Answers
1 Briefing notes
To: Joss Dylan
From: Audit manager
Regarding: Audit planning for the Adams Group

Introduction
These briefing notes are prepared for use by the audit engagement partner of the Adams Group, and relate to the planning of the audit of the Group for the year ended 31 May 2014. The notes contain an evaluation of audit risk, as well as requests for additional information. The notes also explain the matters to be considered in respect of using the work of Clapton & Co, and the relevant procedures to be performed.

(a) (i) and (ii) Evaluation of audit risk and additional information

New audit client
The Group is a new client of our firm which may create detection risk as we have no previous experience with the client. However, thorough planning procedures which focus on obtaining a detailed knowledge and understanding of the Group and its activities will minimise this risk. 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. There is also risk that comparative information and opening balances are not correct.

Brand name
The Adams brand is recognised in the statement of financial position as an intangible asset. This is appropriate given that the brand is a purchased intangible asset. However, the asset is recognised at its original cost and 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 risk is that the assumption that the brand has an indefinite life is not correct, and that the asset is overstated and operating expenses understated through the lack of an annual amortisation charge against the asset.

The brand is material at 7.4% of Group assets. Further information is needed to understand the nature of advertising and marketing used to support the brand name and therefore its indefinite life, and how the brand name is used, for example, does it apply to all products of the Group.

Tutorial note: Credit will be awarded for discussion of possible reasons for impairment/limited useful life of the brand, for example, the use of low cost overseas labour by Lynott Co.

Associate
A new associate has been acquired during the year, which gives rise to several risks. It is material at 11.2% of Group assets.

Because this is the first addition to the Group for many years, there is an inherent risk that the Group lacks accounting knowledge on the appropriate accounting treatment. Associates are accounted for under IAS 28 Investments in Associates and Joint Ventures, which states that an entity with joint control of, or significant influence over, an investee shall account for its investment in an associate or a joint venture using the equity method. There is a risk that the equity method has not been properly applied. The investment in the associate recognised in the statement of financial position has increased in value since acquisition by $0.5 million, presumably due to the inclusion of the Group’s share of profit arising since investment. There is a risk that this has not been calculated correctly, for example, it is not based on the correct share of profit, and the investment may therefore be over or under stated.

Risk also arises in relation to any possible impairment of the investment, which may cause it to be overstated in both the individual financial statements of Adams Co, and the Group financial statements.

There is also a disclosure issue, as the Group’s share of post-investment profit of Stewart Co should be recognised in profit, and IAS 1 Presentation of Financial Statements requires that the profit or loss section of the statement of profit or loss shall include as a line item the share of the profit or loss of associates accounted for using the equity method. The draft statement of profit or loss 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.

There is also a risk that the investment should not have been classified as an associate. According to IAS 28, if an entity holds, directly or indirectly, 20% or more of the voting power of the investee, it is presumed that the entity has significant influence, unless it can be clearly demonstrated that this is not the case. If the 25% holding does not give rise to significant influence, for example, if the shares do not convey voting rights, it should be classified as an investment rather than an associate. There is a risk of inappropriate classification, recognition and measurement of the investment in Stewart Co.

Additional information is required on the reason for the investment being made, and whether the Group exercises significant influence over Stewart Co. The purchase agreement and documentation showing the extent of Adams Co’s involvement in Stewart Co will clarify matters such as whether Adams Co can appoint board members. This will help
determine the true nature of the investment. The share documentation should also be obtained, to confirm that the shareholding is in equity shares which convey voting rights.

**Ross Co’s sales through department stores**

Almost all of the company’s sales are made through department stores. This may give rise to a risk in relation to revenue recognition, as 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 retains neither continuing managerial involvement to the degree usually associated with ownership nor effective control over the goods sold.

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 in multiple locations**

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 under statement 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 properties**

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. According to IAS 40 Investment Property, an entity can use either the fair value model or the cost model to measure investment property. When the fair value model is used the gain is recognised in profit or loss. The draft consolidated statement of profit or loss and other comprehensive income includes the investment property revaluation gain as other comprehensive income rather than as profit or loss, and therefore the gain is not presented in accordance with IAS 40.

An accounting error may have been made in the adjustment made to increase the value of the investment property. The statement of financial position shows an increase in value of investment properties of $2·5 million, however, the gain in the statement of profit or loss and other comprehensive income is stated at $1 million. There is a risk that the gain is understated and part of the gain may have been classified elsewhere in profit or loss. The gain as stated in the statement of profit or loss and other comprehensive income material at 9·3% of total comprehensive income.

It would be important to obtain information on the type of properties which have been invested in, and whether there have been any additions to the portfolio during the year, as part of the movement in the investment property balance during the year could be explained by acquisitions and disposals. Information should also be obtained on any disposals of investment properties during the year, and whether a profit or loss was made on such disposals.

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.

Further information should be sought from the previous auditor of the Group in relation to the accounting treatment for the investment properties, and whether it had been identified as an error, in which case the audit reports of both Beard Co and the Group should have been modified. A review of prior year audit reports is necessary, as well as a review of the previous audit firm’s working papers, assuming permission is given for this to take place.

**Bonus scheme**

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. 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.

It is also noticeable from the draft statement of financial position that there is no accrual recognised in respect of the bonus scheme, unless it has been included inappropriately in trade or tax payables. This indicates a potential understatement of liabilities and overstatement of profit if any necessary accrual has not been made for any bonus which is payable.

Information is required on the exact terms of the bonus scheme, for example, the number of people who are members of the scheme and the increase in revenue required to trigger bonus payment, and whether any bonus is payable based on this year’s increase in revenue.

**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
revenue. There is a risk that these payables and the corresponding receivable have not been accrued in the individual
financial statements.

At Group level, the inter-company balances should be eliminated on consolidation. If this has not happened, the
liabilities and receivables in the Group financial statements will be overstated, though there would be no net effect on
Group profit if the balances were not eliminated.

**Tutorial note:** Credit will also be awarded for comments on relevant issues to do with transfer pricing and relevant tax
implications which have not been considered and recognised appropriately in the financial statements.

**Inventory**
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.

**Intercompany transfers**
Ross Co transfers goods to Lynott Co for recycling when its goods are considered obsolete. There is a risk that at Group
level the intercompany trading is not eliminated on consolidation, which would lead to overstated receivables and
payables. In addition, if the inventory is transferred at a profit or loss, which is then not realised by the Group at the
year end, the Group inventory figure and operating profit could be over or understated if any necessary provision for
unrealised profit or loss is not recognised.

**Goodwill**
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.

Further information is required on why goodwill is not recognised, and reviews of historical financial statements should
provide details on this matter. The original acquisition documents should also be sought, to allow an assessment as to
whether any goodwill actually arose on acquisition.

**Component auditor**
Lynott Co is audited by an overseas firm of auditors. This may introduce audit risk in that Dando & Co will be relying to
some extent on their work. Careful planning will be needed to reduce this risk to a minimum, and this is discussed in
the next section of the briefing notes.

**Tutorial note:** Credit will be awarded for relevant calculations which form part of relevant analytical review performed,
such as calculations relating to profit margins, liquidity and gearing, and for discussion which is relevant to the
evaluation of audit risk. Credit will also be awarded for discussion of other relevant audit risks, for example, risks
associated with the lack of a deferred tax figure in the statement of financial position, and the change in effective tax
rate.

(b) Matters to be considered and procedures to be performed in respect of using the work of Clapton & Co

The requirements in respect of using the work of component auditors are given in ISA 600 Special Considerations – Audits
of Group Financial Statements (Including the Work of Component Auditors). ISA 600 requires that if the Group engagement
team plans to request a component auditor to perform work on the financial information of a component, the group
engagement team shall obtain an understanding of four matters.

(i) 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.

(ii) 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. The fact that Clapton & Co is
a member of an international network means it is likely to have access to regular training programmes and technical
updates which adds to the credibility of their audit work.

(iii) 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.

(iv) 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. This
allows greater reliance to be placed on their work.

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
2 (a) (i) Before accepting the engagement to review Waters Co's prospective financial information, there are several matters to be considered. A significant matter is whether it is ethically acceptable to perform the review. The review would constitute a non-assurance service provided to an audited entity, and IESBA's Code of Ethics for Professional Accountants states that this may create self-interest, self-review and advocacy threats to independence. In this case, the advocacy threat may be deemed particularly significant as Hunt & Co could be perceived as promoting the client's position to the bank. The review engagement should only be provided if safeguards can be used to reduce the threat to an acceptable level, which may include:

- 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.

As well as ethical matters, ISAE 3400 The Examination of Prospective Information requires that certain matters are considered before a review engagement is accepted. Hunt & Co must also consider the specific terms of the engagement. For example, the firm will need to clarify whether the bank has requested a review report to be issued, and what exact information will be included in the application to the bank. It is likely that more than just a forecast statement of profit or loss is required, for example, a forecast statement of cash flows and accompanying narrative, including key assumptions is likely to be required for a lending decision to be made.

ISAE 3400 also requires that consideration should be given to the intended use of the information, and whether it is for general or limited distribution. 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. ISAE 3400 states that the auditor should not accept an engagement when the assumptions used are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. 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. If the work on the cinemas is scheduled to be completed by September 2014, presumably the cash will have to be provided very soon, meaning a tight deadline for the review engagement to be performed.

(ii) Examination procedures should include the following:

- 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.
- The forecast should be cast to confirm accuracy.
- The time frame of the work to be carried out needs to be discussed with management, with enquiry being made to ascertain how the work can be carried out in such a short period of time, for example, will all cinemas be closed for the period of refurbishment? This will help to confirm the accuracy of the revenue and expenses recognised.
- 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.
- Consider the capacity of the cinemas and the number of screenings which can take place to assess the reasonableness of projected revenue.

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.
- Ascertain 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 operates.

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.
Matters to consider:

(b) (i) 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.

(ii) There are many elements which should be in place as part of an anti-money laundering programme, which are outlined in ACCA’s Technical Factsheet 145 Anti-Money Laundering Guidance for the Accountancy Sector.

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. Suspicions 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.

There are also firm-wide elements of an anti-money laundering programme. 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.

Tutorial note: Credit will be given for other relevant elements of an anti-money laundering programme to a maximum of four different matters.

3 (a) (i) Matters to consider:

The factories are a class of assets which is material to the statement of financial position, representing 25% of total assets. The factories manufacturing the chemical which is to be phased out are half of the total class of assets, representing 12.5% of total assets and therefore material.

The new government regulation indicates that the products made in these factories will be phased out by 2017. According to IAS 36 Impairment of Assets, this is an indicator of potential impairment of the assets. IAS 36 gives examples of indicators that an asset may be impaired in value, one of which is significant adverse changes which have taken place or are expected to take place in the technological, market, economic or legal environment in which the entity operates.

Management should have conducted an impairment review to determine the recoverable amount of the factories, which would be the greater of the fair value less cost to sell and the value in use of the assets.
In relation to a material related party transaction, IAS 24 requires disclosure of the nature of the related party relationship. Financial statements will be necessary to avoid a material misstatement. Therefore, disclosure of the transaction in the notes to the financial statements will be necessary, regardless of monetary amount. Hannah Osbourne is a related party of Cooper Co. This is according to IAS 24 Related Party Disclosures, which states that a member of key management personnel is a related party of the reporting entity. ISA 550 Related Parties requires that the auditor evaluates whether identified related party relationships and transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework. In addition, ISA 550 requires that where a significant related party transaction outside of the entity’s normal course of business is identified, the auditor shall:

- Inspect the underlying contracts or agreements, if any, and evaluate whether:
  - The business rationale (or lack thereof) of the transactions suggests that they may have been entered into to engage in fraudulent financial reporting or to conceal misappropriation of assets;
  - The terms of the transactions are consistent with management’s explanations; and
  - The transactions have been appropriately accounted for and disclosed in accordance with the applicable financial reporting framework.

The auditor shall also obtain audit evidence that the transactions have been appropriately authorised and approved. IAS 24 states that a related party transaction should be disclosed if it is material. Based on monetary value the amount of the transaction is not material, based on either the book value or the market value of the car, as it represents less than 1% of total assets and of profit using either measure of value. However, the materiality should also be judged based on the significance of the transaction to the person involved. The car’s market value of $75,000 could be deemed significant to Hannah, especially if she is not going to settle the amount, meaning effectively that she has been given the car for free by the company. And, because the transaction is with a member of key management personnel, it is effectively material by nature, regardless of monetary amount. Therefore disclosure of the transaction in the notes to the financial statements will be necessary to avoid a material misstatement.

In relation to a material related party transaction, IAS 24 requires disclosure of the nature of the related party relationship along with information about the transaction itself, such as the amount of the transaction, any relevant terms and conditions, and any balances outstanding. If the related party transaction has not been disclosed, the auditor should consider the implications for the audit report, which may need to be modified on the grounds of material misstatement.

Finally the auditor should consider the recoverability of the $50,000 outstanding, given that the invoice was raised several months before the year end and the amount has not yet been paid. If the amount is not recoverable and needs to be written off, this will not be material in monetary terms for Cooper Co but an adjustment would be advisable to avoid overstatement of receivables and operating profit.

Evidence:
- A review of the notes to the financial statements to confirm that sufficient disclosure has been made to comply with the requirements of IAS 24.
- A copy of the invoice raised, and agreement to the receivables ledger to confirm the amount of $50,000 which is outstanding.
- A copy of any contract or other document pertaining to the sale of the car to Hannah, and a review of its terms and conditions, e.g. specification of when the amount is due for payment.
Business risk is defined in ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and its Environment. The definition states that business risk is a risk resulting from significant conditions, events, circumstances, actions or inactions which could adversely affect an entity’s ability to achieve its objectives and execute its strategies, or from the setting of inappropriate objectives and strategies.

Risk of material misstatement is defined in ISA 200 Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with ISAs as the risk that the financial statements are materially misstated prior to audit. Risk of material misstatement comprises inherent risk and control risk.

ISA 315 states that the auditor shall perform risk assessment procedures to provide a basis for the identification and assessment of risks of material misstatement at the financial statement and assertion levels. Business risks can be broken down into operational risk, financial risk and compliance risk. Each of these components can have a direct impact on the financial statements, and therefore understanding the components of business risk can help the auditor to identify risks of misstatement, and to design a response to that risk.

Some business risks impact the inherent risk component of risk of material misstatement. For example, the auditor may have identified that an audited entity has significant levels of debt with covenants attached. The business risk is that the covenants are breached and the debt recalled. An associated inherent risk at the financial statement level is that the financial statements could be manipulated to avoid breaching the debt covenant.

Other business risks impact on the control risk component of risk of material misstatement. For example, the auditor may have identified that an audited entity has a business risk due to having lost key members of personnel in the accounting department. This has a clear impact on control risk, as it means the accounting department is short of competent staff and errors are likely to go undetected and uncorrected.

Therefore the ISAs’ approach to planning an audit is underpinned by the concept that it is essential for an auditor to understand the business risks of an audited entity in order to effectively identify and respond to risks of material misstatement.
Outsourcing is when certain functions within a business are contracted out to third parties known as service organisations. It is common for companies to outsource one or more of it functions, with payroll, IT and human resources being examples of functions which are typically outsourced.

Outsourcing does have an impact on audit planning. ISA 402 Audit Considerations Relating to an Entity Using a Service Organisation requires the auditor to obtain an understanding of how the audited entity (also known as the user entity) uses the services of a service organisation in the user entity’s operations, including the following matters:

- The nature of the services provided by the service organisation and the significance of those services to the audited entity, including the effect on internal control;
- The nature and materiality of the transactions processed or accounts or financial reporting processes affected by the service organisation;
- The degree of interaction between the activities of the service organisation and those of the audited entity;
- The nature of the relationship between the audited entity and the service organisation, including the relevant contractual terms.

The reasons for the auditor being required to understand these matters is so that any risk of material misstatement created by the use of the service organisation can be identified and an appropriate response planned.

The auditor is also required under ISA 402 to evaluate the design and implementation of relevant controls at the audited entity which relate to the services provided by the service organisation, including those which are applied to the transactions processed by the service organisation. This is to obtain understanding of the control risk associated with the outsourced function, for example, whether the transactions and information provided by the service organisation is monitored and whether checks are performed prior to inclusion in the financial statements.

Information should be available from the audited entity to enable the understanding outlined above to be obtained, for example, through reports received from the service organisation, technical manuals and the contract between the audited entity and the service organisation.

The auditor may decide that further work is necessary in order to evaluate the risk of material misstatement associated with the outsourcing arrangement's impact on the financial statements. It is common for a report on the description and design of controls at a service organisation to be obtained. A type 1 report focuses on the description and design of controls, whereas a type 2 report also covers the operating effectiveness of the controls. This type of report can provide some assurance over the controls which should have operated at the service organisation.

Alternatively, the auditor may decide to contact the service organisation to request specific information, to visit the service organisation and perform procedures, probably tests on controls, or to use another auditor to perform such procedures. All of these methods of evaluating the service organisation’s controls require permission from the client and can be time consuming to perform.

The purpose of obtaining the understanding above is to help the auditor to determine the level of competence of the service organisation, and whether it is independent of the audited entity. This will then impact on the risk of material misstatement assessed for the outsourced function.

A potential conflict between the interest of two audit clients arises from Ryder & Co offering advice to Crow Co on the tender being presented to Hatfield Co. A conflict of interest may create potential threats to objectivity, confidentiality or other threats to compliance with the fundamental principles of the IESBA Code of Ethics for Professional Accountants.

In this scenario, Ryder & Co faces the problem of potentially giving advice to one audit client in relation to another audit client, which threatens objectivity. There may also be problems to do with confidentiality of information, as either party could benefit from information obtained from the audit firm about the other party.

In dealing with conflicts of interest, the IESBA Code requires the significance of any threats to be evaluated, and safeguards to be applied when necessary to eliminate the threats or reduce them to an acceptable level. The most important safeguard is disclosure by Ryder & Co. The audit firm should notify both Crow Co and Hatfield Co of the potential conflict of interest and obtain their consent to act.

Other possible safeguards could include:

- 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.

Ryder & Co may decide, having evaluated the threats and available safeguards, that the threats cannot be reduced to an acceptable level, in which case the firm should decline from giving advice to Crow Co regarding the tender.

If Ryder & Co were to be involved with the events organised by Campbell Co, this could be perceived as a close business relationship. Such relationships can arise when an audit firm has a commercial relationship or common financial interest with an audit client. Examples are given in the IESBA Code of situations in which a close business relationship can arise.
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. The ITC states that a quality audit should be accompanied by an informative audit report which delivers value to the entity’s stakeholders and that the auditor’s report should better explain key matters.

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.

It is clear that the financial crisis of recent years sparked a new debate into the appropriateness of the use of the going concern assumption by management, and into whether the auditor’s report contains sufficient information about going concern matters. Many users of financial statements have argued that going concern is such a critical issue that it should be discussed in more detail, and in an understandable way in the auditor’s report. The current audit report has been criticised as containing insufficient information regarding going concern and added to the perceived expectation gap. The ITC suggestion to include specific statements regarding going concern will add clarity on this matter.

The issue of auditors making an affirmative statement regarding going concern is likely to add more credibility to the financial statements, which will provide a level of comfort for all users of financial statements. Specifically for users such as providers of finance, they may be more willing to make lending decisions based on financial statements on which an affirmative statement in respect of going concern has been given by the auditor.

The proposed disclosures include a statement regarding material uncertainties which relate to going concern. This can be seen to be informative and should help users to understand the subjective nature of the going concern assumption.

Overall, the suggestions made by the ITC should go some way to bridge the expectation gap but users of financial statements will need to treat statements made in relation to going concern with some caution, due to its highly subjective nature. 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.

Tutorial note: Answers which refer to more recent IAASB documents on the proposed changes to auditor’s reports will be given credit.
In terms of structure, the basis of opinion and opinion paragraphs should not be combined together. ISA 705 *Modifications to the Opinion in the Independent Auditor’s Report* requires that when the auditor modifies the opinion on the financial statements, the auditor shall include a paragraph in the auditor’s report which provides a description of the matter giving rise to the modification. The auditor shall place this paragraph immediately before the opinion paragraph in the auditor’s report and use the heading ‘Basis for Qualified Opinion’, ‘Basis for Adverse Opinion’, or ‘Basis for Disclaimer of Opinion’, as appropriate. Therefore the audit report needs to be amended to include two separate paragraphs.

The paragraph states the materiality used during the audit. Although ISA 700 *Forming an Opinion and Reporting on Financial Statements* does require the auditor to include a paragraph outlining the auditor’s responsibility including a description of the scope of the audit, there is no requirement to specifically state the materiality level which has been applied. This should be removed from the draft auditor’s report.

The paragraph states that audit procedures have ‘proven conclusively’ in respect of trade receivables. This term is misleading, implying that every transaction has been tested. Audit procedures provide a reasonable, but not absolute, level of assurance on the financial statements, and conclusive proof is not an appropriate term to be used in the auditor’s report.

The amount of the potential adjustment to trade receivables and its financial impact should be included in the paragraph. ISA 705 requires that if there is a material misstatement of the financial statements which relates to specific amounts in the financial statements (including quantitative disclosures), the auditor shall include in the basis for modification paragraph a description and quantification of the financial effects of the misstatement, unless impracticable. The relevant financial reporting standard should also be referred to.

The paragraph uses unprofessional wording by naming the finance director. The auditor’s report should refer to management collectively and not single out one person as being responsible for the financial statements. In addition, it should not state that she ‘refused’ to make an adjustment.

The incorrect type of modified audit opinion seems to have been given. The trade receivables balance is material at $2.5 million, which is in excess of the materiality threshold of $1.5 million used in the audit and so a qualification due to material misstatement seems necessary. The auditor’s report uses a disclaimer of opinion, which is used when the auditor cannot form an opinion, usually due to lack of audit evidence, which does not appear to be the case here.

In addition, the level of modification seems incorrect. The matter is material but is unlikely to be pervasive to the financial statements based on the level of profit of $11 million. Therefore a qualified opinion is sufficient.

The use of an Emphasis of Matter paragraph in respect of the court case is not appropriate. ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor’s Report* states that an Emphasis of Matter paragraph is used to refer to a matter appropriately presented or disclosed in the financial statements which, in the auditor’s judgement, is of such importance that it is fundamental to users’ understanding of the financial statements. The court case and its potential legal consequences are not material, being well below the materiality threshold of $1.5 million. The matter is certainly not fundamental to users’ understanding of the financial statements. Due to the immaterial nature of the matter it need not be referred to in the auditor’s report at all.

The auditor has reached the conclusion that the court case has not been accounted for correctly. The Emphasis of Matter paragraph should only be used to highlight matters which have been appropriately accounted for and disclosed within the financial statements, and its use to describe non-compliance with the relevant financial reporting standard is not appropriate.
1 (a) (i) Audit risk evaluation

In relation to the matters listed below:

Up to 2 marks for each audit risk evaluated
Up to 1 mark for each relevant calculation/trend and ½ mark for relevant materiality calculations

- New audit client
- Brand name – indefinite useful life and lack of amortisation
- Equity accounting – measurement of associate and possible impairment
- Disclosure of income from associate
- Classification as an associate
- Ross Co’s revenue recognition
- Ross Co’s inventory – control issues relating to multi-location of inventory
- Lynott Co’s new inventory control system
- Beard Co’s investment property – measurement of the gain
- Beard Co’s investment property – incorrect classification as other comprehensive income
- Possible error in comparative information and need for skepticism
- Bonus scheme – inherent risk of overstating revenue
- Trend calculations, comment on increase in both revenue and operating expenses
- Elimination of management charges
- Inventories – movement in the year and potential overstatement
- Intercompany trading (inventories)
- Goodwill – none recognised

Maximum marks 18

(ii) Additional information requests

1 mark for each additional information identified and explained to a maximum of 5 marks:

- Details of marketing and advertising to support the indefinite life of the brand name
- Reasons for the investment in Stewart Co
- Details relevant to how Adams Co exercises influence over Stewart Co, e.g. right to appoint board members
- Previous auditor’s working papers especially in relation to Beard Co’s investment properties
- Previous years’ auditor’s reports for the Group
- Terms of the management bonus scheme
- Original purchase documentation for each subsidiary

Maximum marks 5
(b) Using the work of a component auditor

Up to 1½ marks for each matter explained:
- Compliance with ethical requirements
- Professional competence
- Sufficient involvement in component auditor’s work/resources
- Existence of a regulated environment
- Assess level of risk in the subsidiary audited by the component auditor

1 mark for each relevant procedure:
- Review the local ethical code (if any) and compare with the IESBA Code
- Establish whether Clapton & Co is a member of an auditing regulatory body, and the professional qualifications issued by that body
- Discuss the audit methodology used by Clapton & Co in the audit of Lynott Co, and compare it to those used under ISAs
- A questionnaire or checklist could be used to provide a summary of audit procedures used
- Ascertain 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 operates

Maximum marks 8

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
2 (a) (i) Matters to consider before accepting the review engagement

Up to 1½ marks for each matter explained:

– Independence – types of threats raised
– Appropriate safeguards
– Competence and time frame
– Elements to be included in the application and intended use
– Key assumptions and time period covered

Maximum marks

(ii) Examination procedures

1 mark for each described procedure. Also allow 1 mark for relevant analytical procedures used in the explanation of procedures.

– Agreement that the accounting policies used in preparing the forecast information are consistent with those used in historical financial information and comply with IFRS
– The forecast should be cast to confirm accuracy
– Review of capital expenditure forecasts
– Quotations received from potential suppliers of the new technology should be reviewed
– The time frame of the work to be carried out needs to be discussed with management
– Review of market research documents and review of prices charged by competitors
– Analytical review followed by discussion with management on the trend in revenue
– Revenue 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
– In 2014, operating expenses are 80·7% of revenue, but this is forecast to reduce to 73·4% in 2015 and to 69·8% in 2016
– Recalculation of depreciation expense and agreement to forecast statement of financial position
– Recalculation of finance cost to ensure that interest payable with confirmation of the rate of interest to bank documentation

Maximum marks

(b) (i) Stages of money laundering

Up to 2 marks for each stage explained with relevance to Waters Co:

– Placement – cash based business and mixing of illegal and legitimate sources of cash
– Layering – complex transactions to hamper tracing the cash such as transfer overseas
– Integration – investing or spending cash to place it into the legitimate economy

Maximum marks

(ii) Elements of an anti-money laundering programme

Up to 1½ marks for each element recommended:

– MLRO – senior person, responsibilities
– Firm-wide training programme
– Know your client procedures
– Record keeping

Maximum marks

Maximum
3 (a) (i) Factories

Generally up to 1½ marks for each matter and up to 1 mark for each evidence point explained:

Matters:
- Materiality of factories to statement of financial position
- Government regulation is an indicator of impairment
- Management need to conduct an impairment review
- Implication for financial statements if factories are overstated
- Impairment review may reveal that factories are not overstated
- Research costs may not be capitalised
- No going concern issues this year but could be a longer term problem

Evidence:
- A copy of the government regulation
- Agreement of the carrying value of the factories making this product to the non-current asset register and general ledger
- A review of forecast financial statements and management accounts to confirm the amount of revenue still being generated by the factories
- A copy of and assessment of management’s impairment test
- A discussion with management regarding the potential future use of the factories, and whether the potential new product can be produced by them
- Confirmation that the research costs are included in operating expenses, and have not been capitalised

Maximum marks 8

(ii) Related party transaction

Generally up to 1½ marks for each matter and up to 1 mark for each evidence point explained:

Matters:
- Hannah is a member of key management personnel and therefore a related party
- Auditor required to review documents and to consider whether transaction authorised
- Materiality should not be based solely on monetary calculations – it is material by nature
- The amount is outstanding and may need to be written off
- Disclosure needed in notes to financial statements
- Implications for audit report if appropriate disclosure not made

Evidence:
- A review of the notes to the financial statements to confirm that sufficient disclosure has been made
- A copy of the invoice raised, and agreement to the receivables ledger
- A copy of any contract or other document pertaining to the sale of the car to Hannah, and a review of its terms and conditions
- A post year-end review of the bank statement and cash books to confirm if the amount has been received subsequent to the year end
- Confirmation that the carrying value of $50,000 has been removed from the non-current asset register and general ledger
- Confirmation that profit or loss on disposal has been included in profit or loss
- A review of board minutes to confirm the transaction was appropriately authorised
- A written representation from management

Maximum marks 7

(b) Prior year material misstatement

Generally 1 mark per point explained:
- The prior year error is material at 6% of profit for 2013
- A prior year adjustment is required
- If no adjustment is made the audit opinion for 2014 will be modified
- The client must be informed of the error
- Potential for legal action against the audit firm
- Audit of 2014 financial statements to include procedures on the prior year adjustment
- Quality control on prior year audit was lacking and should be investigated
- May be implications for firm-wide quality control procedures

Maximum marks 5

Maximum 20
4 In general up to 1½ marks for each comment/explanation/definition:

(a) Risk assessment
- Definition of business risk (1 mark)
- Definition of risk of material misstatement (1 mark)
- Business risks impact on the financial statements and therefore risk of material misstatement
- Business risk impacts inherent risk
- Business risk impacts control risk

Maximum marks 4

(b) Outsourcing
- Need to assess significance of outsourced function on financial statements
- Need to understand relationship and interaction between audited entity and service organisation
- Obtain understanding of the service organisation including internal controls
- Means of obtaining understanding – type 1 and type 2 reports
- Other means of obtaining understanding – requesting information, performing tests on controls at the service organisation

Maximum marks 4

(c) Conflict of interest
- Identify/explain the conflict of interest
- Threats to objectivity and confidentiality created
- Safeguard of disclosure to both parties
- Other safeguards (½ mark each), e.g. separate teams, confidentiality agreements, review of situation by independent partner
- If threats too significant the advice should not be given

Maximum marks 5

(d) Business opportunity
- Identify the opportunity as a close business relationship/financial interest in a client
- Threats created – self-interest and intimidation
- Can only be accepted if the interest is insignificant
- Unlikely to be insignificant due to nationwide programme
- Consider commercial angle – return on investment/cash availability
- Skills and competence to provide speakers
- Resource availability

Maximum marks 7

Maximum 20
5  (a)  Discussion regarding IAASB Invitation to Comment (ITC) on the auditor’s report

In general up to 1½ marks for each relevant discussion point:

– Relevant introduction, e.g. reference to the reasons for the ITC
– 1 mark for each correct suggestion from the ITC:
  o Suggestion of auditor’s affirmation regarding use of going concern assumption
  o Suggestion of description of material uncertainties regarding going concern
  o Positioning of the going concern statements within the auditor’s report
  o Description of management responsibility regarding going concern
– Current audit report has insufficient information and is part of expectation gap
– Additional disclosures could add clarity and transparency
– Credibility of financial statements is enhanced
– May help to highlight the subjective nature of going concern assessment
– Drawbacks include the affirmation being perceived as a guarantee of financial health

Maximum marks 8

(b)  Evaluation of draft auditor’s report

In general up to 1½ marks for each relevant point of evaluation:

– Incorrect presentation and combining of Opinion and Basis of Opinion paragraphs
– Reference to materiality threshold is unnecessary
– Wording regarding ‘proven conclusively’ is inappropriate
– Description of material misstatement should include quantification and impact on financial statements
– The relevant financial reporting standard should be referred to
– Unprofessional wording regarding the finance director
– Inappropriate opinion given – should be modified due to material misstatement not due to disclaimer of opinion
– Level of modification incorrect – it is material but not pervasive
– Court case not fundamental so not appropriate to include in Emphasis of Matter paragraph
– Emphasis of Matter should only be used for matters appropriately accounted for which is not the case

Maximum marks 12

Maximum 20