Answers

1 Briefing notes

To: Audit Partner

From: Audit Manager

Regarding: Audit planning issues in relation to Parker Co

Introduction

These briefing notes include the results of a preliminary analytical review and evaluate the audit risks to be considered in planning the audit of Parker Co for the year ending 30 June 2013, and identify additional information required. In addition, ethical issues will be discussed and appropriate actions recommended.

(a) Results of preliminary analytical review and audit risk evaluation

The appendix to the briefing notes contains the detailed results of the analytical review performed, which are evaluated in the following section.

Profitability

Parker Co's profitability has declined, with gross profit falling by 21·5% and operating profit by 32·7%. The company's revenue has fallen by 8·2%.

Ratio analysis shows that both gross and operating margins have fallen, the projected gross profit margin at the year end is 27·2% (2012 – 31·8%) and the projected operating margin is 11·4% (2012 – 15·6%). The return on capital employed also shows significant decline, falling from 6·2% to 3·8%. The declines can be explained by a price cutting strategy, difficult economic conditions, and the costs of the legal claim of the company amplify the fall in profitability.

The trends in profitability cause going concern issues. If the company's results do not improve next year, for example, if the new organic range of goods is not successful, the company may become loss-making, especially if margins are squeezed by further price cuts.

Some further information would be helpful to make a more detailed assessment of profitability, for example, an analysis of revenue and profit by product range, which would allow margins to be calculated for individual product ranges to identify those that are particularly underperforming. In addition, the results of any market research that has been performed on the new organic product range to evaluate the potential of the development to generate future profit.

Further adjustments may be necessary to the financial statements, which may reduce the current year's profit further. These adjustments relate to possible incorrect accounting treatments applied to the provision, development costs, finance costs and tax expense, which are discussed later in the briefing notes.

Liquidity

The company's cash position has deteriorated dramatically during the year, moving from a positive cash balance of $1 million, to a projected overdraft of $900,000 at the year end. Analytical review shows that the current and quick ratios have both deteriorated, and it is projected that current assets will not cover current liabilities, as the current ratio projected at the year end is 0·96 (2012 – 1·8). Parker Co will therefore find it difficult to pay liabilities as they fall due, increasing the going concern risk.

Payables days have increased from 63 days to 86 days; this indicates that the company is experiencing difficulties making payments to suppliers as they fall due. This could result in supplier relationships deteriorating and they may stop supplying Parker Co if they see them as a 'risky' customer. Suppliers may also restrict the credit terms offered to Parker Co, causing further working capital problems.

Receivables days have increased from 34 to 42; this could be as a result of poor credit control. A significant control deficiency could affect our overall risk assessment of the client. Alternatively, the increased receivables balance could be the result of irrecoverable debts that require a provision to be made against them; this could further affect profit levels if such a provision is required.

The current and quick ratios will deteriorate further if an adjustment is necessary in respect of the provision, which has been recognised for a potential penalty payment (discussed further below).

Working capital also seems to be a problem, with inventory holding period, receivables collection period and trade payables period all increasing. The inventory holding period is perhaps the most significant, increasing from 136 days to 167 days. This shows that a large amount of working capital is tied up in inventory, and it is likely that some of these goods are obsolete (for example, ranges of cosmetics that are out of fashion) and will never generate a cash flow.

This creates a further audit risk, that the inventory is overstated and needs to be written off to net realisable value. Any write off necessary will put further pressure on the gross profit margin.

To help the risk assessment in relation to cash management, a statement of cash flows projected to the year end would be useful. This is important in order to analyse the main cash generating activities and, more importantly, where cash has been used during the year. A cash flow forecast for at least the next 12 months would also help with going concern assessment.

Solvency

Parker Co's gearing ratio is projected to increase from 0·8 to 1. This indicates a high level of gearing, and the company may, as a result, find it difficult to raise further finance if required, again increasing the going concern risk. The company extended its bank loan during the year and now also has a significant overdraft. It seems very reliant on finance from its bank, and it may be that the bank will be reluctant to offer any further finance, especially in the current economic climate.

It will be important to obtain the details of the bank loan and overdraft, as this will impact on the going concern assessment. In particular, additional information is needed on the overdraft limit to determine how close the current and projected overdraft is to the limit.

The interest cover has fallen from 10·6 to 5·7. Based on these figures, there still appears to be plenty of profit to cover the finance charges, but of course there is a lack of cash in the company, meaning that payments of interest and capital may be difficult.

Finance charge

The finance charge expensed in the statement of profit or loss and other comprehensive income appears very low when compared to the company's level of interest bearing debt and its overdraft. To illustrate, the year-end interest bearing debt and overdraft is $12·725 million ($11·825 million non-current liabilities + $900,000 overdraft), which when compared to the finance charge for the year of $155,000 implies an overall interest rate on all interest bearing debt of only 1·2%. This seems very low, especially when the preference shares have an interest rate of 2%.

This rough calculation indicates that finance charges may be understated. This may also be the case for the comparative figures and creates significant audit risk. If the finance cost needs to be increased, this will further reduce profit before tax and could cause either or both years to become loss-making.

There is a risk that the dividend paid to preference shareholders has been incorrectly accounted for as a distribution from retained earnings, but the correct treatment would be to include the dividend within finance charges, in accordance with IAS 32 *Financial Instruments: Presentation*.

Further information is needed, such as the dates that new finance leases were taken out, the interest rates applicable to each interest-bearing balance and the annual payment due to preference shareholders. This will help to assess whether the finance charge is at risk of understatement.

Tax expense

The effective tax rate based on the projected figures for 2013 is 9·5% (70/735), compared to 25% (300/1,197) in 2012. The tax expense for 2013 seems low and it is possible that a proper estimate has not yet been made of tax payable. The statement of financial position shows a tax payable figure of $50,000 whereas the tax expense is $70,000. This also indicates that the tax figures are not correct and will need to be adjusted.

Provision

A provision in relation to a fine against the company has been recognised in cost of sales. There are two audit risks in relation to this item. First, the provision may not be measured correctly. $450,000 is the amount of the potential amount payable, but only $250,000 has been provided. According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised where there is a present obligation as a result of a past event, a probable outflow of economic benefit and a reliable estimate can be made. Assuming that these criteria have been met, it would be reasonable to expect the full amount of the fine against the company to be provided. Therefore there is a risk that profit is overstated and current liabilities are understated by $200,000. Additional information is needed from management to understand the rationale behind the amount that has been provided.

Furthermore, the provision has been charged to cost of sales. This is not the normal classification of items of this type, which would usually be classified as an operating expense. A presentation risk therefore arises, which affects the gross and operating profit figures. If the full amount of the provision were recognised in operating expenses, the operating margin for 2013 would only be 8·9%.

Development cost

A significant amount, $2·25 million, has been capitalised during the year in relation to costs arising on development of the new organic product range. This represents 8·3% of total assets. There is a risk that this has been inappropriately capitalised, as IAS 38 *Intangible Assets* only permits the capitalisation of development costs as an internally generated intangible asset when certain criteria have been met. There is therefore a risk that non-current assets and operating profit are overstated by $2·25 million if the criteria have not been met, for example, if market research does not demonstrate that the new product will generate a future economic benefit. There is also a risk that inappropriate expenses, such as revenue expenses or costs of developing a brand name for the organic range of products, have been capitalised incorrectly.

This is a significant risk, as if an adjustment were necessary to write off the intangible asset, the profit for the year of $665,000 would become a loss for the year of $1·585 million, and retained earnings would become retained losses of $975,000. This adds to the going concern risk facing Parker Co.

Revaluation of properties

A revaluation during the year has led to an increase in the revaluation reserve of $500,000, representing 1·8% of total assets. Despite the valuations being performed by an independent expert, we should be alert to the risk that non-current assets could be overstated in value. This is especially the case given that Parker Co faces solvency problems resulting in potential

management bias to improve the financial position of the company. Information is needed on the expert to ensure the valuation is objective, thereby reducing the audit risk.

There is also a risk that depreciation was not re-measured at the point of the revaluation, leading to understated expenses.

The revaluation should also have a deferred tax consequence according to IAS 12 *Income Taxes*, as the revaluation gives rise to a taxable temporary difference. If a deferred tax liability is not recognised, the statement of financial position is at risk of misstatement through understated liabilities. Currently there is no deferred tax liability recognised, indicating that liabilities are understated. The same is true for the comparative figures, so an adjustment may be needed in the opening balances.

Finally, a further audit risk is incorrect or inadequate disclosure in the notes to the financial statements. IAS 16 *Property, Plant and Equipment* requires extensive disclosure of matters such as the methods and significant assumptions used to estimate fair values, the effective date of the revaluation and whether an independent valuer was used, as well as numerical disclosures. The revaluation gain should also be disclosed as Other Comprehensive Income and there is a risk that this disclosure is not made. The financial statements provided by Ruth Collie do not contain any items of Other Comprehensive Income and the risk is that the financial statements have not been prepared in accordance with IAS 1 *Presentation of Financial Statements*.

Payroll

Parker Co's internal audit team found control deficiencies when auditing the processing of overtime payments. Additional information is needed on the nature of the deficiencies in order to determine the significance of them, and to plan our approach to the audit of overtime payments. The fact that the processing is no longer carried out by human resources could indicate that the problems were significant. We also need to know the monetary value of the overtime payments to determine its materiality to the financial statements.

The fact that the finance function is now performing the processing will affect our assessment of control risk. On one hand, finance department members should be familiar with the operation of internal controls and understand their importance, which would reduce control risk. However, as all of the processing is now done by one department there is less segregation of duty, which could lead to higher control risk.

New client

Parker Co is a new client, and therefore our firm lacks cumulative knowledge and experience of the business. This increases our detection risk somewhat, but this will be mitigated by thorough planning, including developing an understanding of the business including the internal control environment.

There may also be risks attached to the comparative information and opening balances, especially as the audit risk evaluation has highlighted some potential areas of concern.

Appendix: Results of preliminary analytical review

	2013	2012
Profitability:		
Gross profit margin:		
Gross profit/revenue	2,120/7,800 = 27·2%	2,700/8,500 = 31·8%
Operating profit margin:		
Operating profit/revenue	890/7,800 = 11·4%	1,322/8,500 = 15·6%
Operating profit margin for 2013 adjusted to include full amount of provision	890 – 200/7,800 = 8·9%	
Return on capital employed:		
Operating profit/capital employed	890/11,775 + 11,825 = 3·8%	1,322/11,455 + 9,725 = 6·2%
Return on capital employed adjusted to include full amount of provision	890 – 200/11,775 + 11,825 = 2·9%	
Liquidity:		
Current ratio:		
Current assets/current liabilities	3,500/3,650 = 0·96	3,965/2,185 = 1·8
Quick ratio:		
Current assets – inventory/current liabilities	3,500 – 2,600/3,650 = 0·25	3,965 – 2,165/2,185 = 0·82
Inventory holding period:		
Inventory/cost of sales x 365	2,600/5,680 x 365 = 167 days	2,165/5,800 x 365 = 136 days
Receivables collection period:		
Receivables/revenue x 365	900/7,800 x 365 = 42 days	800/8,500 x 365 = 34 days
Trade payables payment period:		
Trade payables/cost of sales x 365	1,340/5,680 x 365 = 86 days	1,000/5,800 x 365 = 63 days
Gearing:		
Gearing ratio:		
Long-term liabilities/equity	11,825/11,775 = 1	9,725/11,455 = 0·8
Interest cover:		
Operating profit/finance costs	890/155 = 5·7	1,322/125 = 10·6

Tutorial note: *Credit will be awarded for calculation of ratios on alternative bases and using different assumptions, as long as stated. Credit will also be awarded for relevant trend analysis.*

(b) **Ethical matters**

Parker Co is intending to acquire Beauty Boost Co, which is an audit client of our firm. This raises an ethical issue, as the auditor could be involved with advising both the acquirer and the intended target company in relation to the acquisition, which could create a conflict of interest. IESBA's (IFAC) *Code of Ethics for Professional Accountants* states that in relation to the fundamental principle of objectivity, an auditor should not allow bias, conflict of interest or undue influence of others to override professional or business judgements.

IESBA's Code requires that, when faced with a potential conflict of interest, an auditor shall evaluate the significance of any threats and apply safeguards when necessary to eliminate the threats or reduce them to an acceptable level.

An important safeguard is that both parties should be notified of the potential conflict of interest in relation to the planned acquisition. The notification should outline that a conflict of interest may exist and consent should be obtained from both Parker Co and Beauty Boost Co for our firm, Hound & Co, to act for both in relation to the acquisition. If the requested consent is not obtained, the auditor should not continue to act for one of the parties in relation to this matter.

The auditor shall also determine whether to apply one or more of the following additional safeguards:

- The use of separate engagement teams;
- Procedures to prevent access to information (for example, strict physical separation of such teams, confidential and secure data filing);
- Clear guidelines for members of the engagement team on issues of security and confidentiality;
- The use of confidentiality agreements signed by employees and partners of the firm; and
- Regular review of the application of safeguards by a senior individual not involved with relevant client engagements.

If the conflict of interest creates a threat to objectivity or confidentiality that cannot be eliminated or reduced to an acceptable level through the application of safeguards, Hound & Co should not advise Parker Co regarding the acquisition.

Parker Co has specifically requested advice on financing the acquisition. IESBA's Code has specific guidance on such activities, which are corporate finance activities.

The provision of such services can create advocacy and self-review threats to objectivity. The advocacy threat arises as the audit firm could be put in a position of promoting the audit client's interests, for example, when negotiating financial arrangements. The self-review threat arises because the financing arrangements will directly affect amounts that will be reported in the financial statements on which the firm will provide an opinion.

The significance of any threat must be evaluated and safeguards applied when necessary to eliminate the threat or reduce it to an acceptable level. Examples of such safeguards include:

- Using professionals who are not members of the audit team to perform the corporate finance service; or
- Having a professional who was not involved in providing the corporate finance service to the client advise the audit team on the service and review the accounting treatment and any financial statement treatment.

The extent of the self-review threat should be evaluated, for example, by considering the materiality of the potential financing transactions to the financial statements, and the degree of subjectivity involved in determining the amounts to be recognised.

Where no safeguards could reduce the threat to an acceptable level, the corporate finance advice should not be provided.

Conclusion

These briefing notes have evaluated the audit risks to be considered in planning the audit of Parker Co, and going concern has been highlighted as a particular area of concern. Preliminary analytical review determined that Parker Co is facing problems with profitability, cash flow and long-term solvency. Our audit approach should focus on this issue. In addition, some specific areas of risk in relation to provisions, finance charges, tax and non-current assets have been identified. Further information as specified in the briefing notes should be requested from the client in order to complete our audit planning.

Our firm should also consider the ethical issues raised by acting for Parker Co and for its potential target acquisition. Furthermore, the provision of a specific corporate finance service to Parker Co must be evaluated as safeguards will be needed to reduce threats to an acceptable level.

2 **(a)** There are many concerns raised regarding quality control. Audits should be conducted with adherence to ISA 220 *Quality Control for an Audit of Financial Statements* and it seems that this has not happened in relation to the audit of the Retriever Group, which is especially concerning, given the Group obtaining a listing during the year. It would seem that the level of staffing on this assignment is insufficient, and that tasks have been delegated inappropriately to junior members of staff.

Time pressure

The junior's first comment is that the audit was time pressured. All audits should be planned to ensure that adequate time can be spent to obtain sufficient appropriate audit evidence to support the audit opinion. It seems that the audit is being rushed and the juniors instructed not to perform work properly, and that review procedures are not being conducted appropriately. All of this increases the detection risk of the audit and, ultimately, could lead to an inappropriate opinion being given.

Procedures not performed

The juniors have been told not to carry out some planned procedures on allegedly low risk areas of the audit because of time pressure. It is not acceptable to cut corners by leaving out audit procedures. Even if the balances are considered to be low risk, they could still contain misstatements. Directors' emoluments are related party transactions and are material by their nature and so should not be ignored. Any modifications to the planned audit procedures should be discussed with, and approved by, senior members of the audit team and should only occur for genuine reasons.

Method of selecting sample

ISA 530 *Audit Sampling* requires that the auditor shall select items for the sample in such a way that each sampling unit in the population has a chance of selection. The audit manager favours non-statistical sampling as a quick way to select a sample, instead of the firm's usual statistical sampling method. There is a risk that changing the way that items are selected for testing will not provide sufficient, reliable audit evidence as the sample selected may no longer be representative of the population as a whole. Or that an insufficient number of items may be selected for testing. The juniors may not understand how to pick a sample without the use of the audit firm's statistical selection method, and there is a risk that the sample may be biased towards items that appear 'easy to audit'. Again, this instruction from the audit manager is a departure from planned audit procedures, made worse by deviating from the audit firm's standard auditing methods, and likely to increase detection risk.

Audit of going concern

Going concern can be a difficult area to audit, and given the Group's listed status and the fact that losses appear to have been made this year, it seems unwise to delegate such an important area of the audit to an audit junior. The audit of going concern involves many subjective areas, such as evaluating assumptions made by management, analysing profit and cash flow forecasts and forming an overall opinion on the viability of the business. Therefore the going concern audit programme should be performed by a more senior and more experienced member of the audit team. This issue shows that the audit has not been well planned as appropriate delegation of work is a key part of direction and supervision, essential elements of good quality control.

Review of work

The juniors have been asked to review each other's work which is unacceptable. ISA 220 requires that the engagement partner shall take responsibility for reviews being performed in accordance with the firm's review policies and procedures. Ideally, work should be reviewed by a person more senior and/or experienced than the person who conducted the work. Audit juniors reviewing each other's work are unlikely to spot mistakes, errors of judgement and inappropriate conclusions on work performed. The audit manager should be reviewing all of the work of the juniors, with the audit partner taking overall responsibility that all work has been appropriately reviewed.

Deferred tax

It is concerning that the client's financial controller is not able to calculate the deferred tax figure. This could indicate a lack of competence in the preparation of the financial statements, and the audit firm should consider if this impacts the overall assessment of audit risk.

The main issue is that the junior prepared the calculation for the client. IESBA's (IFAC) *Code of Ethics for Professional Accountants* states that providing an audit client with accounting and bookkeeping services, such as preparing accounting records or financial statements, creates a self-review threat when the firm subsequently audits the financial statements. The significance of the threat depends on the materiality of the balance and its level of subjectivity.

Clients often request technical assistance from the external auditor, and such services do not, generally, create threats to independence provided the firm does not assume a management responsibility for the client. However, the audit junior has gone beyond providing assistance and has calculated a figure to be included in the financial statements. The Group is listed and generally the provision of bookkeeping services is not allowed to listed clients.

IESBA's Code states that, except in emergency situations, in the case of an audit client that is a public interest entity, a firm shall not prepare tax calculations of current and deferred tax liabilities (or assets) for the purpose of preparing accounting entries that are material to the financial statements on which the firm will express an opinion.

The calculation of a deferred tax asset is not mechanical and involves judgements and assumptions in measuring the balance and evaluating its recoverability. The audit junior may be able to perform a calculation, but is unlikely to have sufficient detailed knowledge of the business and its projected future trading profits to be able to competently assess the deferred tax position. The calculation has not been reviewed and poses a high audit risk, as well as creating an ethical issue for the audit firm.

The deferred tax balance calculated by the junior should be assessed for materiality, carefully reviewed or re-performed, and discussed with management. It is unclear why the junior was discussing the Group's tax position with the financial controller, as this is not the type of task that should normally be given to an audit junior.

Tax planning

The audit junior should not be advising the client on tax planning matters. This is an example of a non-audit service, which can create self-review and advocacy threats to independence. As discussed above, the audit junior does not have the appropriate level of skill and knowledge to perform such work.

The junior's work on tax indicates that the audit has not been properly supervised, and that the junior does not seem to understand the ethical implications created. As part of a good quality control system, all members of the audit team should understand the objectives of the work they have been allocated and the limit to their responsibilities.

(b) (i) Planning a forensic investigation

Planning the investigation will involve consideration of similar matters to those involved in planning an audit.

The planning should commence with a meeting with the client at which the investigation is discussed. In particular, the investigation team should develop an understanding of the events surrounding the theft and the actions taken by the client since it occurred. 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;
- Whether the client has contacted the insurance company and discussed the events leading to the potential claim.

The insurance policy should be scrutinised to clarify the exact terms of the insurance, to ensure that both the finished goods and stolen lorry will be included in the claim. The period of the insurance cover should be checked, to ensure that the date of the theft is covered, and the client should confirm that payments to the insurance company are up to date, to ensure the cover has not lapsed.

The audit firm should also consider the resources that will be needed to conduct the work. Kennel & Co has a forensic accounting department, so will have staff with relevant skills, but the firm should consider if staff with specific experience of insurance claims work are available.

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 output of the investigation should be confirmed, which is likely to be a report addressed to the insurance company. It should be clarified that the report is not to be distributed to any other parties. Kennel & Co should also confirm whether they would be required to act as expert witness in the event of the thieves being caught and prosecuted.

Tutorial note: *Credit will also be awarded for explanations of acceptance issues such as the need for a separate engagement letter drawn up to cover the forensic investigation, outlining the responsibilities of the investigation team and of the client. Fees should also be discussed and agreed.*

(ii) 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.

3 (a) Matters

The properties classified as assets held for sale are material to the financial statements as the year-end carrying value of $24 million represent 8% of total assets. The amount written off the assets' value at the date of classification as held for sale of $2 million represents less than 1% of revenue and 4·2% of profit before tax, which on both measures is immaterial to the statement of profit or loss and other comprehensive income.

Assets can only be classified as held for sale if the conditions referred to in IFRS 5 *Non-current Assets Held for Sale and Discontinued Operations* are met. The conditions include the following:

- Management is committed to a plan to sell;
- The assets are available for immediate sale;
- An active programme to locate a buyer is initiated;
- The sale is highly probable, within 12 months of classification as held for sale (subject to limited exceptions);
- The asset is being actively marketed for sale at a sales price reasonable in relation to its fair value;
- Actions required to complete the plan indicate that it is unlikely that the plan will be significantly changed or withdrawn.

There is a risk that the assets have been inappropriately classified if the above conditions have not been met.

IFRS 5 requires that at classification as held for sale, assets are measured at the lower of carrying value and fair value less costs to sell. This appears to have been correctly accounted for when classification occurred in October 2012. Though not specifically required by IFRS 5, an impairment review should take place at 31 January 2013, to ensure that there is no further impairment of the properties to be recognised at the year end. If an impairment review has not taken place, the assets may be misstated in value.

The assets should not be depreciated after being classified as held for sale, therefore audit procedures should confirm that depreciation has ceased from October 2012.

Disclosure is needed in the notes to the financial statements to include a description of the non-current assets classified as held for sale, a description of the facts and circumstances of the sale and its expected timing, and a quantification of the impairment loss and where in the statement of profit or loss and other comprehensive income it is recognised.

Evidence

- A copy of the board minute at which the disposal of the properties was agreed by management.
- Details of the active programme in place to locate a buyer, for example, instructions given to real estate agency, marketing literature.
- A copy of any minutes of meetings held with prospective purchasers of any of the properties, or copies of correspondence with them.
- Written representation from management on the opinion that the assets will be sold before October 2013.
- Subsequent events review, including a review of post year-end board minutes and a review of significant cash transactions, to confirm if any properties are sold in the period after the year end.
- Details of any impairment review conducted by management on the properties at 31 January 2013.
- A copy of the client's depreciation calculations, to confirm that depreciation was charged up to October 2012 but not subsequent to the reclassification of the assets as held for sale.

(b) Matters

The sale and leaseback arrangement relates to an asset with a carrying value of $27 million, which represents 9% of total assets and is material to the statement of financial position. The fair value of the asset (cash proceeds) is also material at 12·3% of total assets.

It appears appropriate to classify the leaseback as a finance lease, as Setter Stores Co retains the risk exposure of the asset and the economic benefit of using the asset for the remainder of its useful life.

The accounting treatment for a sale and leaseback transaction should follow the requirements of IAS 17 *Leases*. Where the leaseback is a finance lease, the substance of the transaction is a financing arrangement in which the lessee, in this case Setter Stores Co, never disposes of the risks and rewards of the asset, and so should not recognise a profit or loss on the disposal and should continue to recognise the asset in the statement of financial position. Any apparent profit, being the difference between the fair value of the asset and its carrying value, should be deferred and amortised over the lease term. The asset should be re-measured to fair value.

Setter Stores Co appears to have incorrectly accounted for the transaction. The following entry should have been made on the disposal and leaseback of the property complex:

DR	Cash	$37 million
CR	Property, plant and equipment	$27 million
CR	Deferred income	$10 million

And the asset and finance lease liability should be recognised at fair value:

DR	Property, plant and equipment	$37 million
CR	Obligations under finance lease	$37 million

Therefore property, plant and equipment is understated by $10 million and deferred income also understated by $10 million. $10 million represents 3·3% of total assets and is material. An adjustment should be made and, if not, the audit firm should consider the implication for the auditor's opinion, which may be qualified on the grounds of material misstatement.

In forthcoming accounting periods, depreciation should be calculated based on the $37 million carrying value of the asset allocated over the remaining life of the property of 20 years, and the deferred income should be amortised over the same period.

Evidence

- A copy of the lease, signed by the lessor, and a review of its major clauses to confirm that risk and reward remains with Setter Stores Co, and that the arrangement is a finance leaseback.
- A copy of insurance documents stating that Setter Stores Co is responsible for insuring the asset.
- Physical inspection of the property complex to confirm it is being used by Setter Stores Co.
- Confirmation of the fair value of the property complex, possibly using an auditor's expert.
- Agreement of the $37 million cash proceeds to bank statement and cash book.
- A schedule showing the adjustment required in the financial statements.
- Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements.

(c) Matters

The amount capitalised as an intangible asset is material to the statement of financial position, representing 5% of total assets.

According to IAS 38 *Intangible Assets*, an intangible asset is recognised in the financial statements if it meets the definition of an intangible asset, if it is probable that future economic benefits will flow to the reporting entity, and if its cost can be reliably measured. It would seem appropriate that the licence is recognised as an intangible asset as it has been purchased as a separable asset without physical substance and has a reliable cost. Management should be able to demonstrate the economic benefit that has been, or is expected to be, derived from the licence.

As the licence has a fixed term of five years, it should be amortised over that period. However, it appears that amortisation has not been charged, as the amount recognised at the year end is the original cost of the licence. Amortisation of $1·25 million (15 million/5 years x 5/12) should have been charged from 1 September to the year end. This amount represents less than 1% of revenue and only 2·6% of profit before tax, and is not considered material to profit.

Evidence

– A copy of the distribution licence, confirming the five-year period of the licence, and the cost of $15 million.
– Agreement of the cash paid to the bank statement and the cash book.
– Minutes of a discussion with management regarding the apparent non-amortisation of the licence, including any reasons given for the non-amortisation.
– Sales records in relation to the soft drink and also forecast sales, to determine the future economic benefit to be derived from the licence.

4 (a) Spaniel Co

It is not the auditor's primary responsibility to detect fraud. According to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*, management is primarily responsible for preventing and detecting fraud. The auditor is required to obtain reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or error.

The total amount estimated to have been stolen in the payroll fraud represents 5·6% of Spaniel Co's assets. If the amount has been stolen consistently over a 12-month period, then $3 million (8/12 x 4·5 million) had been stolen prior to the year end of 31 December 2012. $3 million is material, representing 3·8% of total assets at the year end. Therefore the fraud was material and it could be reasonably expected that it should have been discovered.

However, material misstatements arising due to fraud can be difficult for the auditor to detect. This is because fraud is deliberately hidden by the perpetrators using sophisticated accounting techniques established to conceal the fraudulent activity. False statements may be made to the auditors and documents may have been forged. This means that material frauds could go undetected, even if appropriate procedures have been carried out.

ISA 240 requires that an audit is performed with an attitude of professional skepticism. This may not have been the case. Spaniel Co is a long-standing client, and the audit team may have lost their skeptical attitude. Necessary tests of control on payroll were not carried out because in previous years it had been possible to rely on the client's controls.

It seems that ISAs may not have been adhered to during the audit of Spaniel Co. ISA 330 *The Auditor's Responses to Assessed Risks* requires that the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively. It can be acceptable for the auditor to use audit evidence from a previous audit about the operating effectiveness of specific controls but only if the auditor confirms that no changes have taken place. The audit partner should explain whether this was the case.

Substantive procedures have not been performed on payroll either. This effectively means that payroll has not been audited.

This leads to a conclusion that the audit firm may have been negligent in conducting the audit. Negligence is a common law concept in which an injured party must prove three things in order to prove that negligence has occurred:

– That the auditor owes a duty of care;
– That the duty of care has been breached;
– That financial loss has been caused by the negligence.

Looking at these points in turn, Groom & Co owes a duty of care to Spaniel Co, because a contract exists between the two parties. The company represents all the shareholders as a body, and there is an automatic duty of care owed to the shareholders as a body by the auditor.

A breach of duty of care must be proved for a negligence claim against the audit firm to be successful. Duty of care generally means that the audit firm must perform the audit work to a good standard and that relevant legal and professional requirements and principles have been followed. For an audit firm, it is important to be able to demonstrate that ISAs have been adhered to. Unfortunately, it seems that ISAs have been breached and so the audit firm is likely to have been negligent in the audit of payroll.

Tutorial note: *Credit will be awarded for references to legal cases as examples of situations where audit firms have been found to have been negligent in performing an audit, such as* Re Kingston Cotton Mill.

Finally, a financial loss has been suffered by the audit client, being the amount stolen while the fraud was operating.

In conclusion, Spaniel Co is likely to be able to successfully prove that the audit firm has been negligent in the audit of payroll, and that Groom & Co is liable for some or all of the financial loss suffered.

(b) The audit of financial instruments

There are many reasons why financial instruments are challenging to audit. The instruments themselves, the transactions to which they relate, and the associated risk exposures can be difficult for both management and auditors to understand. If the auditor does not fully understand the financial instrument and its impact on the financial statements, it will be difficult to assess the risk of material misstatement and to detect errors in the accounting treatment and associated disclosures. Even relatively simple financial instruments can be complex to account for.

The specialist nature of many financial instruments means that the auditor may need to rely on an auditor's expert as a source of evidence. In using an expert, the auditor must ensure the objectivity and competence of that expert, and then must evaluate the adequacy of the expert's work, which can be very difficult to do where the focus of the work is so specialist and difficult to understand.

The auditor may also find that there is a lack of evidence in relation to financial instruments, or that evidence tends to come from management. For example, many of the financial reporting requirements in relation to the valuation of financial instruments are based on fair values. Fair values are often based on models which depend on management judgement. Valuations are therefore often subjective and derived from management assumptions which increase the risk of material misstatement.

It is imperative that the auditor retains professional skepticism in the audit of financial instruments, but this may be difficult to do when faced with a complex and subjective transaction or balance for which there is little evidence other than management's judgement.

There may also be control issues relating to financial instruments. Often financial instruments are dealt with by a specialist department and it may be a few individuals who exert significant influence over the financial instruments that are entered into. This specialist department may not be fully integrated into the finance function, leading to the accounting treatment being dealt with outside the normal accounting system. Internal controls may be deficient and there may not be the opportunity for much segregation of duty. However, some companies will have established strong internal controls around financial instruments, leading to a lower risk of material misstatement.

In planning the audit of Bulldog Co's financial instruments, the auditor must first gain an understanding of the relevant accounting and disclosure requirements. For example, the applicable financial reporting standards should be clarified, which are likely to be IFRS 9 *Financial Instruments* and IFRS 7 *Financial Instruments: Disclosures*. These standards can be complex to apply, and the auditor should develop a thorough understanding of how they relate to Bulldog Co's financial instruments.

The auditor must also obtain an understanding of the instruments in which Bulldog Co has invested or to which it is exposed, including the characteristics of the instruments, and gain an understanding of Bulldog Co's reasons for entering into the financial instruments and its policy towards them.

It is important that the resources needed to audit the financial instruments are carefully considered. The competence of members of the audit firm to audit these transactions should be assessed, and it may be that an auditor's expert needs to be engaged. If so, this should be explained to the client. Instructions will have to be drawn up and given to the expert to ensure that the work performed is in line with audit objectives and follows the relevant financial reporting requirements, for example, in relation to valuing the financial instruments.

The audit planning should include obtaining an understanding of the internal control relevant to Bulldog Co's financial instruments, including the involvement, if any, of internal audit. An understanding of how financial instruments are monitored and controlled assists the auditor in determining the nature, timing and extent of audit procedures, for example, whether to perform tests on controls.

Specific consideration should be given to understanding management's method for valuing financial instruments for recognition in the year-end financial statements. The valuation is likely to involve some form of estimate, and ISA 540 *Auditing Accounting Estimates, Including Fair Value Accounting Estimates and Related Disclosures* requires the auditor to obtain an understanding of how management makes accounting estimates and the data on which accounting estimates are based.

Finally, the materiality of the financial instruments should be determined and the significance of the risk exposure associated with them should be assessed.

5 (a) Toy Co

The amount claimed against Toy Co is material to consolidated profit, representing 25% of consolidated profit before tax. The amount is not material to consolidated total assets, representing less than 1% of that amount.

The same accounting policies should be applied across the Group in the consolidated financial statements. Therefore in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised in the consolidated financial statements if the amount is probable to be paid. The adjustment needed is:

DR	Operating expenses	$500,000
CR	Current liabilities – provisions	$500,000

The audit evidence obtained by the component auditors is insufficient. Verbal evidence is not a reliable source of evidence. Further audit procedures should be performed, including:

- Obtain written evidence from Toy Co's legal advisors including a statement that in their opinion the damages are probable to be paid, and the basis of that opinion;
- Review the claim itself to confirm that $500,000 is the amount claimed by the ex-employee;
- Inspect the board minutes of Toy Co for evidence of discussion of the claim, to obtain an understanding as to the reason for the claim and whether it has been disputed by Toy Co.

These further audit procedures may be performed by the component auditor, or by the Group audit team.

If, having obtained evidence to confirm that the damages are probable to be paid, the consolidated financial statements are not adjusted to include the provision, the consolidated statement of profit or loss and other comprehensive income will be materially misstated. This would result in a qualified 'except for' opinion due to the material, but not pervasive, nature of the material misstatement. In accordance with ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, the report should contain a paragraph entitled 'Basis for Qualified Opinion' describing the matter giving rise to the qualification. A quantification of the financial effect of the misstatement should also be given.

The auditor should discuss the need for the adjustment with the client (including those charged with governance), and explain that a qualified opinion will result from the material misstatement.

(b) Trade receivable

The trade receivable is material to the consolidated financial statements, representing 2·8% of total assets and 80% of profit before tax. The amount that is potentially irrecoverable is 90% of the total balance outstanding, i.e. $1·44 million. This amount is also material, representing 2·5% of total assets and 72% of profit before tax.

IFRS 9 *Financial Instruments* requires that impaired trade receivables are recognised at fair value, which is the present value of estimated cash inflows. According to the information provided by Terrier Co's administrators, it is likely that 10% of the amount outstanding will be paid and the remaining 90% should be written off. The adjustment needed is:

DR	Operating expenses (irrecoverable debts expense)	$1,440,000
CR	Trade receivables	$1,440,000

The amount should be adjusted in the financial statements for the year ended 31 March 2013, even though notice was not received until May 2013. This is because according to IAS 10 *Events After the Reporting Period*, an adjusting event is one that provides additional information about conditions existing at the year end.

If the financial statements are not adjusted for the impaired receivable, current assets will be overstated and profits overstated by $1·44 million. This is a very significant matter as the adjustment to profit is highly material.

Tutorial note: *Credit will be awarded for comments relating to whether separate disclosure on the face of the statement of profit or loss and other comprehensive income is appropriate, due to the material and unusual nature of the item.*

The auditor should perform additional procedures as follows:

- Obtain the notice from Terrier Co's administrators confirming that the company is insolvent and that only 10% of amounts outstanding is likely to be paid;
- Obtain a written confirmation from the administrators stating the expected timing of the payment;
- Check post year-end cash receipts to see if any of the amount outstanding has been received from Terrier Co;
- Recalculate the impairment losses and trace the posting of the impairment into the general ledger and the financial statements.

If the consolidated financial statements are not adjusted for the irrecoverable amount, both the statement of financial position and the statement of profit or loss and other comprehensive income will be materially misstated. This would result in a qualified 'except for' opinion due to the material, but not pervasive, nature of the material misstatement.

Aggregate impact on the financial statements

The materiality and overall significance of the two matters discussed above should be considered in aggregate. When combined, the adjustment needed to net assets and to operating expenses is $1·94 million. This adjustment would reduce the draft consolidated profit before tax to only $60,000.

The combined misstatement could be considered both material and pervasive to the financial statements as the profit figure is so impacted by the adjustments necessary. In this case, the auditor should express an adverse opinion, stating that the

financial statements do not show a true and fair view. A paragraph should be included above the opinion, entitled 'Basis for Adverse Opinion', which describes the reason for the adverse opinion and provides quantification.

The auditor should discuss the need for the adjustment with the client (including those charged with governance), and explain that a qualified or adverse opinion will result from the material misstatements. This communication is required by ISA 705.

(c) Chairman's statement

ISA 720 *The Auditor's Responsibilities Relating to Other Information in Documents Containing Audited Financial Statements* requires the auditor to read other information, defined as financial and non-financial information, included in a document containing audited financial statements and the auditor's report.

The purpose of reading the other information is to identify material inconsistencies with the audited financial statements. A material inconsistency arises where the other information contradicts information in the audited financial statements, and may possibly raise doubt about the audit opinion. A material inconsistency undermines the credibility of the audit opinion.

ISA 720 requires that in the event of a material inconsistency being discovered, the auditor shall determine whether the financial statements or the other information needs to be revised, so that the inconsistency is removed. If the inconsistency is not resolved, the auditor's responsibilities depend on whether it is the other information, or the financial statements that have not been corrected.

In the Group's case, the chairman's statement contains an inconsistency, as according to the consolidated financial statements, revenue has increased by 5·9%, but the chairman states that revenue has increased by 20%.

The audit work performed on revenue should be reviewed to ensure that sufficient and appropriate evidence has been gained to support the figures in the financial statements.

The matter should be discussed with management, who should be asked to amend the disclosure in the chairman's statement. Management should be presented with the results of the audit work, to justify, if necessary, that the amendment needs to be made. The inclusion of the incorrect figure in the draft chairman's statement could be a genuine mistake, in which case management should be happy to make the change.

If management refuse to change the disclosure in the other information, then the audit report should contain an Other Matter paragraph. This should be presented immediately after the opinion paragraph and should describe the inconsistency clearly. The matter should also be communicated to those charged with governance.

If the inconsistency remains, the audit firm may wish to speak at a meeting of shareholders of the Poodle Group to explain the additional paragraph that has been included in the audit report.

Marks

1 (a) Audit risk evaluation, preliminary analytical review and additional information requests

In relation to the matters listed below:

Up to 2 marks for each audit risk/area from preliminary analytical review evaluated
1 mark for each ratio and comparative calculated (½ mark for a trend) to a maximum of 6 marks
1 mark for each additional information request to a maximum of 5 marks

- Profitability
- Liquidity
- Solvency
- Going concern
- Provisions
- Finance costs
- Tax expense
- Development costs
- Property revaluation
- Overtime payments control risk
- New client detection risk
- Opening balances

Maximum marks 24

(b) Ethical matters

Generally 1 mark per comment:

- Conflict of interest threat to objectivity
- Evaluate significance of threat and potential safeguards
- Contact both parties to request consent to act
- Identify safeguards (1 mark each)
- If consent not obtained cannot act for both parties
- Explain why corporate finance service creates advocacy threat
- Explain why corporate finance service creates self-review threat
- Identify safeguards (1 mark each)

Maximum marks 7

Professional marks for the overall presentation, structure and logical flow of the briefing notes, and for the clarity of the evaluation and explanations provided.

Maximum marks 4

Maximum **35**

Marks

2 (a) Quality control, ethical and other professional matters

Up to 2 marks for each matter evaluated (up to a maximum 3 marks for identification only)

– Time pressure
– Planned procedures ignored on potentially material item
– Sampling method changed – increases sampling risk
– Inappropriate review by juniors
– Inappropriate delegation of tasks
– Deferred tax – management not competent
– Deferred tax – self-review/management responsibility threat
– Tax planning – non-audit service with advocacy threat
– Junior lacks experience for this work regardless of ethical issues
– Junior not supervised/directed appropriately
– Overall conclusion

Maximum marks 13

(b) (i) Planning the forensic investigation

Up to 1½ marks for each planning matter identified and explained (up to a maximum 2 marks for identification only)

– Develop understanding of the events surrounding the theft
– Meeting with client to discuss the investigation
– Confirm insurance policy details (period covered, what is covered)
– Agree output of investigation
– Confirm access to necessary information
– Discuss confidentiality and ability to discuss with police/insurance company
– Consider resources for the investigation team
– Deadlines/fees

(ii) Procedures to be performed

1 mark for each specific procedure recommended:

– Watch the CCTV to form an impression of the quantity of goods stolen
– If possible, from the CCTV, determine the type of goods stolen
– Determine how many items of finished goods are in each box
– Agree the cost of an individual item 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 and agree to the non-current asset register

Maximum marks 12

Maximum **25**

Marks

3 (a) Assets held for sale

Generally 1 mark for each matter considered/evidence point explained:

Matters:
- Assets held for sale are material (calculation)
- Amount written off is not material (calculation)
- Conditions required to classify assets as held for sale (up to 2 marks)
- Re-measurement at classification appears correct
- Further impairment review may be needed at year end
- Depreciation should not be charged after reclassification
- Disclosure in notes to financial statements

Evidence:
- Board minute at which the disposal of the properties was agreed by management
- Details of the active programme in place to locate a buyer
- A copy of any minutes of meetings held with prospective purchasers of any of the properties
- Written representation from management that the assets will be sold before October 2013
- Subsequent events review
- Confirm depreciation ceased on reclassification
- Details of any impairment review conducted by management

Maximum marks — 8

(b) Sale and leaseback

Generally 1 mark for each matter considered/evidence point explained:

Matters:
- Asset is material (calculation)
- On disposal the asset should be re-measured to fair value
- Apparent profit should be deferred and amortised
- Accounting treatment currently not correct
- Discuss materiality of adjustments needed
- Implication for auditor's opinion
- Treatment as a finance lease appears correct

Evidence:
- A copy of the lease to confirm that the arrangement is a finance lease
- Physical inspection of the property complex
- A copy of insurance documents
- Confirmation of the fair value of the property complex, possibly using an auditor's expert
- Agreement of the $37 million cash proceeds to bank statement and cash book
- A schedule showing the adjustment required in the financial statements
- Minutes of a discussion with management regarding the accounting treatment and including an auditor's request to amend the financial statements

Maximum marks — 7

(c) Distribution licence

Generally 1 mark for each matter considered/evidence point explained:

Matters:
- Materiality of the asset (calculation)
- Identify event as intangible asset that should be capitalised
- Identify that no amortisation has been charged
- The non-amortisation is not material

Evidence:
- A copy of the licence
- Agreement of cost to bank statement and cash book
- Discussion with management regarding the non-amortisation
- Sales records of the soft drink since 1 September 2012

Maximum marks — 5

Maximum — 20

Marks

4 (a) Fraud and auditor's liability

Generally up to 2 marks for each point explained:

- Not auditor's primary responsibility to detect fraud unless it is material in impact on financial statements
- Determine that the payroll fraud would have been material (include calculation)
- Reasons why fraud is hard to detect
- Audit firm may not have been sufficiently skeptical
- Non-adherence to ISAs on controls assessment and evidence obtained
- Discuss whether duty of care owed to client
- Discuss breach of duty of care
- Identify financial loss suffered and firm likely to have been negligent

Maximum marks 12

(b) Audit of financial instruments

Generally up to 1½ marks for each point explained:

Why is audit of financial instruments challenging?
- Financial reporting requirements complex
- Transactions themselves difficult to understand
- Lack of evidence and need to rely on management judgement
- Auditor may need to rely on expert
- May be hard to maintain attitude of skepticism
- Internal controls may be deficient

Planning implications
- Obtain understanding of accounting and disclosure requirements
- Obtain understanding of client's financial instruments
- Determine resources, i.e. skills needed and need for an auditor's expert
- Consider internal controls including internal audit
- Determine materiality of financial instruments
- Understand management's method for valuing financial instruments

Maximum marks 8

Maximum **20**

Marks

5 Audit completion, adjustments necessary, additional audit procedures, implications for auditor's report

Generally up to 1 mark for each point assessed/procedure recommended:

(a) Toy Co

- Potential provision is material to Group accounts (calculation)
- Group accounting policy should be applied
- Adjustment needed to operating profit and current liabilities
- Recommend additional procedures (1 mark each)
- Material misstatement if not adjusted and qualified opinion
- Describe 'Basis for Qualified Opinion' paragraph

Maximum marks 7

(b) Trade receivable

- Potential impairment of receivables is material to Group accounts (calculation)
- Account for as an adjusting event
- Adjustment needed to operating profit and current assets
- Recommend additional procedures (1 mark each)
- Material misstatement if not adjusted and qualified opinion

Potential adjustments in aggregate (marks can be awarded either in answer to (a) or (b))

- In aggregate, the two matters almost wipe out profit before tax
- Could be considered to be pervasive to financial statements leading to adverse opinion
- Must be discussed with those charged with governance

Maximum marks 7

(c) Chairman's statement

- Auditor required to read other information which includes the draft chairman's statement
- Other information should be consistent with financial statements
- Inconsistencies undermine the audit opinion
- The draft chairman's statement contains a misstatement of fact regarding revenue
- Review audit work performed on revenue
- Request draft chairman's statement to be amended
- If inconsistency remains, the auditor's report to include an Other Matter paragraph
- Consider speaking at meeting of shareholders regarding the inconsistency

Maximum marks 6

Maximum **20**