Answers
1 BATELEUR ZOO GARDENS

(a) Internal controls

Tutorial note: Remember that not all controls are preventive. Some should detect (so as to correct) things that have ‘gone wrong’.

(i) Lack of investment

■ Monthly review and monitoring of:
  – admission fees;
  – number of day visitors;
  – annual memberships taken out (analysed between new and renewed);
  – lapsed membership;
  – sponsorship waiting lists (animals without sponsors and sponsors waiting for suitable animals).

■ Approval of annual budgets which plan for adequate investment to attract visitors.

■ Monthly comparison of actual expenditure on new exhibits and breeding programs against budget – to see the extent to which the expected level of investment in development is being made.

(ii) Incomplete data transfer

■ Monthly reconciliations of actual (invoiced) sponsorship income to that expected (based on number of sponsorships, by type, per sponsor department records) and investigation of shortfalls.

■ Monitoring of instances of incomplete/inaccurate data transfer – how identified, reason for occurrence, amounts involved, how rectified.

(iii) Non-charges

■ Monitoring of sponsorship income generated (i.e. actual) to that available (e.g. projected), by class of animal, and investigation of shortfalls.

■ Comparison of BZG’s advertising expenditure against budget (to identify potential for unrecorded costs).

(iv) Misappropriated cash

■ Two people could ‘man’ each ticket kiosk at all times. A duty log should be kept (date, time, staff member).

■ The kiosks must not be left unattended while cash is held there.

■ All cash received from visitors should be counted and recorded and a receipt given.

■ Cash and a copy of the receipts should be transferred, securely, to cashiers.

■ The existence of CCTV at the kiosks should be made evident, to act as a deterrent.

■ Daily reconciliation of cash takings to ‘gate’ (i.e. number of day visitors) and investigation of any apparent shortfall.

■ A separate admission gate after the kiosk checks that entrants have been issued a ticket.

■ An auditable cash register system to control cash drawers at ticket booths. Transactions must be traceable in multiple forms of tender (cash, credit card).

■ Multiple cash drawer inserts enabling quick and easy shift changes. An automated audit trail of all movements in and out of each drawer.

(v) Systems not available

■ Back up/recovery/contingency plans must be in place to ensure that BZG can take bookings and issue tickets even when the electronic system is not available.

■ In particular, the back up system should be tested periodically to ensure that credit card bookings can be taken and correct discounts processed for concessionary tickets and group bookings.

■ Preventive arrangements to ensure that any ‘down time’ is kept to a minimum. For example, acquiring highly reliable systems components and frequent housekeeping/maintenance.
(vi) **Unrecorded donations**

- Periodic inspection of animals and comparison with book records (e.g. fixed asset register for larger species and inventory records for smaller species).
- Comparing new animals identified by veterinary records to additions to inventory records (or asset register).

(b) **Financial statement risks**

**Tutorial note:** The numbering in this answer corresponds to the applicable risks in the question.

(i) A going concern (‘failure’) risk arises from lack of investment. Any significant doubts about going concern must be suitably disclosed in the notes to the financial statements. Disclosure risk arises if the requirements of IAS 1 ‘Presentation of Financial Statements’ are not met.

(ii) A reduction in admission income may result in asset impairment. BZG’s management should perform impairment tests on the carrying amount of the larger exhibits, in accordance with IAS 36 ‘Impairment of Assets’.

- Income may be materially understated due to:
  - incomplete data transfer resulting in invoices not being raised;
  - unrecorded sponsorships arising from advertising arrangements.

**Tutorial note:** It is unlikely that income would be overstated as companies would dispute the rates if they were overcharged for sponsorships.

(iii) BZG’s advertising costs will be understated if their barter for sponsorships is not recorded. If material, there is a risk of non-compliance with financial reporting requirements (SIC 31 ‘Revenue – Barter Transactions Involving Advertising Services’).

(iv) Cash asset/admission income will be understated in respect of cash which does not reach the accounts department. If some of this cash is not stolen but rather appropriated for use in the business (e.g. in meeting day-to-day cash expenses) then costs would be understated also. The financial statement risk is greater if income is ‘lost’ through unticketed entry (as it will be more difficult to quantify than if misappropriation occurs after tickets have been issued).

(v) There may be no financial statement risk. For example, if BZG were to admit people for free there would be no admission fees to be recorded for that day. Alternatively, in the absence of an adequate back up system, the risk of unrecorded cash/income identified in (iv) may be exacerbated.

(vi) Assets (and reserves) will be understated if donated animals are not initially recognised at fair value (IAS 16 ‘Property, Plant and Equipment’).

(c) **Substantive analytical procedures – factors to be considered**

**Tutorial note:** The wording of the requirement clearly requires the application of any knowledge of ISA 520 ‘Analytical Procedures’ to planning the extent of substantive procedures in the context of BZG’s income.

- Audit objectives – The principal audit objective relating to income is to ensure the completeness of recording. Analytical procedures can be effective in providing assurance in this area, especially where it is inefficient to perform tests of control or detailed substantive tests.

- Nature of entity – BZG’s income will be seasonal, with more visitors in fine weather, at weekends, during school holidays and on national holidays. The relationship between income and weather/dates will provide a basis for making comparisons year-on-year.

- The greater the degree of disaggregation of information, the greater the extent and reliance on substantive analytical procedures. For example, sponsorship income will be clearly distinguished from ticket income. Also, income from sales of food and retail will be separately identifiable from admissions.

- Availability of information – non-financial information, as well as financial information, should be available on which to base predictions. For example, recorded admission fees can be compared with the number of visitors passing through a gate. This number may also be verified on departure (e.g. through turnstiles).

- Reliability of information – ‘gate’ will be more reliable if physical barriers are independently supervised to ensure that visitors cannot otherwise gain admittance.

- Relevance of information – budgets will be more reliable if based on realistic rather than ideal targets (e.g. achieving 70% rather than 100% sponsorship).

- Source of information available – for verification of completeness of recorded sponsorship income there will be non-financial records of the animals. External sources of information might include weather reports and local newspaper reports of major donations, sponsorships, etc.

- Comparability of information – as the nature of the BZG is quite specialised there may be no broad industry data available. Therefore most of the comparisons will be with prior period information.

- Expectation of relationships – as well as seasonal relationships, there will be an expectation that the higher the ‘gate’, the higher the income from food and retail.
Materiality – as income is the item most material to the income statement, audit evidence regarding its completeness should not be confined solely to analytical procedures. For example, tests of detail on the sponsorship of the larger animals might be expected.

Other audit procedures aimed at the same audit objective – BZG will have trade receivables in respect of sponsorships (invoked) on which other procedures can be carried out. For example, review of credit period taken. However, there will not be amounts due for admission fees and retail sales (cash).

Accuracy of predictions – food and retail sales are likely to have established margins – therefore the completeness of recorded income from these sources may be predicted more accurately than sponsorships (say) where there are no directly attributable costs to be verified.

Inherent and control risk assessments – as much of the income is cash, inherent risk is assessed as high. However, if controls over the issue of tickets are strong, more reliance may be placed on analytical procedures than if control risk in this area was assessed as high.

Tests of controls – if BZG’s controls over recording non-financial information (e.g. ‘gate’) are strong, then more reliance can be placed on analytical procedures using this information.

2 HARRIER MOTORS

(a) Audit risks

Inherent – financial statements level

- Major business expansion increases going concern risk due to increased dependence on financing and the risk of overtrading. This must be taken account of when planning the audit so that, on completion of the fieldwork, sufficient audit work has been obtained to support management’s assertion that the going concern basis is appropriate.

- Multi-locations increase inherent risk. For example, the movement of assets between locations creates a risk of double-counting and/or omission. Inter-location trading (e.g. of parts inventory) may be transferred at a mark-up which must not be recognised until realised.

- It is in the nature of the car trade business that sales are transacted for cash. If controls over the recording of cash income are inadequate this would cast doubts on the truth and fairness of the financial statements as a whole. For example, cash may be spent on capital and/or revenue items and not recorded as business assets/expenditure.

Inherent – assertion level

- The legal form of the consignment inventory is that Harrier Motors does not own it and should therefore not recognise it in the balance sheet. However, Harrier does not return new cars and therefore the substance of the transactions with the supplier is that they are purchases. That Harrier effectively has the rights of ownership and should recognise unsold cars in inventory is supported by the fact that the sales executive can use any car in each consignment. A physical inspection of new car inventory will therefore be required at the year end.

- For vehicles more than three months old, 3% purchase price is not a cost of acquiring inventory but a finance cost which should be expensed (time-apportioned if necessary to give accurate cutoff between accounting periods).

- Liabilities (actual and contingent) arising under the three-year warranties and six-month guarantees will require some provision (to the extent that they are expected to materialise) and disclosure, in accordance with IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’.

- Inventory valuation will depend on whether cars are new, used/trade-in, or ex-demo models. The year-end physical inventory count must ensure that each vehicle is appropriately categorised to ensure that it is correctly valued.

- In particular, used cars accepted in part-exchange (on the sale of a new car), will be assigned a trade-in value which is the difference between the listed selling price on the new car and the cash consideration. Trade-in value may exceed the net realisable value of used cars (which must be serviced in order that they are guaranteed before they can be offered for resale).

- As a member of key management personnel, the sales executive is a related party. Even though there is no consideration for the loan of the assets (new cars) IAS 24 ‘Related Party Disclosures’ applies. There is a cost to Harrier which is the diminution in value between sales price of a new car and ex-demo price. In some jurisdictions this will be a benefit in kind assessable on the sales executive which should be disclosed as part of his remuneration package.

- WIP is unlikely to be material at the year end (as for the most part it is invoiced as finished work on the same day that it is undertaken). However, attention will need to be given to the cutoff between parts inventory (at cost) and completed WIP (at selling price).

- The term ‘indefinite’ does not mean ‘infinite’ but rather that the planned future expenditure on the brand name is in excess of that required to maintain the intangible assets at its current level of performance (IAS 38 ‘Intangible Assets’). This expenditure must therefore be verified to substantiate non-amortisation of the ‘Uni-fit’ brand name.

- As there is a rebuttable presumption that the useful life of an intangible asset does not exceed 20 years, Harrier’s management must also subject the brand name to an annual impairment test.
Control risk

- The existence of an internal audit function may reduce the assessment of control risk on future audits. However, as the department is only now in the process of being established it is unlikely that much, if any, reliance can be placed on it in respect of the current year.

- To the extent that additional staff are recruited to the internal audit department before the year end, there is an opportunity for cooperation in verifying inventory and non-current tangible assets at the balance sheet date.

- Tests of control should be planned on continuous stock-checking to determine the extent of reliance to be placed on this internal control. In particular, Harrier’s storekeepers should be carrying out test counts to a program which ensures that all inventories are counted at least once in each financial year. Discrepancies between book records and physical counts must be corrected by persons independent of the storekeeping function.

(b) Principal matters – instructions for physical inventory counting

- Harrier’s year-end instructions should be approved by the newly-appointed head of internal audit. Any matters raised by the external auditor concerning last year’s count (e.g. in a management letter) should be addressed.

- High value inventory (new cars) are held at three locations more than in the prior year and external audit staff might be expected to attend all three. Internal audit is not yet sufficiently developed to carry out tests of compliance on controls over inventory movements on a ‘cyclical’ basis. The newly appointed head (plus any additional staff recruited before the year end) should therefore plan to attend counts in consultation with the external auditors.

- Attendance at the counts is primarily a test for existence. As new cars contribute most to the valuation of inventory, they will most likely be 100% examined at all locations visited.

- Perpetual inventory records and continuous stock-checking provide a system of control over inventory quantities which, if effective, eliminates the necessity of a full physical count at the year end. If tests of controls in this area are strong Harrier will be performing test checks on a sample basis.

- The risk of material error arising due to cutoff will be reduced if new car consignments are not scheduled to be received close to the year end. The likelihood of material error arising from work in progress is also low as servicing and body repairs are generally performed and invoiced on the same day.

- The greatest risks of material error arise if sales after the year end are brought into the current year sales – particular attention should be given to any cars which are seen to exist but are excluded from the count.

- Physical movement of new cars should be kept to a minimum (so perhaps no test driving on the day of the count).

- In selecting used cars for test checking it will be important to note their physical condition and any indications that they are slow-moving (e.g. if they are not easily accessible for a test drive).

- Consignment inventory which is more than three, six, nine, etc months old should be identified for later consideration of net realisable value. Mr Joop’s car should be included in the count and any of his ex-demo models which are still in inventory.

(c) Audit work – useful life

Tutorial note: ‘Indefinite’ does not mean ‘infinite’. Useful life reflects the level of future maintenance expenditure required to maintain the asset at its standard of performance assessed at the time of estimating its useful life.

- Agree the carrying amount (cost) to prior year working papers.

- Review the history of the ‘Uni-fit’ brand name. In particular, how many years it was in existence before it was purchased.

- Substantiate the level of marketing/advertising expenditure incurred on the brand name during the current year (by agreeing advertising to invoices, etc).

- Compare the accounting policy, of indefinite useful life, with that adopted for similar brand names in the industry.

- Review of planned future expenditure (i.e. advertising budgets) to maintain the brand name at the level of performance at which it was purchased.

- The results of management’s impairment test (i.e. comparison of recoverable amount (per IAS 36) with carrying amount (i.e. cost)).
3 EAGLE ENERGY

(a) Capitalisation of staff training costs

(i) Matters

- $4.3 million represents less than 1.8% of total assets and therefore is not, in isolation, material to the balance sheet. It does, however, represent nearly 60% of profit before taxation and is therefore material.
- If $4.3 million were to be expensed profit before tax would fall to $2.9 million – which is only an eighth (i.e. 12.5%) of profit reported in the prior year.
- However, true it may be that money is spent in the hope of future benefits, staff training costs do not usually meet the definition of an asset as there is insufficient control over them (IAS 38 'Intangible Assets'). They cannot therefore be intangible assets.
- Control might be claimed if Eagle had legal rights over the staff trained, to use and obtain future benefits expected from them. However, whilst this might apply to key individuals it would not apply to its entire technical staff.
- Whether any of the $4.3 million is a cost which can be deferred. For example, pre-payments for any part of the training program not run until after the year end. Or training ‘manuals’ (bound volumes or software programs) which can be used over a future period of time.
- The chief executive’s grounds, if any, for refusing to change the financial statements once it is explained to him that the audit opinion will be qualified ‘except for’ [disagreement] if he does not do so.

(ii) Audit evidence

- A break down of $4.3 million – analysed between external and internal training costs.
- Test checking the largest invoices for external training.
- Physical inspection of training manuals (or other training program related asset).
- The standard terms of the contracts with technical staff (confirming that Eagle Energy does not have sufficient control over them).
- Details of leavers – supporting the argument to the chief executive that future benefits are not protected as Eagle cannot prevent technical staff from taking up alternative employment elsewhere.

(b) Provision for ‘decommissioning’

(i) Matters

- The provision made is 1/15th of the total expected cost and represents approximately 17% of profit before tax (PBT) which is material, but only 1/2% of total assets which is immaterial. Given that materiality based on PBT is exaggerated, because it is small compared to the prior year, on balance it is not material.
- However, the total amount to be provided, the present value of $18 million, will be material (the undiscounted amount is approximately 7/2% of total assets).
- Eagle Energy has a legal obligation to incur $18 million in dismantling/decontamination costs as a result of having assembled a laboratory during the year. The present value of this should be recognised, in full, as a liability (IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’) and as part of the cost of the laboratory (IAS 16 ‘Property, Plant and Equipment’).
- The capitalisation of these future costs in the carrying amount of the asset would increase the depreciation charge for the year by 1/15th of the present value, which would be less than $1.2 million.

**Tutorial note:** For example, assuming a discount rate of 6% the 15 year simple discount factor is 0.42. Therefore depreciation should be $0.5 million as compared with $1.2 million charged to the income statement.

- The chief executive’s grounds, if any, for refusing to change the financial statements once it is explained to him that the audit opinion will be qualified ‘except for’ [disagreement] if he does not do so.

(ii) Audit evidence

- Terms of local authority grant as documented in the permanent audit file.
- Physical inspection of the site at the balance sheet date – to confirm that the laboratory was assembled during the year and the obligation, for settlement in 2020, thereby created.
- Breakdown and calculation of the $18 million cost – whether estimated by Eagle’s management or an independent consultant.
- Assumptions made in estimating the future cost (e.g. concerning degree of contamination).
- An appropriate discount rate – to calculate the adjustment that management should make (or quantify the impact of disagreement if the financial statements are not adjusted).
(c) Monthly adjustment

(i) Matter

- The net movement for the year, $0.3 million, represents only 4% of profit before tax and is therefore immaterial (and negligible to the balance sheet). However, although the net amount is immaterial, consideration should be given not only to the amounts of the adjustments made but their nature.
- The journal entries have no economic substance – they are a manipulation of financial reporting information.
- The fact that the journals are reversed does not mitigate the fact that the adjustments appear to have been made solely to misrepresent reported debt ratios. They are therefore false and, being intentional and deceitful (to obtain/maintain a financial advantage) constitute fraud.
- The adjustments have clear characteristics of being fraudulent journal entries:
  - made to unusual accounts – ‘Sundry 1’ and ‘Sundry 2’;
  - approved by an individual who typically would not be involved in making journal entries (the chief executive);
  - recorded at period end with no description.

(ii) Audit evidence

- List of all such journal entries made (and reversed) during the year.
- Terms and conditions of government funding (from permanent audit file for on going finance and new contracts entered into during the year).
- Recalculation of what the debt ratios should have been, without the adjustments, and whether these indicate a breach of conditions.
- Management representation, signed by the chief executive, that there are no other transactions of a similar nature which have not been brought to the attention of the auditor.
- How the matter was addressed by the prior year audit in respect of the prior year financial statements.

Overall

The chief executive clearly has a position of influence within Eagle Energy. Profit is materially overstated by the capitalisation of staff training costs. If he refuses to adjust the financial statements when requested to do so this would be a further instance of fraudulent reporting and the appropriateness of reporting this to relevant government authorities (as well as qualifying the audit opinion) should be considered.

4 ROOK & CO

(a) Quality control in a smaller audit firm

Why difficult to implement

Audit quality depends, inter alia, on the quality of the people. Smaller firms may lack resources and specialist (audit) expertise. In particular, small firms may not be able to offer the same reward structures to attract and retain staff as larger firms.

Also, whereas larger firms can afford to recruit staff in sufficient numbers to allow for subsequent leavers and provide for their training needs, smaller firms may not be able to offer the same training opportunities. Prospective trainees may perceive a smaller firm’s client base to be less attractive than that of a larger firm (e.g. in terms of the on-the-job training which it offers).

Smaller practices may have less scope to provide staff with internal and on-the-job training and costs of external training may be costly in comparison and also fail to provide the ‘hands-on’ experience necessary for professional development.

The cost of access to external specialists may be prohibitive for smaller firms.

Audit committees play an oversight role which contributes to quality control in larger firms (e.g. on matters of client acceptance/retention, independence issues, etc). When the client base is largely of owner-managed businesses, as for many smaller audit firms, there are no non-executive directors to support the auditor when difficult issues arise.

Quality control requires leadership within the firm. In a larger firm one senior partner may have responsibility for establishing quality control policies and procedures and another, responsibility for monitoring work performed. Splitting these roles may not be practical for a smaller firm (and impossible for sole practitioners).

Small firms operate in a highly competitive environment for audit work and are often busy with non-audit work and under-resourced. Technical updating on audit matters may not be as regular as desirable and audit practice may become inefficient.

How overcome

Where in a larger firm quality control procedures might be the responsibility of a central technical team, in a smaller firm those same responsibilities might be distributed between the reporting partners.
Smaller firms may draw, judiciously, on the expertise of suitably qualified external consultants (e.g. on technical matters). Small firms and sole practitioners have the same access to a wide range of technical and ethical advisory services provided by ACCA (and other professional bodies) and should take advantage of these.

Small firms may work together as a consortium to share training opportunities and sometimes staff. For example, an association of small firms may adopt the same methodology and meet annually (say) for technical updates.

(b) Lammergeier Group – auditor’s report

- The report is confused. It is clearly headed ‘Qualified opinion arising from disagreement …’ yet the reasons for departure (from IAS 7) are ‘sound and acceptable’. The heading is a statement of disagreement, the latter a statement of concurrence. If the auditor concurs with a departure the opinion should not be qualified.

- What is ‘IAS 7’? This should be stated in full, i.e. ‘International Accounting Standard 7 Cash Flow Statements’.

- It might be simpler/clearer to head the opinion paragraph ‘Qualified opinion arising from omission of cash flow statement’.

- The auditors should not be expressing an opinion of Lammergeier’s management in their report. Management’s ‘justification’ should be set out in a note to the financial statements (e.g. in the accounting policies section). The auditor’s report should clearly state that there is non-compliance with IAS 7. For example, ‘As explained in note … the financial statements do not contain a cash flow statement as required by IAS 7 [written out in full]’.

- It cannot be true that the departure ‘does not impact on the truth and fairness …’. The requirement to prepare a cash flow statement (and its associated notes) stems from the need to provide users of financial statements with information about changes in financial resources. If this information is omitted the financial statements cannot show a true and fair view.

- ‘Except for [the non-preparation of the group cash flow statements and associated notes] …’ is a qualified audit opinion. This contradicts Rook & Co’s assertion that the matter ‘does not impact on the truth and fairness …’.

- If the departure from IAS 7 were justified it would assist the user of the financial statements to know precisely where the ‘adequate disclosure has been made’. If the auditor wished to emphasise the matter, without qualifying the audit opinion, an emphasis of matter after the opinion paragraph should refer to the specific note where the departure is explained.

- The grounds for non-compliance is ‘the complexity involved’. This does not seem likely. IAS 7 offers no exemption on these (or any other) grounds.

- The fact that the audit opinion was similarly qualified in the prior year shows that the matter has not been resolved even after a year.

- It is possible that, having qualified on the prior year, it was an ‘easy option’ to qualify again in the same terms rather than draft a more appropriate opinion for the consecutive year.

- The 2003 opinion makes no reference to the fact that the matter is ‘not new’ and that the opinion was similarly qualified in the prior year.

5 HAWK ASSOCIATES

(a) ‘Cold calling’

**Tutorial note:** Recognising that there are three issues to address (i.e. ‘cold calling’, ‘free’ and ‘second opinions’) is likely to earn more marks than focusing on just one.

- Until relatively recently ‘cold calling’ has been largely prohibited throughout the profession (and still is in some countries e.g. Hong Kong). Therefore the ‘direct’ approach may not be suitable.

- Where ‘cold-calling’ restrictions have been relaxed it may still only be permitted for existing business clients (i.e. to offer them additional services), the direct approach to non-business clients being prohibited. This inhibits competition.

- Although the practice may be viewed as ‘a bit grubby and commercial’ it is now generally regarded as an accepted modern business practice. Along with other professional bodies, ACCA removed its prohibition on ‘cold calling’ in 2002.

- Whilst Hawk is permitted to ‘cold call’, the fundamental ethical principles must be adhered to. Whilst solicitation which is decent, honest and truthful may be acceptable, cold calling which amounts to harassment is not.

- Offering a service for ‘free’ is not prohibited provided that the client is not misled about future levels of fees.

- There are strict ethical rules regarding ‘second opinions’ (on accounting treatments). Practitioners are advised NOT to provide second opinions, when requested, without following a procedure of contacting the incumbent auditor/accountant. Therefore to be offering second opinions clearly goes against ethical guidelines – as the practice is to be discouraged.
(b) Tax planning

- Advertising is generally allowed subject to the observance of the fundamental principles of ethical codes (e.g. IFAC’s ‘Code of Ethics for Professional Accountants’, ACCA’s ‘Rules of Professional Conduct’).
- Although direct advertising (i.e. on television, radio, cinema) is prohibited in many jurisdictions (e.g. Hong Kong), an advertisement in a national accountancy magazine is generally permitted.
- Where advertising is permitted, the minimum requirements are that it be decent, honest, truthful and in good taste. These criteria may not be met in this proposal as:
  - expectations of favourable results (lower tax liabilities) may be unjustifiable (or created deceptively);
  - ‘techniques you can apply’ may imply an ability to influence taxation authorities;
  - ‘the best’ is likely to be a self-laudoatory statement and not based on verifiable facts;
  - ‘the best’ may also be making an unjustifiable comparison with other professional accountants in public practice;
  - ‘the best tax planning advice’ may be an unjustifiable claim of expertise or specialism in the field of tax.
- ‘Can ensure …’ and the assertion of ‘all’ may not be supportable claims, therefore the advertisement is not honest in these respects.
- There is a ‘fine line’ between tax avoidance and tax evasion and ‘techniques you can apply’ and ‘alternative fact presentations’ may lean toward the latter and so not be in keeping with the integrity of the profession.
- The assertion of being able to ‘minimise the amount of tax’ may expose Hawk Associates to litigation. The engagement risk associated with taking on this work would be high and so should carry commensurately high fees.
- The ‘no tax saving – no fee’ offer does not compensate for the risk associated with undertaking the work advertised.
- Contingency fees, whereby no fee will be charged unless a specific result is obtained, are prohibited by IFAC (unless otherwise permitted by statute of member body).

(c) Business cards

- Business cards may be considered a form of stationery and should be of an acceptable professional standard and comply with legal and member body requirements concerning names of partners, principals, professional descriptions, designatory letters, etc.
- Whilst placing such an advertisement where a target audience might reasonably be expected to exist (e.g. in an Institute of Directors or Business Men’s Club), displaying it alongside ‘local tradesmen’ may appear to belittle the status of professional accountants.
- An advertisement the size of a business card would be sufficient to provide a name and contact details and in this respect is suitable. However, the danger of giving a misleading impression is pronounced when there is such limited space for information.
- However, the tone of the advertisement may discredit the ACCA name. It is also unsuitable that it seeks to take unfair advantage of the ACCA name. Although the ACCA mark can be used by Hawk Associates on letterheads and stationery (for example) it cannot be used in any way which confuses it with the firm.
- The emphasis on ‘professional’ may be unsuitable as it could suggest that there are other than professional accounting, audit (etc) services to be had.
- Offering a range of non-audit services in the same sentence as ‘audit’ may mislead interested persons picking up the card into thinking that Hawk can provide them together. This conflicts with the fact that Hawk is restricted in providing non-audit services to audit clients.
- There is no basis for asserting ‘competitive rates’.
- It is unlikely that any professional would offer ‘money back’. In the event of dispute (e.g. over fees), the matter would be taken to arbitration (with their member body) if a satisfactory arrangement could not be reached with the client.
- A tradesman may guarantee the quality of his work – and that it can be made good in the event that the customer is not satisfied. However, an auditor cannot guarantee a particular outcome for the work undertaken (e.g. reported profit or tax payable). Most certainly an auditor cannot guarantee the truth and fairness of the financial statements in giving an audit opinion.
6 FRAUD AND ERROR

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) Auditor’s responsibility

Fraud versus error

- Misstatements in the financial statements can arise from fraud or error. The distinguishing factor between fraud and error is whether the underlying action that results in the misstatement is intentional or unintentional.
- Fraud may involve forgery (or other sophisticated and carefully organized schemes designed to conceal), deliberate failure to record transactions, or intentional misrepresentations being made to the auditor.

Detection of fraud and error

- The auditor is responsible for assessing the risk of misstatement in a financial statement audit whether due to fraud or error. However, the auditor’s responsibility for detecting fraud is different due to the characteristics of fraud.
- The risk of not detecting a material misstatement arising from fraud is higher than that from error because of the deceit involved in fraud. Attempts at concealment are even more difficult to detect when accompanied by collusion (which may cause the auditor to believe that audit evidence is persuasive when it is, in fact, false).
- The auditor’s ability to detect a fraud depends on many factors (e.g. the frequency/extent of manipulation, degree of collusion, relative size of amounts manipulated, seniority of individuals involved). While the auditor may be able to identify potential opportunities for fraud, it may be impossible for the auditor to determine intent, particularly in matters involving management judgment (e.g. accounting estimates).
- Audit procedures that are effective for detecting error may be ineffective for detecting fraud.

Reporting of fraud and error

- To shareholders – the auditor has the same responsibility under ISA 700 ‘The Auditor’s Report on Financial Statements’ for fraud as for error. For example, if the auditor is aware of a limitation of scope or disagrees with an accounting treatment the audit opinion will be qualified (assuming the matter to be material). However, if a matter is not material, it cannot be reported.
- To management and those charged with corporate governance – the auditor should report a matter which identifies or indicates fraud as soon as practicable to the appropriate level of management. This is even if the matter appears inconsequential (e.g. a minor defalcation by an employee). However, the auditor would not report such inconsequential errors.
- To regulatory and enforcement authorities – ordinarily, reporting to third parties on both fraud and error is precluded by the auditor’s professional duty of confidentiality. However, the auditor may have a duty to report the occurrence of fraud in some countries.

(b) ‘Professional skepticism’

- Professional skepticism recognizes the possibility that circumstances may exist that cause the financial statements to be materially misstated.
- It is an aspect of ‘rigor’ that information and explanations obtained are assessed and additional evidence sought as necessary.
- Due to the characteristics of fraud, the auditor’s attitude of professional skepticism is particularly important when considering the risk of material misstatement. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- The auditor must be prepared to consider that a material misstatement due to fraud could exist, notwithstanding the auditor’s past experience with the entity and the auditor’s belief about the honesty and integrity of management and those charged with governance of the entity.
- When making inquiries and obtaining other audit evidence, the auditor exercises professional skepticism so as not to be satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity.
- An audit of financial statements rarely involves the authentication of documentation, nor is the auditor trained as (or expected to be) an expert in such authentication. However, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over its preparation and maintenance where relevant. Unless the audit reveals audit evidence to the contrary, the auditor ordinarily accepts records and documents as being genuine.
“Earnings management” – Difficulties for the auditor

Earnings management aims to deceive users of financial statements by influencing their perceptions about the entity’s performance and profitability. At its extremes, it constitutes fraudulent financial reporting. There are four broad categories:

- intentional breach of financial reporting requirements which are, in isolation, immaterial;
- unsuitable revenue recognition;
- ‘big bath’ provisions/reserve accounting;
- improper accruals/estimation of liabilities.

Overly conservative reporting (e.g. creating reserves in good times for release on ‘rainy days’) and aggressively optimistic outcomes both hold consequences for the quality of financial reporting.

Earnings management may be relatively innocuous (a ‘tendency’) and within gaap, or so aggressive as to constitute fraud (i.e. in violation of gaap). One difficulty for the auditor is establishing the boundary between acceptable and unacceptable earnings management and an intention to commit fraud. This is a matter for judgement and requires an attitude of professional skepticism.

Earnings management may start out with small biased judgments in financial reporting and/or structuring transactions. If amounts are individually immaterial ‘standard’ audit procedures may not detect them.

Making use of flexibility in accounting estimates is often the beginning of aggressive earnings management. Such flexibility may develop ‘creative’ choices. Accounting standards need to be rigorous and not so imprecise that it is impossible for an auditor to obtain sufficient, appropriate audit evidence to confirm the amounts derived under them.

Pressures and incentives may lead these actions to increase to the extent that they are not acceptable under the applicable financial reporting framework. Controls that otherwise may appear to be operating effectively may be overridden by management. In such a case it is likely that management representations cannot be relied on.

Opportunities for earnings management arise, in particular, where there is no accounting standard covering a particular accounting issue. As many techniques of earnings management involve accruals the auditor must be alert to the level of accruals appropriate to the industry and client and the appropriate recognition of liabilities.
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 ½ a mark for a point of knowledge, increased to 1 mark for the application of knowledge and 1¼ 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)  **Internal controls**  
Generally 1 mark each point, max 3 any one risk  

**Ideas**  
- control procedures/specific controls  
- control environment/pervasive controls  
- monitoring activities (including reconciliations)  

(b)  **Financial statement risk**  
Generally 1 mark each point  

**Ideas**  
**Assets**  
- impairment (IAS 36)/overstatement (tangibles)  
- useful lives  
- existence assurance (tangibles, cash)  
- completeness (tangibles, receivables)  
**Income statement**  
- admission fees (understatement)  
- sponsorship income/advertising expense understatement (SIC 31)  
**Reserves**  
- existence/disclosure  
**Disclosure risk**  
- going concern (IAS 1)  

(c)  **Substantive analytical procedures**  
Generally \( \frac{1}{2} \) mark each factor + up to 1 mark a comment  

**Ideas (ISA 520)**  
- audit objectives  
- nature of entity  
- degree of disaggregation of information  
- availability of information  
- reliability of information  
- relevance of information  
- source of information available  
- comparability of information  
- expectation of relationships  
- materiality  
- other audit procedures  
- accuracy of predictions  
- inherent and control risk assessments  
- tests of controls
2 (a) Audit risks
Generally \(\frac{1}{2}\) mark for identification + 1 mark each point of explanation

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Inherent – financial statements level</td>
</tr>
<tr>
<td>■ business expansion/going concern</td>
</tr>
<tr>
<td>■ multi-location</td>
</tr>
<tr>
<td>■ cash</td>
</tr>
<tr>
<td>Inherent – assertion level</td>
</tr>
<tr>
<td>■ consignment inventory/substance over form</td>
</tr>
<tr>
<td>■ contingent liabilities (IAS 37) – warranty/guarantee</td>
</tr>
<tr>
<td>■ inventory valuation (used/trade-in cars, ex-demo models)</td>
</tr>
<tr>
<td>■ related party disclosures (IAS 24)</td>
</tr>
<tr>
<td>■ WIP</td>
</tr>
<tr>
<td>■ intangible assets (IAS 38) – non-amortisation</td>
</tr>
<tr>
<td>Control</td>
</tr>
<tr>
<td>■ internal audit</td>
</tr>
<tr>
<td>■ continuous stock-checking</td>
</tr>
</tbody>
</table>

(b) Principal matters – year-end physical inventory counting
Generally \(\frac{1}{2}\) mark each principal matter identified + 1 mark each point contributing to an explanation

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ internal audit – supervisory role</td>
</tr>
<tr>
<td>■ multi-site operations (‘cyclical compliance’ not appropriate)</td>
</tr>
<tr>
<td>■ high value items (new cars) existence – 100%</td>
</tr>
<tr>
<td>■ parts – continuous stock checking – sample basis</td>
</tr>
<tr>
<td>■ cutoff – not material for WIP</td>
</tr>
<tr>
<td>■ restrictions on movement</td>
</tr>
<tr>
<td>■ used cars – condition</td>
</tr>
<tr>
<td>■ consignment inventory – age, ex-demo model identification</td>
</tr>
</tbody>
</table>

(c) Audit work
Generally \(\frac{1}{2}\) – 1 mark each appropriate suggestion of audit work + \(\frac{1}{2}\) – 1 mark for relevance of brand name and/or Harrier

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ prior year working papers</td>
</tr>
<tr>
<td>■ brand history</td>
</tr>
<tr>
<td>■ marketing/advertising expenditure</td>
</tr>
<tr>
<td>■ industry comparatives</td>
</tr>
<tr>
<td>■ budgeted future expenditure</td>
</tr>
<tr>
<td>■ impairment test (IAS 36)</td>
</tr>
</tbody>
</table>
3 (i) **Matters**
Generally 1 mark each comment
maximum 5 marks each issue × 3

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>• materiality (assessed)</td>
</tr>
<tr>
<td>• relevant IASs (e.g. 16, 37, 38) &amp; ‘The Framework’</td>
</tr>
<tr>
<td>• substance of matter/management’s intention</td>
</tr>
<tr>
<td>• risks (e.g. FS assertions – existence, completeness)</td>
</tr>
<tr>
<td>• adjustment required</td>
</tr>
<tr>
<td>• overall conclusion</td>
</tr>
</tbody>
</table>

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

<table>
<thead>
<tr>
<th>Ideas (ISA 500)</th>
</tr>
</thead>
<tbody>
<tr>
<td>• oral vs written</td>
</tr>
<tr>
<td>• internal vs external</td>
</tr>
<tr>
<td>• auditor generated</td>
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<tr>
<td>• procedures (AEIOU(^1))</td>
</tr>
</tbody>
</table>

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1 ISA 500 identifies five procedures for obtaining audit evidence: Analytical, Enquiry, Inspection, Observation and compUlation.
(a) **Quality control in a smaller audit firm**
Generally 1 mark each comment contributing to an explanation of difficulties in implementation
+ 1 mark each illustration how overcome

**Ideas**
- Difficulties
  - staffing
  - training
  - client involvement
  - allocation of roles
- How overcome
  - sharing responsibilities
  - external consultation
  - professional advisory services
  - consortium arrangements

(b) **Appropriateness of auditor’s report**
Generally 1 mark a comment

**Ideas**
- Confusion – heading vs statement of concurrence
- IAS 7 – in full
- management vs auditor’s opinion
- ‘truth and fairness’ vs
- ‘except for’
- disclosure note vs
- emphasis of matter
- IAS 7 exemption
- prior year
## Professional issues

Generally 1 mark each comment

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>Cold calling</td>
</tr>
<tr>
<td>■ whether prohibited</td>
</tr>
<tr>
<td>■ permitted (ACCA)</td>
</tr>
<tr>
<td>■ commercial/competitive practice</td>
</tr>
<tr>
<td>■ fundamental principles apply</td>
</tr>
<tr>
<td>■ ‘free’ – when permitted</td>
</tr>
<tr>
<td>■ second opinions – discouraged</td>
</tr>
<tr>
<td>Tax planning advertisement</td>
</tr>
<tr>
<td>■ advertising restrictions</td>
</tr>
<tr>
<td>■ the ‘best?’</td>
</tr>
<tr>
<td>■ how ensure?</td>
</tr>
<tr>
<td>■ assertion of ‘all’</td>
</tr>
<tr>
<td>■ exposure to litigation</td>
</tr>
<tr>
<td>■ contingency fees</td>
</tr>
<tr>
<td>Business cards</td>
</tr>
<tr>
<td>■ where advertised</td>
</tr>
<tr>
<td>■ size of advertisement</td>
</tr>
<tr>
<td>■ use of ACCA name</td>
</tr>
<tr>
<td>■ PROFESSIONAL</td>
</tr>
<tr>
<td>■ range of non-audit services</td>
</tr>
<tr>
<td>■ basis of asserting ‘competitive rates’</td>
</tr>
<tr>
<td>■ ‘money back’</td>
</tr>
<tr>
<td>■ cannot guarantee opinions</td>
</tr>
</tbody>
</table>

15 marks

(a) max 5
(b) max 6
(c) max 4

15 marks
6 (a) Fraud and error – auditor’s responsibility
Generally 1 mark a point

Ideas (illustrative)
■ Fraud vs error (intent vs no intent)
■ Detection
  – ISA 200 (error) vs
  – ISA 240 (fraud)
■ Reporting to
  – shareholders
  – management/those charged with corporate governance
  – regulatory and enforcement authorities

(b) ‘Professional skepticism’
Generally 1 mark a point

Ideas (illustrative)
■ Recognition of circumstances
■ Rigor
■ Importance when considering fraud
■ Past experience and beliefs
■ Less-than-persuasive evidence
■ Authentication of documentation

(c) ‘Earnings management’
Generally 1 mark a point

Ideas (illustrative)
■ Meaning
■ Categories
■ Aggressive earnings management vs fraud
■ Materiality
■ Management override/control effectiveness
■ Detecting/recognition
■ Constraining

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Marks

max 5

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15