Answers
1 AZURE

Tutorial note: As part (b) is clearly related in the requirement to part (a), it is appropriate that a ‘tabular’ approach be adopted.

(a) Business risks

Rights to operate

■ All terms and conditions of the rights to operate, which provide assurance that Azure is a going concern for the time-being, must be met. For example, twice-weekly flights may be a ‘guaranteed’ minimum.

■ Terms and conditions attached to the rights may threaten Azure’s operational existence if, for example, there are any circumstances under which the rights could be withdrawn. For example, if the standard of service falls below a minimum specified level.

Competition

■ Although at the moment there appears to be none (as the rights are exclusive), any competition in the future could reduce profitability (e.g. if the right was to become non-exclusive or an indirect service between Sepiana and Lyme should be established).

Age of aircraft

■ The age of the aircraft (35 years) is likely to have a bearing on fuel consumption and other costs (e.g. repairs and maintenance).

Engine overhaul

■ If the lease is a finance lease it is likely that Azure will have to bear the costs of the overhaul – which may have a detrimental effect on cash flows.

■ The service would need to be suspended while the engine is being overhauled unless an alternative is planned for.

Leased asset

■ Azure operates with just one leased asset which may be withdrawn from service:
  – in the interests of passenger safety (e.g. in the event of mechanical failure);
  – for major overhaul;
  – if Azure defaults on the lease payments.

Fuel prices

■ Increases in fuel prices (a major operational cost) will reduce profitability.

(b) Processes for managing

Accept at the present level (as one that has to be borne) but bear in mind (e.g. when making strategic decisions) the impact that management’s actions could have on any renewal of the rights.

■ Relevant terms and conditions should be communicated to all staff so they are clear about the importance of their areas of responsibility.

■ Monitor the progress of applications for flights to destinations which could provide transit to Lyme.

■ Reduce the risk by increasing the reliability and reputation of Azure’s service, improving comfort etc (e.g. by increasing leg room and providing air-conditioned lounges).

■ Azure should manage its cash flows and borrowing capability (e.g. bank loan facility) to carry out ongoing operating repairs as and when needed.

■ As above, Azure should budget its financial resources to meet the costs of the overhaul, the timing of which can be planned for.

■ The lease agreement with the airline should provide that an equivalent aircraft be available.

■ Azure should enter into a contractual arrangement (e.g. may be included within the terms of an operating lease) for a replacement aircraft in the event that the aircraft be grounded.

■ Azure should carry adequate insurance cover for remedying and/or providing compensation to customers for significant disruptions to the scheduled service.

■ Fuel surcharges should be included in the flights’ price structure so that significant increases can be passed on to the customers.

■ Hedging against the effect of energy price (and exchange rate) risks through forward contracts.
Weather

- Weather conditions may delay or cancel flights. Actual and potential customers may choose not to plan trips if the flight schedule is so unreliable that they expect to face disruptions and uncertain journey times.

Horticultural cargo

- Certain produce may be prohibited from import (e.g. due to the risk of spread of disease). Azure may face fines for carrying banned produce.
- Growers may seek to hold Azure liable for:
  - produce which perishes (e.g. if successive flights are cancelled);
  - impounded goods.

Economy

- With significantly less demand for Business Class than for Economy (which gets over-booked) and even less for First Class, the service is operating at well below capacity (economy is only 54% of seating capacity).
- Azure may not be recouping fixed operating costs in the long run – making the service uneconomical.

Service levels

- Azure's schedule is described as 'efficient and timely'. If the level of service delivered does not meet expectations it is unlikely that a regular customer base will be established.

On-board services

- Passengers are expressing dissatisfaction with meals provided, especially on the 'return' flight from Darke. The food prepared in Lyme may be stale or contaminated by the time it is served.
- Passengers may be deterred from using this flight if they are subject to the risk of illness.

Passenger safety

- Penalties for non-compliance with safety regulations (e.g. maintenance checks on life jackets, etc) may be incurred if inspection logs are not kept.
- Azure may face lawsuits for personal injury or illness (e.g. deep vein thrombosis – ‘dvt’),

Air stewards/Cabin crew safety

- Azure will have difficulty recruiting and maintaining the services of appropriately qualified cabin crew if it does not have sufficient regard for their health and safety.
- Manage the impact of the risk/modify the business activity. For example, as any form of travel may be hazardous if weather conditions are so bad as to disrupt the flight schedule, there should be air-conditioned facilities in which travellers can relax before their journey.

- Contracts with growers should clearly state items of produce that cannot be carried.
- Azure's operational controls should include verification checks on produce carried.
- Azure should have adequate insurance cover against claims for damaged/lost cargo.

- Keep demand for the classes of tickets under review and respond to the excess of supply over demand for Economy seating (and demand shortfall for First and Business Class seats). For example:
  - charge higher prices for economy on peak flights;
  - offer larger discounts for advance bookings on First and Business Class seats;
  - introduce a loyalty scheme for frequent users which offers ‘preferred customer’ seat upgrades.

- Azure should benchmark the timeliness of its service, against a comparable airline service operating under similar weather conditions.

- Azure should consider:
  - changing caterer in Lyme;
  - a contract with a caterer in Darke;
  - expert advice (e.g. of a chef) on preserving the quality of meals for long-haul flights.

- Staff training should be on-going with regular safety drill procedures (e.g. in evacuation procedures and the use of life rafts).
- Safety procedures must be demonstrated before take-off on every flight and passengers referred to safety information, including how to reduce the risk of dvt, provided with each seat.

- Flight personnel rotas should ensure, for example, that:
  - pilots take 'ground leave' between flights;
  - there is adequate 'cover' when crew are sick or taking leave.
Emergency

- A serious accident (e.g. fire), collision or breakdown may threaten operations in both the short and longer-term.

- Accept at the present level, but taking all practicable safety checks now implemented in the airline industry to ensure that Azure is not exposed to preventable risks. For example:
  - x-ray screening of checked-in baggage;
  - security screening of cabin baggage and passengers, etc.

Flight personnel

- Azure may not be able to service the flight in the event of non-supply of flight personnel by the international airline (e.g. due to strike action).

- The agreement with the airline should indemnify Azure for all costs and losses incurred if flights are cancelled or disrupted due to non-availability of flight personnel.

Flight tickets

- Tickets are sold by more than one party (Azure and travel agents) and at more than one location. Also, pricing is complex, with a range of tariffs depending on many factors. This increases the risk that:
  - revenue may be lost if passengers are undercharged or ticket sales unrecorded; and
  - flights may be over-booked, with consequent loss of customer goodwill.

- The configuration of the aircraft does not currently meet the current demand profile of passengers and under the terms an operating lease may not be changeable.

- Strict controls must be exercised over:
  - unused tickets;
  - ticket pricing;
  - real-time reservations; and
  - ticket refund and exchange transactions.

- Commence negotiations with the international airline for an amendment to the current lease terms allowing flexibility in the seating arrangements.

Tutorial note: Candidates are not expected to have specific knowledge of the airline industry. However, marks will be awarded for relevant comments, for example, concerning quotas for landing/take-off slots and IATA’s levy. The preceding answer is not exhaustive. For example, that the aircraft is flying for only 24 hours a week is a risk as this is a low capacity at which to operate for the recovery of overheads.

(c) Operational performance measures

Tutorial note: ‘Measures’ must be quantifiable e.g. per ‘unit’, physical quantities, ratios, or percentages.

Capacity

- Total journeys/flights in month/year.
- Average number of passengers/tonnes of cargo carried per flight/week/month.
- Available seat miles\(^1\) (ASMs) – aircraft miles flown on each flight multiplied by the number of seats available for revenue generation (i.e. excluding those occupied by cabin crew).
- Cargo tonne mile (CTM) – one tonne of cargo transported one mile.
- The proportion of seats filled in the aircraft (‘load factor’).

Efficiency

- Total aircraft travel time for kilometres travelled.
- Average fuel consumption.

Effectiveness

- Proportion of on-time take-off/landings.
- Travel time savings for passengers (as compared with available alternatives).
- Flights cancelled due to bad weather/mechanical failure.
- Number of customer complaints/performance feedback.

Predictability

- Number of flights taking off/landing more than 15 minutes after scheduled departure/arrival times.
- Number of flights cancelled per month/year.

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\(^1\)Similarly, available tonne miles.
Flexibility

- Number of requests by customers (e.g. in satisfaction questionnaire) brought into effect (e.g. providing vegetarian meal options).

Safety

- Incident reports documenting the date, time and nature of each incident, the extent of damage and/or personal injury, and action taken.

Environment

- Number of instances of non-compliance with legislation/regulations (e.g. on emissions/noise).

Evidence

Tutorial note: As there is a wide range of measures of operational performance which candidates could suggest, there is always a wide range of possible sources of audit evidence. As the same evidence may contribute to providing assurance on more than one measure they are not tabulated here, to avoid duplication. However, many candidates may justifiably adopt a tabular layout.

- Captain’s flight logs/timesheets – confirming take-off/landing times and any incidents giving rise to delay.
- Engineer’s inspection reports – confirming equipment, etc is in satisfactory working order. Also, engineer and safety check manuals and the maintenance program.
- The clarity and accuracy of passenger safety information provided on the aircraft.
- The analysis of passenger satisfaction questionnaires.
- Any penalties/fines imposed by the PAA and the reasons for them.
- Airline industry operating data and statistics, e.g:
  - aircraft efficiency;
  - capacity utilization;
  - labour productivity;
  - aircraft utilization hour; and
  - fuel burnout (consumption).
- Ticket reservation/sales reports showing exchanges/refunds/cancellations.
- The frequency and nature of insurance claims (e.g. to recoup the cost of compensation paid to passengers for cancelled flights).
- The calculation of passenger miles flown used to support the premiums for passenger liability insurance.

2 CERISE

(a) Financial statement risks – planning the final audit 31 December 2004

Computer-controlled equipment for production-line industries

- Cerise is manufacturing a relatively high-tech range of products. Inventory will be overstated if sufficient allowance is not made for technical obsolescence and slow-moving items (i.e. writing inventory down to lower of cost and net realisable value).

- As Cerise is ceasing manufacture two months prior to the year end the items remaining in inventory at the year end are likely to require being written down in value. The amount of write down is required to be disclosed in accordance with IAS 2 ‘Inventories’.

Cessation of trade

- Cerise ceased to trade during the year. The financial statements should not therefore be prepared on a going concern basis, but on a ‘break-up’ or other ‘realisable’ basis.

- This has implications for:
  - the reclassification of assets and liabilities (from non-current to current);
  - the carrying amount of assets (at recoverable amount); and
  - the completeness of recorded liabilities.

Redundant workforce

- Liabilities may not be disclosed (if contingent) or provided for, if there are claims arising from the redundant workers (e.g. if their statutory or contractual rights have been breached).

- Although statutory redundancy pay, holiday pay, accrued overtime etc may well have all been settled before the year end there may be additional liabilities in respect of former employees (e.g. pension obligations).

Sale of patented technology and manufacturing equipment

- All assets sold should be derecognised and the profit on disposal disclosed as an exceptional item arising from the discontinuance of operations.

- Plant and equipment will be overstated if:
  - manufacturing equipment that has been sold is left ‘on the books’;
  - assets that were not part of the sale are not:
    - tested for impairment (in accordance with IAS 36 ‘Impairment of Assets’);
    - written down to the higher of net selling price and value in use.

2 As revised December 2003.
Accounts department

- Fewer (‘skeleton’) staff being employed in the accounts department may increase the risk of errors arising as staff assume wider areas of responsibility as the volume of transactions is reduced.
- The risk of errors arising not being detected (i.e. control risk) is also likely to increase. For example, levels of supervision and degrees of segregation of duties may be reduced and adherence to control procedures may slacken.

Premises

- If the unsold properties meet all the criteria of IFRS 5 ‘Non-current Assets Held for Sale and Discontinued Operations’ at the balance sheet date they should be:
  - separately classified as held for sale.
  - carried at the lower of carrying amount (i.e. depreciated cost) and fair value less estimated costs to sell.
- Any after-date losses on disposal would provide evidence of impairment. (However, as it is Cerise’s policy to carry non-current assets at depreciated cost, impairment is less likely than if they were carried at revalued amounts.)
- Unoccupied premises may fall into disrepair with time. The financial statements would be misstated if the management of Cerise sought to provide for:
  - dilapidations on the properties arising after the balance sheet date; and/or
  - future expectation of repairs on unsold properties.

Such provisions are contrary to IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’.

Tutorial note: Consider a property with carrying amount $1 million (depreciated cost) and fair value $16 million. Repair costs of $0.5 million incurred for deterioration after 31 December 2004 cannot be provided for, nor is the carrying amount impaired.

Onerous contracts

- Full provision should be made for the lease obligations under onerous contracts on four premises in accordance with IAS 37. This should not be extended to the head office premises.

Product warranties

- Adequate provision must be made for warranties of:
  - one year (sales in the year to 31 December 2004);
  - up to three years (sales between 1 January 2002 and 31 October 2004); and
  - up to five years (sales between 1 January 2000 and 31 October 2004).
- The provision may be understated if the basis of its calculation is no longer appropriate. For example, if Cerise must now outsource warranty work as it no longer has an in-house capability.

Breach of agreements/contracts

- Since Cerise no longer has the means of fulfilling contracts with distributors, provision should be made for any compensation or penalties arising. Where the penalties due to distributors for breach of supply agreements exceed the amounts due from them, the receivables should be written down and provision made for any excess.
- Adequate provision should be made for breaches of contracts with suppliers (non-purchase). If suppliers do not exercise their rights to invoke penalty clauses disclosure of the contingent liability may be more appropriate than a provision.

(b) Reliance on audit work

(i) Analytical procedures

Tutorial note: Reliance on analytical procedures is only obtained through those that provide substantive audit evidence. This question therefore concerns substantive analytical procedures as evidence – which are optional – not those at the planning and review stages (which are mandatory).

- Overall the extent of reliance on analytical procedures is likely to be less than that for the prior year audit as the scale and nature of Cerise’s activities will differ from the prior year.
- There are a number of individually material transactions in the current year which will require detailed substantive testing (e.g. sale of patented technology and manufacturing equipment and sale of premises).
- Budgetary information used for analytical procedures in prior periods (e.g. budgeted production/sales) will have less relevance in the current year as the cessation of trade is unlikely to have been forecast.
- Information will be comparable with the prior year for at most 10 months (i.e. January to October). Costs incurred in November/December will relate to winding down operations – rather than operational activities.
- The impact of the ‘one-off’ circumstance on carrying amounts is more likely to be assessed through detailed substantive testing (e.g. after-date realisation) than reliance on ratios and past history.
- For example, analytical procedures on an aged-debt analysis and calculation of average collection period used in prior years will not be relevant to assessing the adequacy of the write-down now needed. Similarly, inventory turnover ratios will no longer be comparable when inventory is no longer being replenished.
- However, some reliance will still be placed on certain analytical procedures. For example, in substantiating charges to the income statement for the 10 months of operations.

(ii) Management representations

- Overall the extent of reliance on management representations is likely to be increased as compared with the prior year audit.
- The magnitude of matters of judgement and opinion is greater than in prior years. For example, inventory/trade receivable write-downs, impairment losses and numerous provisions. The auditor will seek to obtain as much
corroborative evidence as is available. However, where amounts of assets have still to be recovered and liabilities settled, management will be asked to make representations on the adequacy of write-downs, provisions, etc and the completeness of disclosures (e.g. for claims and other contingent liabilities).

- Where negotiations are under discussion but not yet formalised (e.g. with a prospective buyer for premises), management may be the only source of evidence (e.g. for the best estimate of sale proceeds).
- However, the extent to which reliance can be placed on representations depends on the extent to which those making the representation can be expected to be well-informed on the particular matters. Therefore, as the human resources and production directors will not be available after the balance sheet date particular thought should be given to obtaining representations on matters pertaining to employee obligations and product warranties (say).

(c) Principal audit work – carrying amount

Tutorial note: Discussions with management and obtaining management representations are not ‘principal audit work’.

(i) Amounts due from distributors

- Agreeing gross amounts due to accounts receivable balances (for sales made in the normal course of business up to 31 October 2004 and in the ‘running down’ of inventory to 31 December 2004).
- As a significant portion of account balances outstanding will already be two months old at 31 December 2004, all receipts of after-date cash (if any) should be monitored for evidence of recoverability.

Tutorial note: A standard direct confirmation of accounts receivable will not be principal audit work in respect of the carrying amount since the scenario identifies recoverability as the financial statements risk.

- Review of agreements with distributors to confirm the unexpired period (up to three years) and the penalties stipulated.
- Recalculation of amounts due to distributors for the early termination of the agreements with them.
- Review of Cerise’s correspondence to the distributors (e.g. offering financial settlement) and responses received.

Tutorial note: Distributors might settle for a waiver of the amounts they are owed and/or a lump sum which amount to less than the penalties due to them under the terms of their agreements.

(ii) Lease liabilities

Tutorial note: It is clearly stated that no new lease agreements were entered into during the year. Therefore ‘re-auditing’ from scratch what would have been examined in previous years as though it was a new transaction is neither necessary nor efficient.

- Confirm the leases as operating leases to prior period working papers/disclosures in the previous year’s financial statements.
- To confirm contracts as onerous and justify full provision:
  - review Cerise’s correspondence with the lessors requesting terms for an early exit from the lease period;
  - visit premises to confirm that Cerise is not receiving any economic benefit from them (i.e. they are not still occupied or sub-let).
- Agree/reconcile the amounts provided for liabilities under onerous contracts to the present value of the future minimum lease payments under non-cancellable operating leases.
- Agree/reconcile the future minimum lease payments used in the calculation of the provision to those disclosed (under IAS 17 ‘Leases’) in the financial statements to 31 December 2003 as:
  - later than one year and not later than five years; plus
  - later than five years.

Tutorial note: The payments ‘not later than one year’ in the prior year financial statements will have been paid during the year and so form no part of the provision.

3 VERDI

(a) Sale of factory building

Tutorial note: ‘Going concern’ and ‘discontinuing activities’ are not relevant matters to be considered in the context of how the factory has come to be surplus to requirements.

(i) Matters

- The gain on disposal, $2·3 million ($11·5 million less $9·2 million), represents 0·7% of revenue (to which it has been credited), and is therefore material.
- The gain represents 14 1/2% of draft profit before taxation (but see below) and is therefore material.
- The size (material), nature (derecognition) and incidence (not every year) of the item (gain) is such that it should be disclosed separately for Verdi’s financial performance to be understood. (And not, for example, offset against operating expenses.)
- Any gain arising on derecognition of a tangible non-current asset should be included in profit but not classified as revenue (IAS 16 ‘Property, Plant and Equipment’).
- On disposal, the whole of the revaluation surplus could have been transferred directly to retained earnings (as permitted by IAS 16) but not through profit or loss (i.e. the income statement).
$3.7 million incorrectly credited to the income statement represents 23% of profit before tax and is therefore material.

If the surplus had not been wrongly credited to the income statement, profit before tax would be $12.2 million – a fall of $1.5 million (10.9% of prior year profit).

$6 million ($2.3 million + $3.7 million) of profit before tax (37.8%) is attributable to the sale of the building just two days before the reporting date. (Is this fortuitous?)

The sale should only be recognised in the year to 30 September 2004 if the contract to sell is binding. Otherwise it should be disclosed as a non-adjusting post balance sheet event (IAS 10).

If the sale was not completed as at 30 September 2004 and consideration was still to be received, Verdi will have an ‘other receivable’ of $11.5 million. This is very material (6.1% of total assets) and should be stated at recoverable amount, if lower.

If any of the consideration receivable is deferred the cash price equivalent would be less (and profit on disposal reduced by the amount of interest on the debt receivable).

All Verdi’s buildings (assets in the same class) should be carried at revalued amount. The building’s revaluation was out of date as the gain represented 25% of its carrying amount (1.2% of total assets). The remaining three factory buildings should have been revalued more recently than 2001, as their fair value may otherwise be materially different from their carrying amount.

Verdi’s treatments of the gain on disposal and revaluation surplus are contrary to IAS 16 and the audit opinion should be qualified ‘except for’ if the financial statements are not adjusted.

(ii) Audit evidence

Binding sale agreement effective as at 29 September 2004 (such that the risks and rewards of ownership of the building have been transferred to the buyer).

Valuation report supporting the agreed selling price.

Receipt of sale proceeds (per bank statement) agreed to the payment schedule in the contract.

Carrying amount agreed to prior year working papers, non-current asset register, etc.

(b) Repayable on demand loan

(i) Matters

$7 million represents 3.7% of total assets and is therefore material. However, there is no impact on the balance sheet in terms of total assets/liabilities.

The issue is whether it should be classified as current or non-current. This will impact on current (liquid) and/or acid test ratios.

Classification as non-current would be consistent with the prior period.

However, as at the balance sheet date the lender had an absolute right to demand repayment immediately, based on the terms of the agreement then in force.

The lender’s subsequent arrangement to ‘roll over’ the interest is a non-adjusting post balance sheet event (IAS 10).

However, 5.75% interest for year to 30 June 2004 ($0.4 million) represents 2.5% of profit before tax and is not material.

Interest accrued should include $106,000 charge for three months to 30 September 2004 (5.75% x $7.4 million x 3/12). However, this is also not material.

If the financial liability is not reclassified as current in the balance sheet, with the subsequent arrangement being disclosed as a non-adjusting post balance sheet event, the audit opinion should be qualified ‘except for’ non-compliance (IAS 1 and IAS 10).

If the loan is secured on the manufacturing equipment the existence and amounts of equipment pledged as security must be disclosed (IAS 16 ‘Property, Plant and Equipment’).

(ii) Audit evidence

Amount of loan principal, interest and repayment terms agreed to prior year working papers (e.g. loan agreement on permanent audit file).

Direct confirmation from the lender of amounts owing, including accrued interest, as at 30 September 2004.

Legal correspondence (or contract variation) from the bank to Verdi setting out the change in repayment terms for the first year’s interest.

Proposed disclosures in the draft financial statements:

- pledged assets in the non-current assets note;
- significant terms and conditions of the loan in the financial liability note.

Tutorial note: Audit evidence to confirm the receipt of the loan last year is not relevant.

(c) Warranty provision

(i) Matters

$5.2 million represents nearly 1.6% of revenue and is therefore material.

However, of this only $4.2 million represents installation fees carrying the warranty agreement. (Which is still material at 1.2% of revenue.)

The draft note disclosure effectively admits to Verdi having legal obligations, which are not remote (otherwise no disclosure would have been required).
A best estimate of the obligation of as little as $1 million would be material (6.3%) to profit before tax.

There is clearly a present obligation as a result of a past obligating event for installations undertaken during the nine months to 30 September 2004.

The probability of outflow of resources should have been determined by considering the class of installation warranties as a whole. Although the likelihood of outflow for any one installation may be small it is probable that some outflow will be needed to settle the class of such obligations.

The term ‘contingent liability’ encompasses liabilities that do not meet the recognition criteria, for example, in respect of reliable measurement (IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’).

However, it is extremely rare that no reliable estimate can be made (IAS 37) – the use of estimates being essential to the preparation of financial statements.

Verdi’s management must make a best estimate of the cost of rectifying installations taking into account, for example:
- the proportion of installations during the nine months to 30 September 2004 showing defects at the balance sheet date; and/or
- the average age of an installation showing a defect;
- the number of defective installations to date (i.e. including the post balance sheet event period to December 2004);
- the expected cost of a reinstallation (as a proportion of the original installation cost).

Estimated costs may need to be discounted (e.g. if they are not expected to be incurred under the terms of the warranty until the third year after installation).

The 40% increase might provide a prudent estimate of the upper (most pessimistic) end of the range of possible outcomes.

If management do not make a provision for the best estimate of the obligation the audit opinion should be qualified ‘except for’ non-compliance with IAS 37 (no provision made).

(ii) Audit evidence
- The warranty terms of installation.
- Management's costings of the new warranty terms used to set the 40% increase in price.
- Schedule of installations undertaken during the nine months to 30 September 2004 agreed on a sample basis to sales invoices and/or customers' orders.
- Correspondence with customers complaining about installation (both before and after the new warranty terms were brought into effect).
- Costs of any reinstallations undertaken during the year per job cards (or other work records of time taken, parts used, etc).
- Average cost of an (initial) installation (compared with reinstallation) calculated from completed job cards.

4 BEIGE INTERIORS

(a) Materiality

Tutorial note: A definition of ‘materiality’ is not called for.

Planning stage
An audit is planned (and performed) to provide reasonable assurance that the financial statements are free from material misstatement (and give a true and fair view).

Assessing materiality is a matter of professional judgment that includes consideration of both the amount (quantity) and nature (quality) of misstatements.

Materiality is considered in the context of the financial statements as a whole and in relation to individual account balances, classes of transactions and disclosures. At the planning stage the emphasis is on the assertion level (i.e. individual account balances and classes of transactions).

The assessment of materiality at the planning stage assists in establishing an efficient and effective audit approach. This ‘preliminary materiality’, together with the assessment of risk, determines the nature, timing and extent of audit procedures.

A materiality threshold in monetary terms is often established according to percentage criteria. So, for example, if draft profit before tax is $100,000, less than $5,000 (5%) is immaterial and more than $10,000 (10%) is material.

Overall review stage
The emphasis here is on the financial statements as a whole and disclosures. In evaluating whether the financial statements give a true and fair view, the materiality of the aggregate of uncorrected misstatements is assessed. This comprises specific misstatements (including uncorrected misstatements identified in prior periods if they affect the current period) and the best estimate of other misstatements.

If this aggregate is material, an unmodified opinion would not be appropriate unless management adjusts the financial statements to the extent that any unadjusted amount is not material.

At this stage qualitative factors may render monetary (quantifiable) materiality irrelevant. For example, where matters are required to be disclosed in accordance with the financial reporting framework (e.g. related party transactions).
(b) Suitability of Jade’s draft

Jade has drafted a ‘disclaimer’ of opinion which is appropriate if the effect of a limitation on scope is pervasive.

Principal matters relevant to forming an appropriate opinion

Conduct of the audit in compliance with International Standards on Auditing (ISAs) is affected if the auditor is unable to gather sufficient appropriate audit evidence. The fact that some accounting records were not available means that the scope of the audit has been limited. Although Jade has stated this, users of the financial statements will not know which accounting records were missing, or why, or the accounting period which they covered.

An audit includes an assessment of significant estimates and judgments made by management. Management will have had to make estimates and judgments with regard to the reconstruction of financial information. Evidence about transactions in the first four months of the financial year may not be sufficient to form an unmodified opinion. Factors to be taken into account include the extent to which financial records have been reconstructed (e.g. from prior year closing balances, bank statements, invoices, etc). The adequacy of management’s disclosure in the notes to the financial statements about the effects of reconstruction on classes of transactions and account balances will affect how much disclosure needs to be made in the auditor’s report. If there is none, as in Jade’s draft, there should be a cross-reference to the notes.

An unmodified opinion provides reasonable assurance that the financial statements are free of misstatement caused by fraud or error. Even if the amount of reconstruction was extensive the auditor would most likely qualify their opinion ‘to be on the safe side’. Fraud is generally quantifiable. The former CEO’s actions (and timing) may suggest fraudulent reporting which may not be quantifiable. Evidence about transactions in the first four months of the financial year may not be sufficient to form an unmodified opinion.

Depending on the amount of reconstruction undertaken the potential misstatement, though material, may not be pervasive. Jade has supposed the matter to be pervasive in disclaiming an opinion on the financial statements as a whole. However, the loss of accounting records is unlikely to affect the carrying amounts of non-current assets, inventory, trade receivables, cash at bank etc as at 30 September 2004. Disclaiming an opinion on the income statement can be achieved with ‘except for’.

The prior year audit opinion (unmodified) may not have been appropriate. The accounting records which were taken would have provided evidence about balances at 30 September 2003. The auditor should reconsider the extent to which the CEO contributed to sufficient evidence in forming the prior period opinion. The fact that the prior year’s opinion was unmodified does not preclude a disclaimer of opinion on the comparative information. Since reference to comparatives is not standard wording Jade has not considered this.

5 EBONY – ETHICAL AND PROFESSIONAL ISSUES

(a) Audit team

There are many factors to be taken into account when allocating staff to an assignment, for example:

– the number of staff and levels of technical expertise required;
– logistics of time and place;
– the needs of staff (e.g. for study leave); and
– what is in the client’s (i.e. the shareholders’) best interest (e.g. an expeditious audit).

As a matter of practice management, a client should not dictate who staff their audit. If the Finance Director’s requests are based solely on the premise that to have staff other than as requested would cause disruption then he should be assured that anyone assigned to the audit will be:

– technically competent to perform the tasks delegated to them;
– adequately briefed and supervised; and
– mindful of the need not to cause unnecessary disruption.

Ebony may have other (more complex) assignments on which Xavier (and other staff previously involved in the audit of Almond) could be better utilised.

To re-assign Xavier to the job may be to deny him other on-the-job training necessary to his personal development. For example, he may be ready to assume a more demanding supervisory role with another client – or he may wish to expand the client base on which he works to obtain a practising certificate (say).

To keep Xavier with Almond for a third year may also increase the risk of familiarity with the client’s staff – a threat to the independence of the audit.

If it is usual to assign new trainees to Almond then the Finance Director should be advised that to assign a higher grade of staff is likely to increase the audit fee (as more experienced staff cannot necessarily do the work of more junior staff in any less time).

Conclusion

The Finance Director’s requests should be granted only if:

(1) it is in the interests of Almond’s shareholders (primarily);
(2) meets the needs of Ebony’s staff; and
(3) Almond agrees to the commensurate audit fee.
(b) ‘Phantom ticking’

- Ebony’s quality control procedures should be such that:
  - the work delegated to Alex was within his capability;
  - Alex was supervised in its execution; and
  - the work performed by Alex was reviewed by appropriate personnel (i.e. someone of at least equal competence).

- Alex’s working papers for the audit of Phantom should be re-reviewed to confirm that there is evidence of his work having been properly directed, supervised and reviewed. If there is nothing which appears untoward – it should be discussed with Alex’s supervisor on the assignment whether Alex’s confession to Kurt could have been ‘a joke’.

- As Alex has already left not only the firm, but the profession, it may not seem worth the effort taking any disciplinary action against him (e.g. reporting the [alleged] misconduct to ACCA). However, ACCA’s disciplinary committee would investigate such a matter and take appropriate action.

- It is likely that Ebony will have given Alex’s new employer a reference. This should be reviewed in the light of any evidence which may cast aspersions on Alex’s work ethics.

- As there are now doubts about the integrity of Alex, his work should now be re-reviewed, to determine the risk (if any) that the conclusions drawn on his work may be unsubstantiated (in terms of the relevance, reliability and sufficiency of audit evidence).

- It should also be considered whether the reviewer of Alex’s work should have seen the problem. (For example, in a purchase test, the reviewer should have been put upon enquiry if a test indicated that a goods received note had been inspected where a purchase was clearly for services provided and not goods received.) If the reviewer did not detect an evident problem they should be (re)trained as necessary.

- The work undertaken by Alex for audit clients other than Phantom should also be subject to scrutiny.

**Conclusion**

As Kurt is already aware of the potential problem, it may be appropriate that he be assigned as AIC to audits on which Alex undertook audit work, as he will be alert to any ramifications. It is possible that Ebony should not want to make the situation known to its staff generally.

**Tutorial note:** Marks will be awarded for any sensible conclusion drawn on a reasoned discussion. For example, it may be appropriate to assign a more experienced AIC to Phantom than the audit would usually warrant.

(c) Prior year audit failure

- It appears that the subsequent events review was inadequate in that an adjusting event (the out-of-court settlement) was not taken account of.

- The financial statements for the year ended 31 December 2003 contained a material error in that they disclosed a contingent liability (of unspecified amount) when a provision should have been made (for a known liability).

- The reasons for the error/oversight should be ascertained. For example:
  - who was responsible for signing off on the post balance sheet event review?
  - when was the review completed?
  - for what reason, if any, was it not extended to the date of signing the audit report?
  - on what date was the management representation letter signed?
  - did the management representation letter cover the outcome of pending litigation (for example)?

- The error has implications for the firm’s quality control procedures. For example:
  - was the AIC adequately directed and supervised in the completion of the post balance sheet event review?
  - was the work delegated to Alex within his capability?
  - was the work of the AIC adequately reviewed, to notice (for example) that it was not extended up until the date on which the auditor’s report was signed?

- Ebony may need to review and improve on its procedures for the audit of provisions, contingent liabilities and post balance sheet events.

- If the AIC (or other staff) involved in the prior year audit of Magenta were not as thorough as they should have been, with respect to the post balance sheet event review, then other audit clients may be similarly affected.

- The auditor has a duty of care to draw the error/oversight to Magenta’s attention. This would be an admission of fault for which Ebony should be liable if Magenta were to take action against the firm.

**Tutorial note:** Action is not necessarily suing for damages. For example Magenta could file a complaint with ACCA as grounds on which to dispute the prior year audit fee.

- If Ebony were to remain silent and hope the error is unnoticed there is the risk that Magenta will find out anyway.

- As the matter is material it warrants a prior period adjustment (IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’). If this is not made the financial statements will be materially misstated with respect to the current year and comparatives – because the expense of the out-of-court settlement should be attributed to the prior period and not the current year’s net profit or loss.

- The most obvious implication for the current year audit of Magenta is that a more thorough post balance sheet event review will be required than the previous year. This may have a consequent effect on the time/fee/staff budgets of Magenta for the year ended 31 December 2004.

- As the matter is material, it needs to be brought to the attention of Magenta’s management, so that a prior year adjustment is made. In the absence of which a qualified auditor’s report ‘except for’ should be required.

**Conclusion**

The staffing of the final audit of Magenta should be reviewed and perhaps a more experienced person assigned to the post balance sheet event review than in the prior year. The assignments allocated to the staff responsible for the oversight in Magenta’s prior period should be reviewed and their competence/capability re-assessed.
GROUP AUDIT ISSUES

Tutorial note: The answer which follows is indicative of the range of points which might be made. Other relevant material will be given suitable credit.

(a) Co-operation between auditors

ISA 600 requires that other auditors, knowing the context in which the principal auditor will use their work, should co-operate with the principal auditor.

However, this may be frustrated by legal and professional considerations. For example:

- legal: when the component is not controlled by the parent (e.g. an associated company) the other auditor cannot communicate with the principal auditors if the component’s management withholds their permission;
- professional: other auditors complying with national requirements may not be bound by the IFAC ‘Code of Ethics for Professional Accountants’ and ISAs (and/or the requirements of the country of the parent).

It has been proposed that ISA 600 (Revised) will require that other auditors be instructed to carry out their work in accordance with ISAs (as well as any national requirements applicable to the group financial statements).

As ISAs are to be required for all EU statutory audits from 2005, co-operation between auditors within the EU will be better facilitated. (Similarly, wherever else IASB pronouncements are promulgated.)

(b) Multi-location audits

ISA 600 applies when the financial information of a ‘component’ is included in the financial statements audited by the principal auditor. Components, including subsidiaries, associated companies, branches, etc, could be in the same location as the parent or in multiple locations.

Current guidance mostly relates to:

- the group auditor’s relationship with other auditors;
- co-operation between group and other auditors;
- access to information; and
- reporting responsibilities.

There is a lack of guidance on the application of other standards to group situations. So, for example, although ISA 3 is understanding the entity and its environment and assessing the risks of material misstatement identifies ‘multiple locations’ as an issue which may give rise to a risk of material misstatement, it provides no detail of the specific risks arising in a group audit.

(c) ‘Business empires’

The risks associated with ‘business empires’ (including horizontal groups and economic dependency) have been significant contributors to major business failures (e.g. Enron and Parmalat).

The concept of business empires is now recognised as a related party issue.

Tutorial Note: Interpretation SIC–12 ‘Consolidation – Special Purpose Entities’ (SPEs) provides guidance for financial reporting purposes on when an SPE requires consolidation.

Since there is none provided by ISA 600 more auditing guidance is needed on the specific risks associated with SPEs and other related party issues (e.g. economic dependency) and the audit procedures to be undertaken to obtain sufficient evidence about their impact on the parent’s financial statements.

(d) Joint audits

The ISA does not deal with situations where two or more auditors are appointed as joint auditors.

Joint audits are more costly as there is replication of audit work because the auditors are jointly and severally responsible for the auditor’s report (which they both sign).

Joint audits are therefore uncommon in many countries (France being a notable exception).

However, there have been calls for more joint auditing in the wake of Enron and the reduction in the number of global accountancy firms. If this is to be a practical solution to some of the problems of auditor independence and audit quality the cost, to the client, must not be prohibitive. This will require a new auditing standard.

(e) Division of responsibility

Under ISA 600, the principal auditor has responsibility for reporting on the financial statements of an entity notwithstanding that they include the financial information of components audited by others.

In many jurisdictions principal auditors have sole responsibility for their audit opinion and any reference to other auditors in their report is considered inappropriate.

Whilst it is desirable that the auditor’s report should not be misunderstood (e.g. reference to other auditors may be interpreted as a qualification or division of responsibility) ISA 600 permits a division of responsibility when that accords with local regulations.

As ISAs are more widely adopted separate guidance is needed for sole responsibility (as in the UK) and a division where national regulation permits reference to other auditors in the auditor’s report on the group financial statements (e.g. South America and the US).
Marks must only be awarded for points relevant to answering the question set. Unless otherwise indicated, marks should not be awarded for restating the facts of the question.

For most questions you should award $\frac{1}{2}$ a mark for a point of knowledge, increased to 1 mark for the application of knowledge and $1\frac{1}{2}$ marks for a point demonstrating the higher skill expected in Part 3.

The model answers are indicative of the breadth and depth of possible answer points, but are not exhaustive.

Most questions require candidates to include a range of points in their answer, so an answer which concentrates on one (or a few) points should normally be expected to result in a lower mark than one which considers a range of points.

In awarding the mark to each part of the question you should consider whether the standard of the candidate’s answer is above or below the pass grade. If it is of pass standard it should be awarded a mark of 50% or more, and it should be awarded less than 50% if it does not achieve a pass standard. When you have completed marking a question you should consider whether the total mark is fair.

Finally, in awarding the mark to each question you should consider the pass/fail assessment criteria:

- Adequacy of answer plan
- Structured answer
- Inclusion of significant facts
- Information given not repeated
- Relevant content
- Inferences made
- Commercial awareness
- Higher skills demonstrated
- Professional commentary

In general, the more of these you can assess in the affirmative, the higher the mark awarded should be. If you decide the total mark is not a proper reflection of the standard of the candidate’s answer, you should review the candidate’s answer and adjust marks, where appropriate, so that the total mark awarded is fair.
1 (a) Business risks

Generally 1/2 mark for identification +
1 mark each point of explanation

Ideas
- Environment risks
  ■ competition
  ■ weather
  ■ emergency
- Financial risks
  ■ overhaul costs
  ■ fuel prices
  ■ lease obligations
  ■ economy
  ■ loss of revenue
- Compliance risks
  ■ rights to operate
  ■ safety management
- Operations risks
  ■ age of aircraft
  ■ poor service levels (e.g. catering, timely operation)
  ■ passenger/crew safety
  ■ over-bookings

Tutorial note: Although in practice an analysis of the risks would be structured around suitable classifications of risk (e.g. those suggested above) many candidates will identify the risks as they come to them in reading through the scenario. To show that this is acceptable, the model answer has been left in such an order. However, candidates struggling to identify sufficient risks in the scenario could have drawn on a classification to give them ideas on what to look for.

(b) Risk management processes

Generally 1 mark each point

Ideas
- Accept the risk
  ■ low impact risks
  ■ benchmark (or could reduce risk)
- Reduce the risk
  ■ by implementing improved internal controls
  ■ staff training
  ■ hedge against it (e.g. fuel prices)
- Avoid unacceptable risks
  ■ non-compliance
- Transfer the risk
  ■ by insurance (amount/type)
  ■ contractual risk sharing

(c) Operational performance measures

Generally 1/2 mark each measure suggested
1/2 – 1 mark each source of evidence

Ideas
- Types of performance measure (e.g. efficiency, capacity)
- Numbers/proportions/\%s
  - flights
  - passengers
  - cargo (tonnes)
- Audit evidence
  ■ Oral vs written
  ■ Internal vs external
  ■ Auditor generated
  ■ Procedures (AEIOU)\(^3\)

\(^3\)ISA 500 identifies 7 (revised) procedures for obtaining audit evidence: Analytical, Inquiry (confirmation), Inspection, Observation, Recalculation and Reperformance.
2 (a) **Financial statement risks**

Generally $\frac{1}{2}$ mark for identification +
\[1 \text{ mark each point of explanation} \]
(in context of planning final audit) max 12

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ Inventory – lower of cost and NRV</td>
</tr>
<tr>
<td>■ Going concern – basis of presentation</td>
</tr>
<tr>
<td>■ Employee liabilities</td>
</tr>
<tr>
<td>■ Sale of assets – derecognition</td>
</tr>
<tr>
<td>■ Remaining assets – impairment</td>
</tr>
<tr>
<td>■ Accounting – errors and increased control risk</td>
</tr>
<tr>
<td>■ Onerous contracts – provision</td>
</tr>
<tr>
<td>■ Product warranties – provision</td>
</tr>
<tr>
<td>■ Breach of contract – provision/disclosure</td>
</tr>
</tbody>
</table>

(b) **Extent of reliance on audit evidence**

Generally 1 mark each point of explanation/comparison,
up to maximum 4 each (i) and (ii) 8

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Analytical procedures – less (conclusion)</td>
</tr>
<tr>
<td>■ Material items requiring 100% testing</td>
</tr>
<tr>
<td>■ Relevance of available information</td>
</tr>
<tr>
<td>■ Comparability of available information (10 months)</td>
</tr>
<tr>
<td>■ Efficiency and effectiveness of alternative procedures</td>
</tr>
<tr>
<td>■ Proviso – still of some use</td>
</tr>
<tr>
<td>Management representations – more (conclusion)</td>
</tr>
<tr>
<td>■ Matters of judgment and opinion</td>
</tr>
<tr>
<td>■ Knowledge confined to management</td>
</tr>
<tr>
<td>■ Proviso – limitation on possible reliance</td>
</tr>
</tbody>
</table>

(c) **Principal audit work**

Generally 1 mark each area of principal audit work
maximum 3 marks each (i) and (ii) 6

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Amounts due from distributors</td>
</tr>
<tr>
<td>■ Ledger account balances</td>
</tr>
<tr>
<td>■ After-date cash (any?)</td>
</tr>
<tr>
<td>■ Agreements – penalties accruing</td>
</tr>
<tr>
<td>■ Settlement offered (any?)</td>
</tr>
<tr>
<td>Lease liabilities</td>
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<tr>
<td>■ Prior period working papers – operating leases</td>
</tr>
<tr>
<td>■ Onerous contract (IAS 37)</td>
</tr>
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<td></td>
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<tr>
<td>■ Prior year IAS 17 disclosure (reconciliation)</td>
</tr>
</tbody>
</table>

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26 23
3 (i) Matters
Generally 1 mark each comment
maximum 6 marks each issue x 3

Idea
- Materiality (assessed)
- Relevant IASs (e.g. 1*, 10*, 16*, 18, 37) and 'The Framework' (e.g. consistency)
- Risks (e.g. FS assertions – fair presentation and disclosure, completeness, appropriate valuation)

(ii) Audit evidence
Generally 1 mark each item of audit evidence (source)
maximum 5 marks each issue x 3

Idea (ISA 500)
- Oral vs written
- Internal vs external
- Auditor generated
- Procedures ('AEIOU')

4 (a) Considerations of materiality
Generally 1 mark each comment

Idea (ISA 320)
- Audit objective
- Quantitative vs qualitative misstatement
- Preliminary materiality ⇒ ‘NET’ of audit procedures
- Criteria (%)
- Evaluating the effect of misstatements
- Qualitative factors

(b) Suitability of draft
Generally 1 mark a comment

Idea
- Opinion disclaimed/limitation and pervasive
- Principal matters relevant to forming an appropriate opinion
- Compliance with ISAs (affected?)
- Limitation of scope (yes)
- Assessment of significant estimates and judgments (made by management)
- Adequacy of disclosure
- Sufficiency of available evidence
- Reasonable assurance – misstatement caused by fraud or error
- Possible effect (material vs pervasive)
- Implications for prior year audit opinion

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*As revised under the Improvements project.
4ISA 500R describes recalculation (rather than computation) and also reperformance.
### Ethical and professional issues

**Generally 1 mark each comment**  
*maximum 5 marks each of 3 matters*

<table>
<thead>
<tr>
<th>Ideas</th>
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<tbody>
<tr>
<td>Implications for:</td>
<td></td>
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<tr>
<td>Practice management</td>
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<tr>
<td>Time/fee/staff budgets</td>
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<tr>
<td>Quality control (direction, supervision, review)</td>
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<tr>
<td>Threats to independence/Possible safeguards</td>
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<tr>
<td>Competence (training)</td>
<td></td>
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<tr>
<td>Integrity (auditor)</td>
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<tr>
<td>Other audits/clients</td>
<td></td>
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<tr>
<td>Audit evidence (RR &amp; S(^5))</td>
<td></td>
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<tr>
<td>Audit opinion/report</td>
<td></td>
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</tbody>
</table>


### Group audit issues

**Generally 1 mark a point up to**  
*maximum 4 marks each issues (a)–(e)*

<table>
<thead>
<tr>
<th>Ideas (illustrative)</th>
<th></th>
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<tbody>
<tr>
<td>Current scope of ISA 600</td>
<td></td>
</tr>
<tr>
<td>Terms defined</td>
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<tr>
<td>Relevance to group audit</td>
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<tr>
<td>Why topical</td>
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<tr>
<td>Need for more guidance</td>
<td></td>
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</tbody>
</table>

\(^5\)Relevance, reliability and sufficiency