million was taken out on 1 August 2013 to help finance the acquisition. The loan carries an annual interest rate of 6\%, with interest payments made annually in arrears. The loan will be repaid in 20 years at a premium of $5 million.

Required:

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.
You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 2014. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognize profit for the year to 31 July 2014 of $23 million (2013 – $33 million) and total assets of $450 million (2013 – $455 million).

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</tr>
<tr>
<td>Fair value of 20% non-controlling interest</td>
<td>13,000</td>
</tr>
<tr>
<td>Less: Fair value of Teapot Co’s identifiable net assets at acquisition</td>
<td>(61,000)</td>
</tr>
<tr>
<td>Goodwill</td>
<td>27,000</td>
</tr>
</tbody>
</table>

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A loan of $60 million was taken out on 1 August 2013 to help finance the acquisition. The loan carries an annual interest rate of 6%, with interest payments made annually in arrears. The loan will be repaid in 20 years at a premium of $5 million.

Evidence

Agreement of the purchase consideration to the legal documentation pertaining to the acquisition, and a review of the documents to ensure that the figures included in the goodwill calculation are complete.

Agreement of the $75 million to the bank statement and cash book of the acquiring company (presumably the parent company of the Group).

Review of board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.

A review of the purchase documentation and a register of significant shareholders of Teapot Co to confirm the 20% non-controlling interest.

If Teapot Co’s shares are not listed, a discussion with management as to how the fair value of the non-controlling interest has been determined and evaluation of the appropriateness of the method used.

If Teapot Co’s shares are listed, confirmation that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition.

A copy of any due diligence report relevant to the acquisition, reviewed for confirmation of acquired assets and liabilities and their fair values.

An evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13.

Review of depreciation calculations, and recalculation, to confirm that additional depreciation is being charged on the fair value uplift.

A review of the calculation of net assets acquired to confirm that Group accounting policies have been applied.

Discussion with management regarding the potential impairment of Group assets and confirmation as to whether an impairment review has been performed.

A copy of any impairment review performed by management, with scrutiny of the assumptions used, and re-performance of calculations.

Re-performance of management’s calculation of the finance charge in relation to the loan, to ensure that the loan premium has been correctly accrued.

Agreement of the loan receipt and interest payment to bank statement and cash book.
You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 2014. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognise profit for the year to 31 July 2014 of $23 million (2013 – $33 million) and total assets of $450 million (2013 – $450 million).

Information in respect of three issues has been highlighted for your attention during the file review.

(b) In September 2014, a natural disaster caused severe damage to the property complex housing the Group’s head office and main manufacturing site. For health and safety reasons, a decision was made to demolish the property complex. The demolition took place three weeks after the damage was caused. The property had a carrying value of $16 million at 31 July 2014.

A contingent asset of $18 million has been recognised as a current asset and as deferred income in the Group statement of financial position at 31 July 2014, representing the amount claimed under the Group’s insurance policy in respect of the disaster. (7 marks)

Required:
Comment on the matters to be considered, and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.

Materiality

The carrying value of the property complex is material to the Group financial statements, representing 3.6% of total assets.

Treatment

The natural disaster is a subsequent event, and its accounting treatment should be in accordance with IAS 10 Events after the Reporting Period. IAS 10 distinguishes between adjusting and non-adjusting events, the classification being dependent on whether the event provides additional information about conditions already existing at the year end. The natural disaster is a non-adjusting event as it indicates a condition which arose after the year end.

Disclosure is necessary in a note to the financial statements to describe the impact of the natural disaster, and quantify the effect which it will have on next year’s financial statements.

The demolition of the property complex should be explained in the note to the financial statements and reference made to the monetary amounts involved. Consideration should be made of any other costs which will be incurred, e.g. if there is inventory to be written off, and the costs of the demolition itself.

The contingent asset of $18 million should not have been recognised. Even if the amount were virtually certain to be received, the fact that it relates to the non-adjusting event after the reporting period means that it cannot be recognised as an asset and deferred income at the year end.

The financial statements should be adjusted to remove the contingent asset and the deferred income. The amount is material at 4% of total assets. There would be no profit impact of this adjustment as the $18 million has not been recognised in the statement of profit or loss.
You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 2014. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognise profit for the year to 31 July 2014 of $23 million (2013 – $33 million) and total assets of $450 million (2013 – $452 million).

Information in respect of three issues has been highlighted for your attention during the file review.

(b) In September 2014, a natural disaster caused severe damage to the property complex housing the Group’s head office and main manufacturing site. For health and safety reasons, a decision was made to demolish the property complex. The demolition took place three weeks after the damage was caused. The property had a carrying value of $16 million at 31 July 2014.

A contingent asset of $18 million has been recognised as a current asset and as deferred income in the Group statement of financial position at 31 July 2014, representing the amount claimed under the Group’s insurance policy in respect of the disaster.

Required:

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above.

**Evidence**

- A copy of any press release made by the Group after the natural disaster, and relevant media reports of the natural disaster, in particular focusing on its impact on the property complex.

- Photographic evidence of the site after the natural disaster, and of the demolished site.

- A copy of the note to the financial statements describing the event, reviewed for completeness and accuracy.

- A schedule of the costs of the demolition, with a sample agreed to supporting documentation, e.g. invoices for work performed and confirmation that this is included in the costs described in the note to the financial statements.

- A schedule showing the value of inventories and items such as fixtures and fittings at the time of the disaster, and confirmation that this is included in the costs described in the note to the financial statements.

- A copy of the insurance claim and correspondence with the Group’s insurers to confirm that the property is insured.

- Confirmation that an adjustment has been made to reverse out the contingent asset and deferred income which has been recognised.
Materiality

The intercompany receivables and payables represent 4.4% of Group assets and are material to the consolidated statement of financial position. The inventory is also material, at 11% of Group assets.

Treatment

On consolidation, the intercompany receivables and payables balances should be eliminated, leaving only balances between the Group and external parties recognised at Group level. There is a risk that during the consolidation process the elimination has not happened, overstating Group assets and liabilities by the same amount.

If the intercompany transaction included a profit element, then the inventory needs to be reduced in value by an adjustment for unrealised profit. This means that the profit made by Marks Co on the sale of any inventory still remaining in the Group at the year end is eliminated. If the adjustment has not been made, then inventory and Group profit will be overstated.

Evidence

Review of consolidation working papers to confirm that the intercompany balances have been eliminated.

A copy of the terms of sale between Marks Co and Roberts Co, scrutinised to find out if a profit margin or mark up is part of the sales price.

A reconciliation of the intercompany balances between Roberts Co and Marks Co to confirm that there are no other reconciling items to be adjusted, e.g. cash in transit or goods in transit.

Copies of inventory movement reports for the goods sold from Marks Co to Roberts Co, to determine the quantity of goods transferred.

Details of the inventory count held at Roberts Co at the year end, reviewed to confirm that no other intercompany goods are held at the year end.
Faster Jets Co is an airline company and is a new audit client of Brown & Co. You are responsible for the audit of the financial statements for the year ended 30 November 2014. The draft financial statements recognise revenue of $150 million and total assets of $250 million. During the year, Faster Jets Co purchased several large plots of land located near major airports at a cost of $12.5 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of $14.5 million. The audit partner has suggested the use of an auditor’s expert to obtain evidence in respect of the fair value of the land.

Required:

In respect of the land recognised as investment property:

(i) Explain the additional information which you require to plan the audit of the land; and
(ii) Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor’s expert.

Note: The total marks will be split equally between each part. 

(a) Details of the reason for the purchase, to understand the business rationale, e.g. is the land held for capital appreciation?

Does management have any specific plans for how Faster Jets Co may make use of the land in the future, e.g. are there plans to construct buildings and if so what will be their purpose?

The date of purchase to ascertain how long it has taken for the land to increase in value by $2 million and whether this seems reasonable.

Whether the land was purchased for cash or if finance was taken out to raise the $12.5 million paid.

Who is renting the land? This could establish whether the arrangement is with a related party.

The type of rental arrangement and whether it constitutes a finance or operating lease.

What is the land being used for? As the legal owner, Faster Jets Co should be aware of its use and any associated risks, e.g. activities close to airports may convey security risks, e.g. terrorism.

The location of the purchased land – this is necessary to plan the logistics of the audit.

Does the company hold any other investment property, and if so, is that also held at fair value? The accounting treatment should be consistent for all investment property.

What is management’s rationale for the accounting policy choice to measure the land at fair value? It will result in profit for the year including the $2 million fair value increase.

Establish who holds the title deeds to the land as this may need to be inspected.
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(i) Explain the additional information which you require to plan the audit of the land; and
(ii) Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor’s expert.

Note: The total marks will be split equally between each part. (10 marks)

ISA 620 using the Work of an Auditor’s Expert contains requirements relating to the objectivity and capabilities of the auditor’s expert, the scope and objectives of their work, and assessing their work.

Objectivity
According to ISA 620, the auditor shall evaluate whether the auditor’s expert has the necessary objectivity. The audit firm will need to ensure that the expert has no connection to Faster Jets Co, for example, that they are not a related party of the company or any person in a position of influence over the financial statements.

Competence
ISA 620 also requires the competence of the expert to be considered; this should include considering the expert’s membership of appropriate professional bodies. Any doubts over the competence of the expert will reduce the reliability of audit evidence obtained. The expert should in this case have experience in valuing land and determining fair value.

Scope of work
ISA 620 requires the auditor to agree the scope of work with the expert. This may include agreement of the objectives of the work, how the expert’s work will be used by the auditor and the methodology and key assumptions to be used. It should be assessed at the end whether this scope was adhered to.

Relevance of conclusions
ISA 620 states that the auditor shall evaluate the relevance and adequacy of the expert’s findings or conclusions. This will involve consideration of the source data which was used, the appropriateness of assumptions and the reasons for any changes in methodology or assumptions.

The conclusion should be consistent with other relevant audit findings and with the auditor’s general understanding of the business. Any inconsistencies should be investigated as they may indicate evidence which is not reliable.
Difficulties

It is common for companies to produce a report on corporate social responsibility (CSR), and in some countries this is a requirement. CSR reports contain a wide variety of key performance indicators (KPIs) relating to the social and environmental targets which the company is aiming to achieve.

Measurements of social and environmental performance are not always easy to define. For example, Faster Jets Co aims to develop an education programme, which is vague in terms of measurement. The measurement is only capable of being quantified if a KPI is attached to it, for example, the number of free education days provided in a year.

It can also be difficult to identify key stakeholders and the KPIs which each stakeholder group is interested in.

Also, targets and KPIs may be difficult to quantify in monetary terms. For example, Faster Jets Co’s provision of free flights to charitable organisations can be quantified in terms of the number of flights donated, but the actual value of the flights is more questionable as this could be measured at cost price or market value.

In addition, systems and controls are often not established well enough to allow accurate measurement, and the measurement of social and environmental matters may not be based on reliable evidence.
Your firm has also been engaged to perform a separate assurance engagement on Faster Jets Co’s corporate social responsibility (CSR) report. This engagement will be performed by Brown & Co’s specialist social and environmental assurance department and there are no ethical threats created by the provision of this service in addition to the audit. An extract from the draft CSR report is shown below:

<table>
<thead>
<tr>
<th>CSR objective</th>
<th>CSR target</th>
<th>Performance in 2014</th>
</tr>
</thead>
<tbody>
<tr>
<td>Continue to invest in local communities and contribute to charitable causes</td>
<td>Make direct charitable cash donations to local charities</td>
<td>Donations of $550,000 were made to local charities</td>
</tr>
<tr>
<td></td>
<td>Build relationships with global charities and offer free flights to charitable organisations</td>
<td>800 free flights with a value of $560,000 were provided to charities</td>
</tr>
<tr>
<td></td>
<td>Develop our Local Learning Initiative and offer free one day education programmes to schools</td>
<td>$750,000 was spent on the Local Learning Initiative and 2,250 children attended education days</td>
</tr>
<tr>
<td>Reduce environmental impact of operations</td>
<td>Reduce the amount of vehicle fuel used on business travel by our employees</td>
<td>The number of miles travelled in vehicles reduced by 5%, and the amount spent on vehicle fuel reduced by 7%</td>
</tr>
</tbody>
</table>

**Required:**

(i) Discuss the difficulties in measuring and reporting on social and environmental performance; and (4 marks)

(ii) Recommend the procedures to be used to gain assurance on the validity of the performance information in Faster Jets Co’s CSR report. (6 marks)

**Procedures**

Obtain a summary of all amounts donated to charitable causes and agree a sample to the cash book.

For large donations above a certain limit (say $10,000) confirm that authorisation for the payment has been made, e.g. by agreeing to minutes of management meetings.

Review correspondence with charities for confirmation of the amounts paid.

For the free flights donated to charity, perform analytical review to confirm that the average value of a flight seems reasonable – the average being $700 ($560,000/800).

For a sample of the 800 free flights, obtain confirmation that the passenger was a guest of Faster Jets Co, e.g. through correspondence with the passenger and relevant charity.

Review relevant press releases and publicity campaigns, e.g. the free flight scheme and the local education schemes are likely to have been publicised.

For the $750,000 spent on the local education scheme, obtain a breakdown of the amounts spent and scrutinise to ensure all relate to the scheme, e.g. payments to educators.

Agree a sample of business miles travelled in vehicles to a mileage log, and fuel costs to employee expenses claims forms and the general ledger.
Outline of Weston & Co
A brief outline of the audit firm, including a description of different services offered, and an outline of the firm’s international locations. This will be important to Jones Co given that it wishes to expand into overseas markets and will be looking for an audit firm with experience in different countries.

Identify the audit requirements of Jones Co
There should be an outline of the statutory audit requirement & regulations in the country in which Jones Co is incorporated, to confirm that the company is now at the size which necessitates a full audit of the financial statements.

Audit approach
A description of the proposed audit approach, outlining the audit process and methodology as well as the risk based nature of the audit. The description should state that the audit will be conducted in accordance with ISA requirements.

Weston & Co should emphasise the need for thorough testing of opening balances and comparatives given that this is the first year that the financial statements will be audited.
Deadlines
Bentley has requested that the audit is completed within four months of the year end. This seems to be reasonable; it should be possible for the audit of a relatively small company with simple transactions and a full-time accountant to be completed within that timeframe.

Quality control and ethics
Weston & Co should clarify its adherence to IESBA’s Code of Ethics for Professional Accountants, and to International Standards on Quality Control. This should provide assurance, particularly to the venture capitalists that the audit firm will provide an unbiased and credible audit report.

Additional non-audit and assurance services
The audit proposal should describe the various non-audit and assurance related services which Weston & Co would be able to offer Jones Co. These may include, for example, business consultancy and corporate finance advice on overseas expansion and obtaining any necessary additional funding to help the planned overseas expansion.

(a) You are an audit manager in Weston & Co which is an international firm of Chartered Certified Accountants with branches in many countries and which offers a range of audit and assurance services to its clients. Your responsibilities include reviewing ethical matters which arise with audit clients, and dealing with approaches from prospective audit clients.

The management of Jones Co has invited Weston & Co to submit an audit proposal (tender document) for their consideration. Jones Co was established only two years ago, but has grown rapidly, and this will be the first year that an audit is required. In previous years a limited assurance review was performed on its financial statements by an unrelated audit firm. The company specialises in the recruitment of medical personnel and some of its start up funding was raised from a venture capital company. There are plans for the company to open branches overseas to help recruit personnel from foreign countries.

Jones Co has one full-time accountant who uses an off-the-shelf accounting package to record transactions and to prepare financial information. The company has a financial year ending 31 March 2015.

The following comment was made by Bentley Jones, the company’s founder and owner-manager, in relation to the audit proposal and potential audit fee:

‘I am looking for a firm of auditors who will give me a competitive audit fee. I am hoping that the fee will be quite low, as I am willing to pay more for services that I consider more beneficial to the business, such as strategic advice. I would like the audit fee to be linked to Jones Co’s success in expanding overseas as a result of the audit firm’s advice. Hopefully the audit will not be too disruptive and I would like it completed within four months of the year end.’

Required:

(i) Explain the specific matters to be included in the audit proposal (tender document), other than those relating to the audit fee; and (8 marks)
June 15 Q5a

You are a manager in the audit department of Nidge & Co, a firm of Chartered Certified Accountants, responsible for the audit of Darren Co, a new audit client operating in the construction industry. Darren Co's financial year ended on 31 January 2015, and the draft financial statements recognise profit before tax of $22.5 million (2014 – $20 million) and total assets of $370 million, including cash of $3 million. The company typically works on three construction contracts at a time.

The audit is nearly complete and you are reviewing the audit working papers. The audit senior has brought several matters to your attention:

(a) Darren Co is working on a major contract relating to the construction of a bridge for Flyover Co. Work started in July 2014, and it is estimated that the contract will be completed in September 2015. The contract price is $20 million, and it is estimated that a profit of $5 million will be made on completion of the contract. The full amount of this profit has been included in the statement of profit or loss for the year ended 31 January 2015. Darren Co's management believes that this accounting treatment is appropriate given that the contract was signed during the financial year, and no problems have arisen in the work carried out so far. (5 marks)

Required:
Discuss the implications of the matters described above on the completion of the audit and on the auditor's report, recommending any further actions which should be taken by the auditor.

Note: The mark allocation is shown next to each of the matters above.

The total estimated profit of $5 million representing 22.2% of profit for the year and is therefore material.

IAS 11 says that if a profit is expected on a construction contract revenue and expenses should be recognised by stage of completion of the contract.

Darren Co has recognised 100% of the contract profit even though the contract is only seven out of fifteen months complete.

Therefore the profit which has been recognised appears to be overstated, and it seems to have been recognised too early.

The audit firm should will need to verify the stage of completion as IAS 11 allows for a variety of methods to be used such as contract costs incurred for work performed to date compared to the estimated total contract costs, or on surveys of work performed.

Evidence should be gathered to verify the contract terms and stage of completion but it would appear that only ($5m x 7/15) $2.7m should be recognised and profit is overstated by $2.3m.

If management refuse to amend the treatment the auditor would need to modify the audit opinion with an ‘Except For’ paragraph with the ‘basis of opinion’ section explaining the reasons and effects.

The auditor should also consider whether other contracts have been treated incorrectly and if this has been the case in previous years as this may lead to larger misstatements.
The amount claimed by Newbuild Co is material to the financial statements, representing 10.8% of total assets and 17.8% of profit before tax.

The large cash amount is also a going concern risk and management should confirm that should the amount become payable, the company has adequate resources to fund the cash outflow, for example, through the existence of lending facilities.

The correct accounting treatment seems to have been applied. According to IAS 37 Provisions, Contingent Liabilities and Contingent Assets, if an amount is possible, rather than probable to be paid, then it is treated as a contingent liability, and a note to the accounts should be provided to describe the nature of the situation, an estimate of the possible financial effect and an indication of any uncertainties.

To ensure that IAS 37 has been complied with, the auditor should review legal correspondence should be reviewed, to confirm that the probability of payment has not changed by the time of the audit report being signed.

Due to the size of the potential cash outflow, the auditor should consider including a Going Concern paragraph in the audit report as this is a material uncertainty.

The paragraph should include a clear reference to the matter and to the note to the financial statements where the matter is disclosed. The paragraph should also make it clear that the audit opinion is not modified in respect of this matter.
The key performance indicators (KPIs) included in an integrated report are by definition ‘other information’ according to ISA 720. Other information is financial and non-financial information which is included in a document containing audited financial statements and the auditor’s report.

According to ISA 720, the auditor is required to read the other information to identify material inconsistencies, if any, with the audited financial statements.

There appears to be an inconsistency because the KPI states that profit before tax has increased by 20%, but the increase shown in the financial statements is 12.5%. The auditor must use professional judgement to determine if this is a material inconsistency.

Assuming that this is deemed to be a material inconsistency, the auditor should consider whether the financial statements or the other information should be amended.

It is most likely that the KPI included in the integrated report should be changed in agreement with the movement in profit shown in the adjusted financial statements, and management should be asked to make the necessary change to the KPI.

If management refuses the auditor should include an Other Matter paragraph in the audit report after the opinion paragraph to describe the material inconsistency.

The auditor may also seek legal advice if management refuses to amend the KPI to remove the material inconsistency.
The IAASB issued its Invitation to Comment (ITC) on Improving the Auditor’s Report as part of a process of improving the quality of audits.

In respect of going concern, the ITC suggests that the auditor’s report should include an auditor’s conclusion on the appropriateness of management’s use of the going concern assumption, and an explicit statement as to whether material uncertainties in relation to going concern have been identified.

A description of management’s responsibilities with respect to going concern will also be required.

The illustration of an improved auditor’s report in the ITC shows a separate paragraph headed Going Concern positioned below the Opinion and Basis of Opinion paragraphs, in which these matters are included.

This is in response to the financial crisis of recent years and criticism of the lack of information around going concern in the Audit Report.

The ITC suggestion to include specific statements regarding going concern will add clarity on this matter and provide more information to users, including lenders in order to make decisions.

The danger is that the auditor’s affirmations may be seen as a guarantee of a company’s future sustainability, which is clearly not their purpose. It can be argued that the requirements of ISA 570 Going Concern are sufficiently robust, and that including going concern as a specific matter in the auditor’s report only when it is an issue provides the best clarity for users of the financial statements.
(b) You are an audit manager in Taylor & Co, a firm of Chartered Certified Accountants, responsible for the audit of Marr Co, with a year ended 28 February 2014. The draft financial statements recognise profit for the year of $11 million. The audit for the year end is nearing completion, and several matters have been highlighted for your attention by the audit senior, Xi Smith. The matters have been discussed with management and will not be adjusted in the financial statements:

1. In January 2014 a major customer went into administration. There was a balance of $2.5 million owing to Marr Co from this customer at 28 February 2014, which is still included in trade receivables.

2. A court case began in December 2013 involving an ex-employee who is suing Marr Co for unfair dismissal. Lawyers estimate that damages of $50,000 are probable to be paid. The financial statements include a note describing the court case and quantifying the potential damages but no adjustment has been made to include it in the statement of financial position or the statement of profit or loss.

Xi Smith has produced a draft audit report for your review, an extract of which is shown below:

Basis for opinion and disclaimer of opinion
We have performed our audit based on a materiality level of $1.5 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Marr Co, Rita Gilmour, has refused to make an adjustment to write off a significant trade receivables balance. Therefore in our opinion the financial statements of Marr Co are materially misstated and we therefore express a disclaimer of opinion because we do not think they are fairly presented.

Emphasis of Matter paragraph
Marr Co is facing a legal claim for an amount of $50,000 from an ex-employee. In our opinion this amount should be recognised as a provision but it is not included in the statement of financial position. We draw your attention to this breach of the relevant IFRS.

Required:
Critically appraise the proposed auditor’s report of Marr Co for the year ended 28 February 2014.

Note: You are NOT required to re-draft the extracts from the auditor’s report. (12 marks)
Subsequent events are events occurring between the date of the financial statements and the date of the auditor’s report, and also facts discovered after the date of the auditor’s report.

Up to the date of the auditor’s report the auditor has an active duty to perform audit procedures designed to identify, and to obtain sufficient appropriate evidence of all adjusting or non-adjusting events. Management should then be asked to include any such events.

Procedures would include reviewing management procedures for ensuring that subsequent events are identified, reading minutes of meetings of shareholders and management, reviewing the latest interim financial statements, and making appropriate enquiries of management.

The auditor does not have any responsibility to identify subsequent events after the date of the auditor’s report. In this period, it is the responsibility of management to inform the auditor of facts which may affect the financial statements.

When the auditor becomes aware of a subsequent event, the matter should be discussed with management. If the financial statements are appropriately amended then a new audit report should be issued and if management do not amend the financial statements to reflect the subsequent event a qualified or adverse opinion should be issued.

Even after the financial statements have been issued where the Auditor then becomes aware of a subsequent event the auditor should issue a new audit report on the revised financial statements.

This report should include an emphasis of matter paragraph referring to a note to the financial statements in which the reason for the revision is fully discussed. If management do not revise the financial statements, the auditor should take legal advice with the objective of trying to prevent further reliance on the auditor’s report.
You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 2009. The audit work has been completed and reviewed and you are due to issue the audit report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 30 September 2009 of $15 million, net profit of $3 million, and total assets at the year end are $80 million.

The finance director of Lychee Co telephoned you this morning to tell you about the announcement yesterday, of a significant restructuring of Lychee Co, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country. There will be some redundancies and the estimated cost of closure is $250,000. The financial statements have not been amended in respect of this matter.

**Required:**

In respect of the announcement of the restructuring:

(i) Comment on the financial reporting implications, and advise the further audit procedures to be performed; and

(ii) Recommend the actions to be taken by the auditor if the financial statements are not amended.

---

**Procedures**

Review any potential note to financial statements which should disclose the non-adjusting event, providing a brief description of the event, and an estimate of the financial effect.

Discuss the reason for the restructuring with management and read minutes of board meetings where the plan was discussed, in order to gain an understanding about the reason for the restructuring.

Verify the approval of the plan itself, and the approval of the announcement of the plan, which can be performed through a review of board minutes.

Confirm the date on which the plan was approved, and also the date of the announcement, using supporting documentation such as press release, letters sent to employees, internal meetings held with employees, etc.

Agree the $250,000 potential cost of closure to supporting documentation, including a schedule showing the number and grade of staff to be made redundant, which should be supported by payroll/contract details.

**Financial Reporting Implications**

The announcement of a restructuring after the reporting date is a non-adjusting event after the reporting date.

This is because the event does not provide evidence in relation to a condition that existed at the year end.

The adjustment is material as it makes up ($250,000/3 million) = 8.3% of profit

Per IAS 10, a note should be provided to the financial statements, which describes the nature of the event, and provides an estimate of the financial effect.
You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 2009. The audit work has been completed and reviewed and you are due to issue the audit report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 30 September 2009 of $15 million, net profit of $3 million, and total assets at the year end are $80 million.

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Required:

In respect of the announcement of the restructuring:

(i) Comment on the financial reporting implications, and advise the further audit procedures to be performed; and

(ii) Recommend the actions to be taken by the auditor if the financial statements are not amended.

If no note is provided to the financial statements, then there is a breach of IAS 10. In this case there is insufficient disclosure provided in the notes to the financial statements regarding a material non-adjusting event after the reporting date.

This would be a material misstatement in the financial statements and would require a modified Audit Report.

As the misstatement is material but not material and pervasive the modification would be an ‘except for’ paragraph in the report.

This would explain the reason for the qualification, specifying the breach of accounting standards, and stating the relevant financial amount.

This should be discussed with the highest level of management to ensure they understand the implications of non-disclosure of the matter.

The auditors could also choose to raise this issue at the annual general meeting, where the matter leading to the qualified audit opinion should be explained to the shareholders of the company.
The auditor should meet the client and matters that should be clarified with the client include:

- The objective of the investigation – to quantify the amount to be claimed under the insurance cover;
- Whether the client has informed the police and the actions taken by the police so far;
- Whether the thieves have been captured and any stolen goods recovered;
- Whether the thieves are suspected to be employees of the Group;
- Any planned deadline by which time the insurance claim needs to be submitted;

The insurance document should be reviewed to ensure everything is covered and that the policy is in date.

The client should confirm that the investigation team will have full access to information required, and are able to discuss the matter with the police and the insurance company without fear of breaching confidentiality.

The audit firm should also ensure that they have sufficient knowledge and experience to undertake the engagement.

In respect of the theft and the associated insurance claim:

(i) Identify and explain the matters to be considered, and the steps to be taken in planning the forensic accounting service; and
(ii) Recommend the procedures to be performed in determining the amount of the claim.

Note: The total marks will be split equally between each part. (12 marks)
June 13 Q2b

The audit committee of the Group has contacted Kennel & Co to discuss an incident that took place on 1 June 2013. On that date, there was a burglary at the Group’s warehouse where inventory is stored prior to despatch to customers. CCTV filmed the thieves loading a lorry belonging to the Group with boxes containing finished goods. The last inventory count took place on 30 April 2013.

The Group has insurance cover in place and Kennel & Co’s forensic accounting department has been asked to provide a forensic accounting service to determine the amount to be claimed in respect of the burglary. The insurance covers the cost of assets lost as a result of thefts.

It is thought that the amount of the claim will be immaterial to the Group’s financial statements, and there is no ethical threat in Kennel & Co’s forensic accounting department providing the forensic accounting service.

Required:
In respect of the theft and the associated insurance claim:
(i) Identify and explain the matters to be considered, and the steps to be taken in planning the forensic accounting service; and
(ii) Recommend the procedures to be performed in determining the amount of the claim.

Note: The total marks will be split equally between each part. (12 marks)

Procedures:

Watch the CCTV to form an impression of the quantity of goods stolen, for example, how many boxes were loaded onto the lorry.

If possible, from the CCTV, determine if the boxes contain either mobile phones or laptop computers.

Inspect the boxes of goods remaining in the warehouse to determine how many items of finished goods are in each box.

Agree the cost of an individual mobile phone and laptop computer to accounting records, such as cost cards.

Perform an inventory count on the boxes of goods remaining in the warehouse and reconcile to the latest inventory movement records.

Discuss the case with the police to establish if any of the goods have been recovered and if, in the opinion of the police, this is likely to happen.

Obtain details of the stolen lorry, for example the licence plate, and agree the lorry back to the non-current asset register where its net book value should be shown.
The first matter that should be considered is the ethical threat created by providing a non-audit service to an audit client. This will raise significant self-review and advocacy threats.

Safeguards should be implemented such as:

Having a professional accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.

Discussing ethical issues with those charged with governance of the client.

Using separate teams to work on the audit and on the review engagement.

The specific terms of the engagement should be considered to see exactly what the report should cover and the level of reliance to be placed on it.

It seems in this case the review engagement and its report will be used solely in connection with raising bank finance, but this should be confirmed before accepting the engagement.

The period covered by the prospective financial information and the key assumptions used should also be considered. For example, the assumption that the necessary capital expenditure can take place by September 2014 may be overly optimistic.

The firm should also consider whether there are staff available with appropriate skills and experience to perform the review engagement, and the deadline by which the work needs to be completed.
You are a manager in Hunt & Co, a firm which offers a range of services to audit and non-audit clients. You have been asked to consider a potential engagement to review and provide a report on the prospective financial information of Waters Co, a company which has been an audit client of Hunt & Co for six years. The audit of the financial statements for the year ended 30 April 2014 has just commenced.

Waters Co operates a chain of cinemas across the country. Currently its cinemas are out of date and use projectors which cannot show films made using new technology, which are becoming more popular. Management is planning to invest in all of its cinemas in order to attract more customers. The company has sufficient cash to fund half of the necessary capital expenditure, but has approached its bank with a loan application of $8 million for the remainder of the funds required. Most of the cash will be used to invest in equipment and fittings, such as new projectors and larger screens, enabling new technology films to be shown in all cinemas. The remaining cash will be used for refurbishment of the cinemas.

The draft forecast statements of profit or loss for the years ending 30 April 2015 and 2016 are shown below, along with the key assumptions which have been used in their preparation. The unaudited statement of profit or loss for the year ended 30 April 2014 is also shown below. The forecast has been prepared for use by the bank in making its lending decision, and will be accompanied by other prospective financial information including a forecast statement of cash flows.

### Forecast statement of profit or loss

<table>
<thead>
<tr>
<th>Year ended</th>
<th>Note relevant to forecast information</th>
<th>Year ending</th>
<th>Year ending</th>
</tr>
</thead>
<tbody>
<tr>
<td>30 April 2014</td>
<td>$000</td>
<td>30 April 2015</td>
<td>$000</td>
</tr>
<tr>
<td>Revenue</td>
<td>35,000</td>
<td>1</td>
<td>43,000</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(28,250)</td>
<td>2</td>
<td>(31,500)</td>
</tr>
<tr>
<td>Operating profit</td>
<td>6,750</td>
<td></td>
<td>11,500</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(1,700)</td>
<td></td>
<td>(2,000)</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>5,050</td>
<td></td>
<td>9,500</td>
</tr>
</tbody>
</table>

Note 1: The forecast increase in revenue is based on the following assumptions:

(i) All cinemas will be fitted with new projectors and larger screens to show new technology films by September 2014.

(ii) Ticket prices will increase from $7.50 to $10 from 1 September 2014.

Note 2: Operating expenses include mainly staff costs, depreciation of property and equipment, and repairs and maintenance to the cinemas.

### Required:

(a) (i) Explain the matters to be considered by Hunt & Co before accepting the engagement to review and report on Waters Co’s prospective financial information. (6 marks)

(ii) Assuming the engagement is accepted, describe the examination procedures to be used in respect of the forecast statement of profit or loss. (8 marks)

Agreement that the accounting policies used in preparing the forecast statement of profit or loss are consistent with those used in historical financial information and comply with IFRS.

Review of market research documents and review of prices charged by competitors showing new technology films to support the assumption regarding increase in price and consumer appetite for the films.

Analytical review followed by discussion with management on the trend in revenue, which is forecast to increase by 22.9% and 7% in the years to 30 April 2015 and 2016 respectively.

Analytical review of the composition of operating expenses to ensure that all expenses are included at a reasonable amount. In 2014, operating expenses are 80.7% of revenue, but is forecast to reduce to 73.4% in 2015 and to 69.8% in 2016, indicating understatement of forecast expenses.

Review the list of operating expenses to ensure that any loss to be recognised on the disposal of old equipment has been included, or that profit on disposal has been netted off.

Quotations received from potential suppliers of the new technology should be reviewed to verify the amount of the capital expenditure and therefore that depreciation included in the forecast statement of profit or loss appears reasonable.

Recalculation of depreciation expense and confirmation that depreciation on the new technology has been included and correctly calculated and agrees to the forecast statement of financial position.
There are three stages typically involved in money laundering. The first is placement, which is when cash obtained through criminal activity is first placed into the financial system.

Business owners who have illegally obtained funds can use a cash-intensive business to mix legitimate cash receipts from business activity with the funds they wish to launder. For Waters Co, the fact that most customers are likely to pay in cash indicates that it would be easy for genuine and illegal cash to be mixed up and banked, thereby placing the illegal cash into the financial system.

The second stage is layering. This is when cash is disguised by passing it through complex transactions involving many layers, making the transactions difficult to trace.

This often involves moving the cash internationally, which adds a layer of complexity to the layering process. Waters Co transfers sums of cash to overseas bank accounts, indicating that layering may be taking place.

The final stage is integration, which is when the illegally gained funds are moved back into the legitimate economy. At this point the funds have become ‘clean’ and are invested in property or financial instruments or otherwise spent.

Waters Co is planning to invest a large sum of cash, $8 million, in its cinema upgrade and refurbishment programme, which could be the integration stage of money laundering.

The audit strategy relevant to the audit of Waters Co concludes that the company has a relatively high risk associated with money laundering, largely due to the cash-based nature of its activities. The majority of customers purchase their cinema tickets and refreshments in cash, and the company transfers its cash to overseas bank accounts on a regular basis.

Required:

(i) Explain the stages used in laundering money, commenting on why Waters Co has been identified as high risk. (5 marks)

(ii) Recommend FOUR elements of an anti-money laundering programme which audit firms such as Hunt & Co should have in place. (6 marks)
There are many elements which should be in place as part of an anti-money laundering programme.

The audit firm must appoint a Money Laundering Reporting Officer (MLRO), who should have a suitable level of seniority and experience; usually this would be a senior partner in the audit firm.

Suspiciouss of money laundering should be reported to the MLRO, who considers whether the matter should be referred to agencies such as the Serious Organised Crime Agency, and prepares and keeps the appropriate documentation.

A training programme is essential, to ensure that individuals are aware of the relevant legislation and regulations regarding money laundering. Individuals should also be trained in the firm’s identification, record keeping and reporting policies. Individuals should also be trained in the money laundering risk factors, and be able to identify such risk factors and respond appropriately, and in matters such as tipping off offences.

An important part of anti-money laundering is customer due diligence, or know your client procedures. This means that audit firms must establish the identity of clients using documents such as certificates of incorporation and passports, and should obtain information about business activities in order to gain an understanding of matters such as sources of income, and the rationale for business transactions.

Finally, the audit firm must ensure that it maintains records of client identification procedures, and of all transactions relevant to audit clients, for example, the receipt of cash for services performed. This is important to ensure that the audit firm does not inadvertently become party to a transaction involving money laundering.
One of the objectives of a due diligence review is for the assets and liabilities of the target company to be identified and valued. Baltimore Co needs to understand and value several customer databases, which, being internally generated, will not be recognised as assets in its statement of financial position.

A second benefit is that the due diligence review should uncover more information about operational issues, which may then help Baltimore Co’s management to decide whether to go ahead with the acquisition. For example, only one of Mizzen Co’s revenue streams appears to be directly relevant to Baltimore Co’s expansion plans.

The due diligence review should cover a wide range of issues, such as reviews of the company’s legal and tax positions, which may uncover significant matters.
An externally provided due diligence review, as opposed to a review conducted by management of Baltimore Co, is likely to provide information in a time-efficient, impartial manner.

Baltimore Co’s management has not previously dealt with an acquisition, whereas the audit firm has the financial and business understanding and expertise to provide a quality due diligence review.

A review report issued by Goleen & Co will add credibility to the planned acquisition, which may help secure the bank loan which is needed to fund the acquisition.
You are a manager in the business advisory department of Gowen & Co. Your firm has been approached to provide assurance to Baltimore Co, a company which is not an audit client of your firm, on a potential acquisition. You have just had a conversation with Mark Clear, Baltimore Co’s managing director, who made the following comments:

“Baltimore Co is a book publisher specialising in publishing textbooks and academic journals. In the last few years the market has changed significantly, with the majority of customers purchasing books from online sellers. This has led to a reduction in profits, and we recognise that we need to diversify our product range in order to survive. As a result of this, we decided to offer a subscription-based website to customers, which would provide the customer with access to our full range of textbooks and journals online.

On investigating how to set up this website, we found that we lack sufficient knowledge and resources to develop it ourselves and began to look for another company which has the necessary skills, with a view to acquiring the company. We have identified Mizzen Co as a potential acquisition, and we have approached the bank for a loan which will be used to finance the acquisition if it goes ahead.

Baltimore Co has not previously acquired another company. We would like to engage your firm to provide guidance regarding the acquisition. I understand that a due diligence review would be advisable prior to deciding on whether to go ahead with the acquisition, but the other directors are not sure that this is required, and they don’t understand what the review would involve. They are also unsure about the type of conclusion that would be issued and whether it would be similar to the opinion in an audit report.

To help me brief the other directors and using the information I have provided, I would like you to:

(a) Discuss THREE benefits to Baltimore Co of a due diligence review being performed on Mizzen Co. (6 marks)

(b) Identify and explain the matters which you would focus on in your due diligence review and recommend the additional information which you will need to perform your work. (16 marks)

(c) Describe the type of conclusion which would be issued for a due diligence report and compare this to an audit report.” (3 marks)

Mark Clear has sent you the following information about Mizzen Co.

Company background

Mizzen Co was established four years ago by two university graduates, Vic Sandhu and Lou Lien, who secured funds from a venture capitalist company, BizGrow, to set up the company. Vic and Lou created a new type of website interface which has proven extremely popular, and which led to the company growing rapidly and building a good reputation. They continue to innovate and have won awards for website design. Vic and Lou have a minority shareholding in Mizzen Co.

Mizzen Co employs 50 people and operates from premises owned by BizGrow, for which a nominal rent of $1,000 is paid annually. The company uses few assets other than computer equipment and fixtures and fittings. The biggest expense is wages and salaries and due to increased demand for website development, freelance specialists have been used in the last six months. According to the most recent audited financial statements, Mizzen Co has a bank balance of $500,000.

The company has three revenue streams:

1. Developing and maintaining websites for corporate customers. Mizzen Co charges a one-off fee to its customers for the initial development of a website and for maintaining the website for two years. The amount of this fee depends on the size and complexity of the website and averages at $10,000 per website. The customer can then choose to pay another one-off fee, averaging $2,000, for Mizzen Co to provide maintenance for a further five years.

2. Mizzen Co has also developed a subscription-based website on which it provides access to technical material for computer specialists. Customers pay an annual fee of $250 which gives them unlimited access to the website. This accounts for approximately 30% of Mizzen Co’s total revenue.

3. The company has built up several customer databases which are made available, for a fee, to other companies for marketing purposes. This is the smallest revenue stream, accounting for approximately 20% of Mizzen Co’s total revenue.

Extracts from audited financial statements

<table>
<thead>
<tr>
<th></th>
<th>Year ended 30 September</th>
<th>Year ended 30 September</th>
<th>Year ended 30 September</th>
<th>Year ended 30 September</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>2013</td>
<td>2012</td>
<td>2011</td>
<td>2010</td>
</tr>
<tr>
<td>Revenue</td>
<td>$4,266</td>
<td>$3,450</td>
<td>$2,150</td>
<td>$500</td>
</tr>
<tr>
<td>Operating expenses</td>
<td>(2,118)</td>
<td>(2,010)</td>
<td>(1,290)</td>
<td>(1,000)</td>
</tr>
<tr>
<td>Operating profit/loss</td>
<td>2,150</td>
<td>1,440</td>
<td>860</td>
<td>(500)</td>
</tr>
<tr>
<td>Finance costs</td>
<td>(250)</td>
<td>(250)</td>
<td>(250)</td>
<td>(250)</td>
</tr>
<tr>
<td>Profit/(loss) before tax</td>
<td>1,900</td>
<td>1,190</td>
<td>610</td>
<td>(500)</td>
</tr>
<tr>
<td>Tax expense</td>
<td>(475)</td>
<td>(300)</td>
<td>(140)</td>
<td>(140)</td>
</tr>
<tr>
<td>Profit/(loss) for the year</td>
<td>1,425</td>
<td>890</td>
<td>470</td>
<td>(500)</td>
</tr>
</tbody>
</table>

There were no items of other comprehensive income recognised in any year.

Required:

Respond to the request from Mark Clear.

Note: The mark allocation is shown against each of the instructions from Mark Clear above.

Equity owners of Mizzen Co and involvement of BizGrow

Key skills and expertise

Internally generated intangible assets

Premises

Other intangible assets

Accounting policy on revenue recognition

Sustainability and relevance of revenue streams

Operating expenses

Finance charges
You are a manager in the business advisory department of Goleen & Co. Your firm has been approached to provide assurance to Baltimore Co, a company which is not an audit client of your firm, on a potential acquisition. You have just had a conversation with Mark Clear, Baltimore Co’s managing director, who made the following comments:

“Baltimore Co is a book publisher specialising in publishing textbooks and academic journals. In the last few years the market has changed significantly, with the majority of customers purchasing books from online sellers. This has led to a reduction in profits, and we recognise that we need to diversify our product range in order to survive. As a result of this, we decided to offer a subscription-based website to customers, which would provide the customer with access to our full range of textbooks and journals online.

“On investigating how to set up this website, we found that we lack sufficient knowledge and resources to develop it ourselves and began to look for another company which has the necessary skills, with a view to acquiring the company. We have identified Mizzen Co as a potential acquisition, and we have approached the bank for a loan which will be used to finance the acquisition if it goes ahead.

“Baltimore Co has not previously acquired another company. We would like to engage your firm to provide guidance regarding the acquisition. I understand that a due diligence review would be advisable prior to deciding on whether to go ahead with the acquisition, but the other directors are not sure that this is required, and they don’t understand what the review would involve. They are also unsure about the type of conclusion that would be issued and whether it would be similar to the opinion in an audit report.

“Before the other directors and using the information I have provided, I would like you to:

(a) Discuss THREE benefits to Baltimore Co of a due diligence review being performed on Mizzen Co. (6 marks)

(b) Identify and explain the matters which you would focus on in your due diligence review and recommend the additional information which you will need to perform your work. (16 marks)

(c) Describe the type of conclusion which would be issued for a due diligence report and compare this to an audit report. (3 marks)

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Mizzen Co employs 50 people and operates from premises owned by BizGrow, for which a nominal rent of $1,000 is paid annually. The company uses few assets other than computer equipment and furniture and fittings. The biggest expense is wages and salaries and due to increased demand for website development, freelance specialists have been used in the last six months. According to the most recent audited financial statements, Mizzen Co has a bank balance of $500,000.

The company has three revenue streams:

1. Developing and maintaining websites for corporate customers. Mizzen Co charges a one-off fee to its customers for the initial development of a website and for maintaining the website for two years. The amount of this fee depends on the size and complexity of the website and averages at $10,000 per website. The customer can then choose to pay another one-off fee, averaging $2,000, for Mizzen Co to provide maintenance for a further five years.

2. Mizzen Co has also developed a subscription-based website on which it provides access to technical material for computer specialists. Customers pay an annual fee of $250 which gives them unlimited access to the website. This accounts for approximately 30% of Mizzen Co’s total revenue.

3. The company has built up several customer databases which are available, for a fee, to other companies for marketing purposes. This is the smallest revenue stream, accounting for approximately 20% of Mizzen Co’s total revenue.

- Contract or legal documentation dealing with BizGrow’s investment in Mizzen Co
- A register of shareholders showing all shareholders of Mizzen Co
- An organisational structure
- A list of employees and their role within the company, obligations and compensation
- A list of freelance designers used by Mizzen Co, a description of the work they perform
- The key terms of contracts or agreements with freelance web designers
- A list of all IT innovations which have been created and developed by Mizzen Co, and details of any patent or copyright agreements relating to them
- Agreements with employees regarding assignment of intellectual property and confidentiality
- Copies of the customer databases
- A list of companies which have contracts with Mizzen Co for website development and maintenance
- A copy of all contracts with customers for review of the period for maintenance
- A breakdown of the revenue that has been generated from making each database available to other companies, and the dates when they were made available
A summary of the controls which are in place to ensure that the database details are regularly updated

A copy of the premises rental agreement with BizGrow

Non-current asset register showing descriptions and values of all assets used in the business

Copies of any lease agreements

Details of any capital expenditure budgets for previous accounting periods, and any planned capital expenditure in the future

Mizzen Co’s stated accounting policy on revenue recognition

Systems and controls documentation over the processing of revenue receipts

Copies of management accounts to agree expenses in the audited accounts are in line and to perform more detailed analytical review

The full set of financial statements and auditor’s reports

Any agreements with banks or other external providers of finance