Answers
GENO VESA FARM

(a) Principal audit risks

Industry

‘Farming’ is an inherently risky business activity – being subject to conditions (e.g. disease, weather) outside management’s control. In some jurisdictions, where the industry is highly regulated, compliance risk may be high.

The risks of mail order retailing ‘exclusive’ products are higher (than for ‘essential’ products, say) as demand fluctuations are more dramatic (e.g. in times of recession). However, the Internet has provided GVF with a global customer base.

The planned audit approach should be risk-based combined with a systems approach to (say) controls in the revenue cycle.

Goat herd

The goat herd will consist of:

■ mature goats held for use in the production of milk and kids which are held for replacement purposes (i.e. of the nature of non-current tangible assets); and
■ kids which are to be sold (i.e. of the nature of inventory).

Tutorial note: IAS 41 is not an examinable document at 2.5 and candidates are not expected to be familiar with its requirements. However, those candidates showing an awareness that biological assets are excluded from the scope of IAS 16 because they are covered by IAS 41 and answered accordingly were not penalised but awarded equivalent marks.

Therefore, the number of animals in each category must be accurately ascertained to determine:

■ the balance sheet carrying amounts analysed between current and non-current assets; and
■ the charge to the income statement (e.g. for depreciation (IAS 16) and fair value adjustments (IAS 41)).

There is a risk that the carrying amount of the production animals will be misstated if, for example:

■ useful lives/depreciation rates are unreasonable;
■ estimates of residual values are not kept under review;
■ they are impaired.

Tutorial note: Under IAS 41 animals raised during the year should be recognised initially and at each balance sheet date at fair value less estimated point-of-sale costs. There is therefore a risk of misstatement if fair value cannot be measured reliably (e.g. if market-determined prices are not available). However, this seems unlikely.

Kids will be understated in the balance sheet if they are not recorded on birth (i.e. their existence needs to be recorded in order that a value be assigned to them).

The net realisable value of animals held for sale may fall below cost if they are not sold soon after reaching optimal size and weight.

The cost of goats is likely to be subjective. For example, the cost of producing a mature goat from a kid might include direct costs (e.g. veterinary bills and cost of feed) and attributable overheads (e.g. sheltering). Care must be taken not to carry the goat herd at more than the higher of value in use and fair value less costs to sell (IAS 36 Revised).

Unrecorded revenue

Raised (bred) animals are not purchased and, in the absence of documentation supporting their origination, could be sold for cash (and the revenue unrecorded).

Although the controls over retailing around the world are likely to be strong, there are other sources of income – the shop and other activities at the farm. Although revenue from these sundry sources may not be material, there is a risk that it could go unrecorded due to lack of effective controls.

‘Rabida Red’

The cost of an ingredient which is essential to the manufacturing process has increased significantly. If the cost is passed on to the customers, demand may fall (increasing going concern risk).

Supplies of the ingredient, Innittu, may be restricted – further increasing going concern risk.

Any disclosure of GVF’s socio-environmental policies (e.g. in other information presented with the audited financial statements), if any, should be scrutinised to ensure that it does not mislead the reader and/or undermine the credibility of the financial statements.

‘Bachas Blue’

If ‘Bachas Blue’ has been specifically cited as a cause of a skin disorder then GVF could face contingent liabilities for pending litigation. However, it is more likely that the fall in demand has threatened GVF’s going concern. As the fall in demand has not been permanent, this threat has been removed for the time being.
The impairment loss previously recognised in respect of the equipment used exclusively in the manufacture of Bachas Blue should be reversed if there has been a change in the estimates used to determine their recoverable amount (IAS 36 ‘Impairment of Assets’).

The recoverable amount would have been based on value in use (since net selling price would not have been applicable). GVF’s management will have to provide evidence to support their best estimates of future cash flows for the recalculation of value in use at 30 September 2005.

Maturing cheese

The substance of the sale and repurchase of cheese is that of a loan secured on the inventory. Therefore revenue should not be recognised on ‘sale’ to Abingdon Bank. The principal terms of the secured borrowings should be disclosed, including the carrying amount of the inventory to which it applies.

Borrowing costs should all be recognised as an expense in the period unless it is GVF’s policy to capitalise them (the allowed alternative treatment under IAS 23 ‘Borrowing Costs’). Since the cost of inventories should include all costs incurred in bringing them to their present location and condition (of maturity), the cost of maturing cheese should include interest at 7% per six months (as clearly the borrowings are specific). There is a risk that, if the age of maturing cheeses is not accurately determined, the cost of cheese will be misstated.

Health and safety legislation

At 30 September 2005 the legislation will have been in effect for three months. If GVF’s management has not replaced the shelves, a provision should be made for the penalties/fines accruing from non-compliance.

If the legislation is complied with:

■ plant and equipment may be overstated e.g:
  – if the replaced shelves are not written off;
  – if the value of equipment, etc is impaired because the maturing cheese business is to be downsized;
■ inventory may be overstated (e.g. if insufficient allowance is made for the deterioration in maturing cheese resulting from handling it to replace the shelves);
■ GVF may no longer be a going concern if it does not have the produce to sell to its exclusive customers.

Grant

There is a risk that the grant received has become repayable. For example, if the terms of the grant specified a timeframe for the development which is now to be exceeded. In this case the grant should be presented as a payable in the balance sheet.

If the reason for deferring the implementation is related to cash flow problems, this could have implications for the going concern of GVF.

(b) Audit work on carrying amounts

Tutorial note: This part concerns audit work to be undertaken in respect of non-current tangible assets (the production animals in the goat herd and certain equipment) and inventories (the for-sale animals and cheese). One of the ‘tests’ for assessing whether or not a point is worthy of a mark will be whether or not the asset to which it relates is apparent. Points which are so vague that they could apply to ANY non-current asset for ANY entity, rather than those of GVF are unlikely to attract many marks, if any, at this level.

(i) Goat herd

■ Physical inspection of the number and condition of animals in the herd and confirming, on a test basis, that they are tagged (or otherwise ‘branded’ as being owned by GVF).
■ Tests of controls on management’s system of identifying and distinguishing held-for-sale animals (inventory) from the production herd (depreciable non-current assets).
■ Comparison of GVF’s depreciation policies (including useful lives, depreciation methods and residual values) with those used by other farming entities.
■ ‘Proof in total’, or other reasonableness check, of the depreciation charge for the herd for the year.
■ Observing test counts or total counts of animals held for sale.
■ Comparing carrying amounts of the kids, according to their weight and age, as at 30 September 2005 with their market values. (These may approximate to actual invoiced selling prices obtained by GVF.)

Tutorial note: Market value of the production herd could also be compared with its carrying amount to assess possible impairment. However, if value in use appears to be less than market value the herd should be sold rather than used for production.

(ii) Equipment used in the manufacture of Bachas Blue

Tutorial note: In the context of GVF, the principal issue to be addressed is whether or not the impairment loss previously recognised should be reversed (by considering the determination of value in use). Marks will also be awarded for consideration of depreciation, additions etc made specific to this equipment.

■ Agree cost less accumulated depreciation and impairment losses at the beginning of the year to prior year working papers (and/or last year’s published financial statements).
■ Recalculate the current year depreciation charge based on the carrying amount (as reduced by the impairment loss).
Calculate the carrying amount of the equipment as at 30 September 2005 without deduction of the impairment loss.

**Tutorial note:** *The equipment cannot be written back up to above this amount (IAS 36 ‘Impairment of Assets’).*

Agree management’s schedule of future cash flows estimated to be attributable to the equipment for a period of up to five years (unless a longer period can be justified) to approved budgets and forecasts.

Recalculate:
- on a sample basis, the make up of the cash flows included in the forecast;
- GVF’s weighted average cost of capital.

Review production records and sales orders for the year, as compared with the prior period, to confirm a ‘steady increase’.

Compare sales volume at 30 September 2005 with the pre-‘scare’ level to assess how much of the previously recognised impairment loss it would be prudent to write back (if any).

Scrubitize sales orders in the post balance sheet event period. Sales of such produce can be very volatile and another ‘incident’ could have sales plummeting again – in which case the impairment loss should not be reversed.

(iii) **Cheese**

- Examine the terms of sales to Abingdon Bank – confirm the bank’s legal title (e.g. if GVF were to cease to trade and so could not exercise buy-back option).
- Obtain a direct confirmation from the bank of the cost of inventory sold by GVF to Abingdon Bank and the amount re-purchased as at 30 September 2005 (the net amount being the outstanding loan).
- Inspect the cheese as at 30 September 2005 (e.g. during the physical inventory count) paying particular attention to the factors which indicate the age (and strength) of the cheese (e.g. its location or physical appearance).
- Observe how the cheese is stored – if on steel shelves discuss with GVF’s management whether its net realisable value has been reduced below cost.
- Test check, on a sample basis, the costing records supporting the cost of batches of cheese.
- Confirm that the cost of inventory sold to the bank is included in inventory as at 30 September 2005 and the nature of the bank security adequately disclosed.
- Agree the repurchase of cheese which has reached maturity at cost plus 7% per six months to purchase invoices (or equivalent contracts) and cash book payments.
- Test check GVF’s inventory-ageing records to production records. Confirm the carrying amount of inventory as at 30 September 2005 that will not be sold until after 30 September 2006, and agree to the amount disclosed in the notes to inventory as a ‘non-current’ portion.

2 **MCM**

(a) **Nature and purpose of a ‘due diligence’ review**

- ‘Due diligence’ may be defined as the process of systematically obtaining and assessing information in order to identify and contain the risks associated with a transaction (e.g. buying a business) to an acceptable level.
- The nature of such a review is therefore that it involves:
  - an investigation (e.g. into a company whose equity may be sold); and
  - disclosure (e.g. to a potential investor) of findings.
- A due diligence assignment consists primarily of inquiry and analytical procedures.

**Tutorial note:** *It will not, for example, routinely involve tests of control or substantive procedures.*

* As the timescale for a due diligence review is often relatively short, but wider in scope than the financial statements (e.g. business prospects, market valuation), there may be no expression of assurance.
- Its purpose is to find all the facts that would be of material interest to an investor or acquirer of a business. It may not uncover all such factors but should be designed with a reasonable expectation of so doing.
- Professional accountants will not be held liable for non-disclosure of information that failed to be uncovered if their review was conducted with ‘due diligence’.

(b) **Matters to be considered (before accepting the engagement)**

**Tutorial note:** *Although candidates may approach this part from a rote-learned list of ‘matters to consider’ it is important that answer points be tailored, in so far as the information given in the scenario permits, to the specifics of Plaza and MCM. It is critical that answer points should not contradict the scenario (e.g. assuming that it is Plaza’s auditor who has been asked to undertake the assignment).*

- Information about Duncan Seymour – What is the relationship of the chief finance officer to Plaza (e.g. is he on the management board)? By what authority is he approaching Andando to undertake this assignment?
- The purpose of the assignment must be clarified. Duncan’s approach to Andando is ‘to advise on a bid’. However, Andando cannot make executive decisions for a client but only provide the facts of material interest. Plaza’s management must decide whether or not to bid and, if so, how much to bid.
The scope of the due diligence review. It seems likely that Plaza will be interested in acquiring all of MCM’s business as its areas of operation coincide with Plaza’s. However it must be confirmed that Plaza is not merely interested in acquiring only the National or International business of MCM.

Andando’s competence and experience – Andando should not accept the engagement unless the firm has experience in undertaking due diligence assignments. Even then, the firm must have sufficient knowledge of the territories in which the businesses operate to evaluate whether all facts of material interest to Plaza have been identified.

**Tutorial note:** Candidates should be querying their competence and experience in the fields of retailing and training as though they were dealing with highly regulated or specialist industries such as banking or insurance.

- Whether Andando has sufficient resources (e.g. representative/associated offices), if any, in Europe and Asia to investigate MCM’s International business.
- Any factors which might impair Andando’s objectivity in reporting to Plaza the facts uncovered by the due diligence review. For example, if Duncan is closely connected with a partner in Andando or if Andando is the auditor of Frontiers.

**Tutorial note:** Candidates will not be awarded marks for going into ‘autopilot’ on independence issues. For example, this is a one-off assignment so size of fee is not relevant. Andando holding shares in MCM is not possible (since wholly-owned).

- Plaza’s rationale for wishing to acquire MCM. Presumably it is significant that MCM operates in the same territories as Plaza. Plaza may be wanting to provide extensive training programs in management, communications and marketing to its workforce.
- The relationship, if any, between Plaza and MCM in any of the territories. Plaza may be a major client of MCM. That is, Plaza is currently outsourcing training to MCM. Acquiring MCM would bring training in-house.

**Tutorial note:** Ascertaining what a purchaser hopes to gain from an acquisition before the assignment is accepted is important. The facts to be uncovered for a merger from which synergy is expected will be different from those relevant to acquiring an investment opportunity.

- Time available – Andando must have sufficient time to find all facts that would be of material interest to Plaza before disclosing their findings.
- The acceptability of any limitations – whether there will be restrictions on Andando’s access to information held by MCM (e.g. if there will not be access to board minutes) and personnel.
- The degree of secrecy required – this may go beyond the normal duties of confidentiality not to disclose information to outsiders (e.g. if unannounced staff redundancies could arise).
- Why Plaza’s current auditors have not been asked to conduct the due diligence review – especially as they are responsible for (and therefore capable of undertaking) the group audit covering the relevant countries.
- Andando should be allowed to communicate with Plaza’s current auditor:
  - to inform them of the nature of the work they have been asked to undertake; and
  - to enquire if there is any reason why they should not accept this assignment.
- In taking on Plaza as a new client Andando may have a later opportunity to offer external audit and other services to Plaza (e.g. internal audit).

(c) Due diligence review

(i) **Inquiries**

**Tutorial note:** These should be focussed on uncovering facts that may not be revealed by the audited financial statements (e.g. off balance sheet finance, contingencies, commitments and contracts) especially where knowledge may be confined to management.

- Do any members of MCM’s senior/executive management have contractual terms that will result in significant payouts to them (e.g. on change of ownership of the company or their being made redundant)?
- What contracts with clients, if any, will lapse or be made void in the event that MCM is purchased from Frontiers?
- What synergy or inter-company trading, if any, currently exists between MCM and Frontiers? For example, Frontiers may publish MCM’s training materials.
- Are there any major clients who are likely to be lost if MCM is purchased by Plaza (e.g. any competitor food retailers)?
- What are the principal terms of the operating leases relating to the International business’s premises?
- What penalties should be expected to be incurred if operating leases and/or contracts with training consultants are terminated?
- Has MCM entered into any purchase commitments since 31 December 2004 (e.g. to buy or lease further premises)?
- Who are the best trainers that Plaza should seek to retain after the purchase of MCM?
- What events since the audited financial statements to 31 December 2004 were published have made a significant impact on MCM’s assets, liabilities, operating capability and/or cash flows? (For example, storm damage to premises, major clients defaulting on payments, significant interest/foreign-exchange rate fluctuations, etc.)
- Are there any unresolved tax issues which have not been provided for in full?
- What effect will the purchase have on loan covenants? For example, term loans may be rendered repayable on a change of ownership.
Analytical procedures

Tutorial note: The range of valid answer points is very broad for this part.

- Review the trend of MCM’s profit (gross and net) for the last five years (say). Similarly earnings per share and gearing.
- For both the National and International businesses compare:
  - gross profit, net profit, and return on assets for the last five years (say);
  - actual monthly revenue against budget for the last 18 months (say). Similarly, for major items of expenditure such as:
    - full-time salaries;
    - freelance consultancy fees;
    - premises costs (e.g. depreciation, lease rentals, maintenance, etc);
    - monthly revenue (also costs and profit) by centre.
- Review projections of future profitability of MCM against net profit percentage at 31 December 2004 for:
  - the National business (10·4%);
  - the International business (38·1%); and
  - overall (19·9%).
- Review of disposal value of owned premises against book values.
- Compare actual cash balances with budget on a monthly basis and compare borrowings against loan and overdraft facilities.
- Compare the average collection period for International’s trade receivables month on month since 31 December 2004 (when it was nearly seven months, i.e. $3·7 \times 365$ days) and compare with the National business.
- Compare financial ratios for each of the national centres against the National business overall (and similarly for the International Business). For example:
  - gross and net profit margins;
  - return on centre assets;
  - average collection period;
  - average payment period;
  - liquidity ratio.
- Compare key performance indicators across the centres for the year to 31 December 2004 and 2005 to date. For example:
  - number of corporate clients;
  - number of delegates;
  - number of training days;
  - average revenue per delegate per day;
  - average cost per consultancy day.

3 VOLCAN

(a) Store impairment

(i) Matters

- Materiality
  - The cost of goodwill represents 3·1% of total assets and is therefore material.
  - However, after three years the carrying amount of goodwill ($2·2m) represents only 1·2% of total assets – and is therefore immaterial in the context of the balance sheet.
  - The annual amortisation charge ($1·1m) represents 11·6% profit before tax (PBT) and is therefore also material (to the income statement).
  - The impact of writing off the whole of the carrying amount would be material to PBT (23%).

Tutorial note: The temporary closure of the supermarket does not constitute a discontinued operation under IFRS 5 ‘Non-Current Assets Held for Sale and Discontinued Operations’.

- Under IFRS 3 ‘Business Combinations’ Volcan should no longer be writing goodwill off over five years but subjecting it to an annual impairment test.
- The announcement is after the balance sheet date and is therefore a non-adjusting event (IAS 10 ‘Events After the Balance Sheet Date’) insofar as no provision for restructuring (for example) can be made.
- However, the event provides evidence of a possible impairment of the cash-generating unit which is this store and, in particular, the value of goodwill assigned to it.
- If the carrying amount of goodwill ($2·2m) can be allocated on a reasonable and consistent basis to this and the other two stores (purchased at the same time) Volcan’s management should have applied an impairment test to the goodwill of the downsized store (this is likely to show impairment).
- If more than 22% of goodwill is attributable to the City Metro store – then its write-off would be material to PBT (22% \times $2·2m ÷ $9·5m = 5%).
- If the carrying amount of goodwill cannot be so allocated; the impairment test should be applied to the cash-generating unit that is the three stores (this may not necessarily show impairment).
Management should have considered whether the other four stores in Urvina (and elsewhere) are similarly impaired.

Going concern is unlikely to be an issue unless all the supermarkets are located in cities facing a downward trend in demand.

**Tutorial note:** Marks will be awarded for stating the rules for recognition of an impairment loss for a cash-generating unit. However, as it is expected that the majority of candidates will not deal with this matter, the rules of IAS 36 are not reproduced here.

(ii) **Audit evidence**

- Board minutes approving the store’s ‘facelift’ and documenting the need to address the fall in demand for it as a supermarket.
- Recomputation of the carrying amount of goodwill \( \frac{2}{5} \times $5.5m = $2.2m \).
- A schedule identifying all the assets that relate to the store under review and the carrying amounts thereof agreed to the underlying accounting records (e.g. non-current asset register).
- Recalculation of value in use and/or fair value less costs to sell of the cash-generating unit (i.e. the store that is to become the City Metro, or the three stores bought together) as at 31 March 2005.

**Tutorial note:** If just one of these amounts exceeds carrying amount there will be no impairment loss. Also, as there is a plan NOT to sell the store it is most likely that value in use should be used.

- Agreement of cash flow projections (e.g. to approved budgets/forecast revenues and costs for a maximum of five years, unless a longer period can be justified).
- Written management representation relating to the assumptions used in the preparation of financial budgets.
- Agreement that the pre-tax discount rate used reflects current market assessments of the time value of money (and the risks specific to the store) and is reasonable. For example, by comparison with Volcan’s weighted average cost of capital.
- Inspection of the store (if this month it should be closed for refurbishment).
- Revenue budgets and cash flow projections for:
  - the two stores purchased at the same time;
  - the other stores in Urvina; and
  - the stores elsewhere.

Also actual after-date sales by store compared with budget.

(b) **Reward scheme**

(i) **Matters**

- If the entire year’s revenue ($303m) attracted store points then the cost of the reward scheme in the year is at most $3.03m. This represents 1% of revenue, which is material to the income statement and very material (31.9%) to profit before tax (PBT).
- The proportion of customers who register for loyalty cards and the percentage of revenue (and profit) which they represent (which may vary from store to store depending on customer profile).
- In accordance with the assumption of accruals, which underlies the presentation and preparation of financial statements (The Framework/IAS 1 ‘Presentation of Financial Statements’), the expense and liability should be recognised as revenue is earned. (It is of the nature of a discount.)
- Any restrictions on the terms for converting points (e.g. whether they expire if not used within a specified time).
- To the extent that points have been awarded but not redeemed at 31 March 2005, Volcan will have a liability at the balance sheet date.
- Agree the total balance due to customers at the year end under the reward scheme to the sum of the points on individual customer reward cards.
- The proportion of reward points awarded which are not expected to be claimed (e.g. the ‘take up’ of points awarded may be only 80%, say).
- Whether reward points are valued at selling price or cost. For example, if the average gross profit margin is 20%, one point is equivalent to 0.8 cents of goods at cost.

(ii) **Audit evidence**

- New/updated systems documentation explaining how:
  - loyalty cards (and numbers) are issued to customers;
  - points earned are recorded at the point of sale; and
  - points are later redeemed on subsequent purchases.
- Walk-through tests (e.g. on registering customer applications and issuing loyalty cards, awarding of points on special offer items).
- Tests of controls supporting the extent to which audit reliance is placed on the accounting and internal control system. In particular, how points are extracted from the electronic tills (cash registers) and summarised into the weekly/monthly financial data for each store which underlies the financial statements.
Analytical procedures on the value of points awarded by store per month with explanations of variations ('variation analysis'). For example, similar proportions (not exceeding 1% of revenue) of points in each month might be expected by store – possibly increasing following any promotion of the ‘loyalty’ scheme.

Tutorial note: Within a close community, for example, a high proportion of customers might be expected to sign up for the reward scheme. However, in big cities, where a large proportion of the customers might be transitory (e.g. tourists or other visitors) the proportion may be much lower.

Tests of detail on a sample of transactions with customers undertaken at store visits. For example, for a sample of copy till receipts:
– check the arithmetic accuracy of points awarded (1 per $1 spent + special offers);
– agree points awarded for special offers to that week’s special offers;
– for cash discounts taken confirm the conversion of points is against the opening balance of points awarded (not against purchases just made).

(c) Site restoration

(i) Matters

The provision for site restoration represents nearly 2-5% of total assets and is therefore material if it is not warranted.

The estimated cost of restoring the site is a cost directly attributable to the initial measurement of the tangible fixed asset to the extent that it is recognised as a provision under IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’ (IAS 16 ‘Property, Plant and Equipment’).

A provision should not be recognised for site restoration unless it meets the definition of a liability, i.e:
– a present obligation;
– arising from past events;
– the settlement of which is expected to result in an outflow of resources embodying economic benefits.

The provision is overstated by nearly $0.34m since Volcan is not obliged to relocate the trees and de facto has only an obligation of $60,000 as at 31 March 2005 (being the penalty for having felled them). When considered in isolation, this overstatement is immaterial (representing only 0.2% of total assets and 3.6% of PBT).

It seems that even if there are local government regulations calling for site restoration there is no obligation unless the penalties for non-compliance are prohibitive (unlike the fines for the trees).

It is unlikely that commencement of site development has given rise to a constructive obligation, since past actions (disregarding the preservation of the trees) must dispel any expectation that Volcan will honour any pledge to restore the valley.

Whether commencing development of the site, and destroying the trees, conflicts with any statement of socio-environmental responsibility in the annual report.

(ii) Audit evidence

A copy of the planning application and permission granted setting out the penalties for non-compliance.

Payment of $60,000 to local government in May 2005 agreed to the bank statement.

The present value calculation of the future cash expenditure making up the $4·0m provision.

Tutorial note: Evidence supporting the calculation of $0·4m is irrelevant as there is no liability to be provided for.

Agreement that the pre-tax discount rate used reflects current market assessments of the time value of money (as for (a)).

Asset inspection at the site as at 31 March 2005.

Any contracts entered into which might confirm or dispute management’s intentions to restore the site. For example, whether plant hire (bulldozers, etc) covers only the period over which the warehouse will be constructed – or whether it extends to the period in which the valley would be ‘made good’.

4 HEGAS

(a) Auditor’s responsibilities for ‘other information’

The auditor has a professional responsibility to read other information to identify material inconsistencies with the audited financial statements (ISA 720 ‘Other Information in Documents Containing Audited Financial Statements’).

A ‘material inconsistency’ arises when other information contradicts that which is contained in the audited financial statements. It may give rise to doubts about:
– the auditor’s conclusions drawn from audit evidence; and
– the basis for the auditor’s opinion on the financial statements.

In certain circumstances, the auditor may have a statutory obligation (under national legislation) to report on other information (e.g. Management Report).

Even where there is no such obligation (e.g. chairman’s statement), the auditor should consider it, as the credibility of the financial statements may be undermined by any inconsistency.

The auditor must arrange to have access to the other information on a timely basis prior to dating the auditor’s report.
Material inconsistency

- If a material inconsistency is identified, the auditor should determine whether it is the audited financial statements or the other information which needs amending.
- If an amendment to the audited financial statements is required but not made, there will be disagreement, resulting in the expression of a qualified or adverse opinion. (Such a situation would be extremely rare.)
- Where an amendment to other information is necessary, but refused, the auditor’s report may include an emphasis of matter paragraph (since the audit opinion cannot be other than unqualified with respect to this matter).

Material misstatement of fact

- A material misstatement of fact in other information exists when information which is not related to matters appearing in the audited financial statements is incorrectly stated or presented in a misleading manner.
- If management do not act on advice to correct a material misstatement the auditors should document their concerns to those charged with corporate governance and obtain legal advice.

Tutorial note: Marks would be awarded here for the implications for the auditor’s report. However, such marks, which are for the restatement of knowledge would NOT be awarded again if repeated in answers to (b).

(b) Implications for the auditor’s report

(i) Management Report

- $4.5 million represents 3.75% of total assets, 1.7% of revenue and 48.9% profit before tax. As this is material by any criteria (exceeding all of 2% of total assets, 1/2% revenue and 5% PBT), the specific disclosure requirements of IASs need to be met (IAS 1 ‘Presentation of Financial Statements’).
- The Management Report discloses the amount and the reason for a material change in equity whereas the financial statements do not show the reason for the change and suggest that it is immaterial. As the increase in equity attributable to this adjustment is nearly half as much as that attributable to PBT there is a material inconsistency between the Management Report and the audited financial statements.
- Amendment to the Management Report is not required.

Tutorial note: Marks will be awarded for arguing, alternatively, that the Management Report disclosure needs to be amended to clarify that the revaluation arises from the first time implementation.

- Amendment to the financial statements is required because the disclosure is:
  - incorrect – as, on first adoption of IAS 40, the fair value adjustment should be against the opening balance of retained earnings; and
  - inadequate – because it is being ‘supplemented’ by additional disclosure in a document which is not within the scope of the audit of financial statements.
- Whilst it is true that the adoption of IAS 40 did not have a significant impact on results of operations, Hegas’s financial position has increased by nearly 4% in respect of the revaluation (to fair value) of just one asset category (investment properties). As this is significant, the statement in the notes should be redrafted.
- If the financial statements are not amended, the auditor’s report should be qualified ‘except for’ on grounds of disagreement (non-compliance with IAS 40) as the matter is material but not pervasive. Additional disclosure should also be given (e.g. that the ‘other difference’ is a fair value adjustment).
- However, it is likely that when faced with the prospect of a qualified auditor’s report Hegas’s management will rectify the financial statements so that an unmodified auditor’s report can be issued.

Tutorial note: Marks will be awarded for other relevant points e.g. citing IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’.

(ii) Chairman’s statement

Tutorial note: Hegas is privately-owned therefore IAS 14 ‘Segment Reporting’ does not apply and the proportion of revenue attributable to hydro-electricity will not be required to be disclosed in the financial statements. However, credit will be awarded for discussing the implications for the auditor’s report if it is regarded as a material inconsistency on the assumption that segment revenue (or similar) is reported in the financial statements.

- The assertion in the chairman’s statement, which does not fall within the scope of the audit of the financial statements, claims two things, namely that the company:
  1. is ‘one of the world’s largest generators of hydro-electricity’; and
  2. has ‘a dedicated commitment to accountable ethical professionalism’.
- To the extent that this information does not relate to matters disclosed in the financial statements it may give rise to a material misstatement of fact. In particular, the first statement presents a misleading impression of the company’s size. In misleading a user of the financial statements with this statement, the second statement is not true (as it is not ethical or professional to mislead the reader and potentially undermine the credibility of the financial statements).
- The first statement is a material misstatement of fact because, for example:
  - the company is privately-owned, and publicly-owned international/multi-nationals are larger;
  - the company’s main activity is civil engineering not electricity generation (only 14% of revenue is derived from HEP);
  - as the company ranks at best eighth against African companies alone it ranks much lower globally.
Hegas should be asked to reconsider the wording of the chairman’s statement (i.e. removing these assertions) and consult, as necessary, the company’s legal advisor.

If the statement is not changed there will be no grounds for qualification of the opinion on the audited financial statements. The audit firm should therefore take legal advice on how the matter should be reported.

However, an emphasis of matter paragraph may be used to report on matters other than those affecting the audited financial statements. For example, to explain the misstatement of fact if management refuses to make the amendment.

Tutorial note: Marks will also be awarded for relevant comments about the chairman’s statement being perceived by many readers to be subject to audit and therefore that the unfounded statement might undermine the credibility of the financial statements. Shareholders tend to rely on the chairman’s statement, even though it is not regulated or audited, because modern financial statements are so complex.

5 BARTOLOME

(a) Senior audit staff leaving for employment with client

Ethical and professional issues

- Leon’s independence is in doubt as he is threatened by self-interest. Leon’s objectivity in relation to the audit may be influenced by a desire to please and impress Moreno, as a prospective employer.

- There appears to be a lack of integrity on the part of James and/or Leon:
  - Leon should have confided in an appropriately senior manager/partner of Bartolome. In not doing so he has compromised the firm by having applied for a position with a client whilst assigned to the client.
  - James may lack integrity in having advised Bartolome of the short-listing if he gave an undertaking to Leon not to do so. (Conversely, James may be acting with integrity in advising Bartolome and as a matter of professional courtesy.)

- Leon should be removed from the audit assignment immediately regardless of whether or not he is finally appointed by Moreno.

- Leon should be given an oral warning (assuming this to be a first offence) for failing to adhere to Bartolome’s quality control policies and procedures (requiring disclosure to the firm of any threat of involvement with an audit client).

- The working papers for all interim audit work relating to Moreno performed under the supervision of Leon should be reviewed as soon as possible, before the balance sheet date (at the end of the month).

Implications for continuation with assignment

The assignment can be properly continued with a new senior in charge of the audit of the financial statements for the year ending 30 June 2005. Any planning of the year end and final audit work by Leon should be reviewed, amended as necessary and approved before any further work is undertaken.

(b) Unmodified auditor’s reports

Ethical and professional issues

- An unmodified opinion means, inter alia, that:
  - there are no material matters giving rise to disagreement with the auditor; and
  - the auditor’s report does not include an emphasis of matter paragraph (e.g. regarding going concern).

- By implication the auditor must have obtained sufficient appropriate evidence that notwithstanding the losses:
  - the going concern basis is appropriate to Ayora’s financial statements and any related matters (e.g. parental support) are adequately disclosed therein;
  - goodwill in Chatam’s consolidated financial statements is not materially impaired.

- Management’s written representation (that the goodwill is not impaired) must have been necessary (otherwise it should not have been asked for). This means that Bartolome does not have sufficient other audit evidence. This seems dubious as management should have carried out an impairment test to satisfy themselves that goodwill is not impaired. This test should similarly have satisfied Bartolome.

- If there is evidence that goodwill is impaired management’s refusal to write it down might be considered a fraud.

- The matter may cast doubt on the quality of audit evidence obtained in other areas. All other matters on which management representations have been obtained should be reviewed by another audit partner/manager.

- Charles Barrington is retiring next year and his share options would presumably be worth less if goodwill were written down. His position in this long-standing client suggests a familiarity threat.

- Bartolome may be threatened by self-interest to accept the representation as sufficient in order to retain the client.

- Bartolome may be unduly influenced by a combination of factors (familiarity and previous experience) and failing to exercise the necessary degree of professional scepticism.

Implications for continuation with assignment

There is no reason why the audit should not be continued. However, a change in senior audit staff and audit manager may be overdue. The unmodified auditor’s reports should be subject to a cold review and any quality control issues raised with the staff who conducted the audit.
(c) Threatened legal action

**Ethical and professional issues**

- An advocacy threat has arisen as Bartolome and Pinzon are in opposition concerning the fee note for the 2004 audit.
- If Pinzon’s allegations are true this may cast serious doubt on the integrity of Bartolome. Pinzon should be advised to take their claims first to ACCA’s Disciplinary Committee.
- If Bartolome has indeed charged full air fares when substantial discounts had been obtained this could be due to:
  - Bartolome incorrectly believing this to be an acceptable industry practice; or
  - a billing error/oversight.

  In either case Bartolome should issue a credit note, although this may be insufficient to make amends and salvage the auditor-client relationship.
- Bartolome may have legitimately claimed for full airfares if this was agreed in its contract (i.e. the terms of engagement) with Pinzon.

**Implications for continuation with assignment**

Unless the threat of legal action is amicably resolved very quickly (which is perhaps unlikely) Pinzon and Bartolome are in conflict. Bartolome cannot therefore be seen to be independent and so should tender their resignation as auditor for the year ending 31 December 2005 (assuming they were re-appointed and have not already been removed from office).

6 **MONEY LAUNDERING**

**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) **Meaning of the term**

- Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity ('dirty' money) allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.
- The term is widely defined to include:
  - possessing; or
  - in any way dealing with; or
  - concealing

  the proceeds of any crime ('criminal property').
- It also includes:
  - an attempt or conspiracy or incitement to commit such an offence; or
  - aiding, abetting, counselling or procuring the commission of such an offence.
- Further, it includes failure by an individual in a regulated sector to inform the financial intelligence unit (FIU), as soon as practicable, of knowledge or suspicion that another person is engaged in money laundering.

**Tutorial note:** *The FIU serves as a national centre for receiving (and, as permitted, requesting), analysing and disseminating suspicious transaction reports (STRs).*

(b) **Need for ethical guidance**

- Accountants (firms and individuals) working in a country that criminalises money laundering are required to comply with anti-money laundering legislation and failure to do so can lead to severe penalties. Guidance is needed because:
  - legal requirements are onerous;
  - money laundering is widely defined; and
  - accountants may otherwise be used, unwittingly, to launder criminal funds.
- Accountants need ethical guidance on matters where there is conflict between legal responsibilities and professional responsibilities. In particular, professional accountants are bound by a duty of confidentiality to their clients. Guidance is needed to explain:
  - how statutory provisions give protection against criminal action for members in respect of their confidentiality requirements;
  - when client confidentiality over-ride provisions are available.
- Further guidance is needed to explain the interaction between accountants’ responsibilities to report money laundering offences and other reporting responsibilities, for example:
  - reporting to regulators;
  - auditor’s reports on financial statements (ISA 700);
  - reports to those charged with governance (ISA 260);
  - reporting misconduct by members of the same body.
- Professional accountants are required to communicate with each other when there is a change in professional appointment (i.e. ‘professional etiquette’). Additional ethical guidance is needed on how to respond to a ‘clearance’ letter where a report of suspicion has been made (or is being contemplated) in respect of the client in question.

**Tutorial note:** *Although the term ‘professional clearance’ is widely used, remember that there is no ‘clearance’ that the incumbent accountant can give or withhold.*
Ethical guidance is needed to make accountants working in countries that do not criminalise money laundering aware of how anti-money laundering legislation may nevertheless affect them. Such accountants may commit an offence if, for example, they conduct limited assignments or have meetings in a country having anti-money laundering legislation (e.g. UK, Ireland, Singapore, Australia and the United States).

(c) Measures

The following measures are designed to assist in preventing professional accountants from being used for money laundering purposes:

- developing programmes against money laundering and terrorist financing;
- compliance officer;
- employee training programme;
- customer due diligence (CDD);
- establishing/enhancing record keeping systems for:
  - all transactions; and
  - the verification of clients’ identities;
- reporting of suspicious transactions;
- refusing to have relationships with 'shell banks'.

Tutorial note: Only FOUR are required.

Developing programmes

- Internal policies, procedures and controls should be established and recorded including:
  - compliance management arrangements (including appointment of a compliance officer);
  - an ongoing employee training programme;
  - an audit function to test the system.

Compliance officer

- Appointing a compliance officer having a suitable level of seniority and experience (e.g. one of the principals of an accountancy firm).
- Making alternative arrangements (e.g. appointing a deputy) when the compliance officer is going to be unavailable for a period of time (as reports have to be made as soon as is reasonably practicable).
- The compliance officer being made responsible for:
  - receiving and assessing money laundering reports from colleagues;
  - making reports to the FIU; and
  - ensuring that individuals are adequately trained.

Employee training programme

- Providing an employee training programme on:
  - relevant legislation (e.g. the main money laundering offences);
  - ethical guidance (e.g. ACCA’s ‘Guidance for Accountants’); and
  - the firm’s procedures to forestall and prevent money laundering.
- Establishing a culture of complying with money laundering requirements.
- Documenting the provision of training (to demonstrate compliance).
- Training methods may effectively include:
  - attending conferences, seminars and training courses run by external organizations; and
  - participating in computer based training courses.

Customer due diligence (CDD)

- Firms should not keep anonymous accounts or accounts in obviously fictitious names.
- Firms should verify the identity of their customers, when:
  - establishing business relations;
  - carrying out occasional transactions (e.g. above a designated threshold);
  - there is a suspicion of money laundering or terrorist financing; or
  - there is doubt about the reliability or adequacy of previously obtained customer identification data.

CDD measures should include:

- Identifying the customer and verifying that customer’s identity using reliable, independent source documents, data or information.

Tutorial note: Similarly identify and verify the beneficial owner.

- Obtaining information on the purpose and intended nature of the business relationship.
- Conducting ongoing due diligence on business relationships by scrutinising transactions to ensure that they are consistent with the firm’s knowledge of:
  - the customer;
  - their business and risk profile;
  - the source of funds.

Tutorial note: These requirements should apply to all new customers and existing customers on the basis of materiality and risk.
Record keeping

- Maintaining all client identification records together with a record of all transactions, in a full audit trail form.
- Maintaining records of transactions (both domestic or international) in a readily retrievable form for a period of at least five years (to facilitate swift compliance with information requests from the competent authorities).

**Tutorial note:** Such records must be sufficient to permit reconstruction of individual transactions (including the amounts and types of currency involved, if any) so as to provide, if necessary, evidence for prosecution of criminal activity.

- Retaining client verification records throughout the period of the relationship and for five years after termination of the relationship.
- Making available identification data and transaction records to domestic competent authorities upon appropriate authority.
- Applying ACCA’s Rules of Professional Conduct ‘Retention of books, files, working papers and other documents’.
- Paying special attention to all complex, unusual large transactions, and all unusual patterns of transactions, which have no apparent economic or visible lawful purpose (in accordance with ISA 240 ‘The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements’).

Client identification

- For an individual – inspecting official documents, with a photograph, establishing the client’s full name and permanent address, e.g:
  - a driving licence or passport, supported by;
  - a recent utility bill.
- For the entity – obtaining from the Registrar of Companies:
  - certificate of incorporation;
  - company’s registered address; and
  - a list of shareholders and directors.
- Checking the names of new clients against lists of known terrorists and other sanctions information.
- For trusts – ascertaining:
  - the nature and purpose of the trust;
  - the original source of funding; and
  - the identities of the trustees/controllers, principal settlers and beneficiaries.

Suspicion reporting

- Prompt reporting of suspicions to the (FIU) in a suspicious transaction report (STR).
- There should be no ‘de minimis’ concessions. Reporting should be irrespective of:
  - the amount involved; or
  - whether tax matters are involved.

**Tutorial note:** Attempted transactions should also be reported.

- Enhancing confidentiality of the source of reports by:
  - disclosing the compliance officer only once; and
  - not naming the personnel making reports to the compliance officer.
- Disclosing further information only if:
  - legally required to do so; or
  - otherwise justified, in the public interest.

Shell banks

**Tutorial note:** A ‘shell bank’ is a bank incorporated in a jurisdiction in which it has no physical presence and which is unaffiliated with a regulated financial group.

- Firms should guard against relationships with parties that permit their accounts to be used by shell banks.
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.
(a) Principal audit risks
Generally 1⁄2 mark for identification +
1 mark each point of explanation

Ideas
Industry
■ ‘farming’ (weather, etc)
■ bad press etc
Goat herd
■ goats – non-current tangible assets
■ kids – inventory/current assets
Rabida Red
■ cost ↑, supply problems ⇒ going concern
■ socio-environmental reporting
Bachas Blue
■ contingent liability_going concern?
■ impairment reversal (IAS 36)
■ value in use
Cheese
■ sale and repurchase/substance over form
■ capitalisation of borrowing costs (IAS 23)
■ non-compliance with legislation ⇒ provision
■ compliance with legislation ⇒ downsizing/impairment (wooden boards)/going concern
Grant
■ reason for implementation being deferred
■ repayable? ⇒ impact on cash flow

(b) Audit work on carrying amounts
Generally 1 mark each point,
max 4 each balance sheet item × 3

Ideas
■ FS assertions (valuation = quantity × price)
■ Qty exists?
■ Price = cost? depreciable amount? FV?
■ Procedures¹

¹ISA 500R identifies 7 procedures for obtaining audit evidence: Analytical, Inquiry, Confirmation, Inspection, Observation, Recalculation and Reperformance.
2 (a) ‘Due diligence’ review
Generally up to 2 marks for each of meaning, nature and purpose

Ideas
- meaning – definition/usage of term
- nature – review = investigation + disclosure
- purpose – fact finding
- investigation = inquiry + analytical procedures

(b) Matters to be considered
Generally 1/2 mark each matter identified (max 4 marks) and up to 1 1/2 marks a point explaining its relevance

‘General’ ideas
- purpose of the review/associated risk
- scope of the assignment
- competence and experience
- resources available
- reason for acquisition
- timescale
- confidentiality
- other service opportunities

Ideas specific to Plaza
- who is Duncan Seymour?
- why has auditor not been engaged for assignment?
- any relationship between Plaza and MCM

(c) Due diligence review
(i) Generally 1/2 – 1 mark each enquiry

Ideas
Concerning
- off balance sheet finance
- contingent liabilities
- commitments/contracts
- knowledge confined to management

(ii) Generally 1 – 1 1/2 marks each analytical procedure

Ideas
Level of procedure
- MCM as a whole
- National/International business
- Centres therein
Concerning
- income statement items (revenue/costs/profit)
- trade receivables
- financial ratios
- KPIs
- cash flow

\[2 \text{i.e. those ‘matters’ that might apply to any new appointment – though answer points must then be tailored to a due diligence review for Plaza}\]
3 (i) **Matters**

Generally 1 mark each comment

*max 6 marks each issue x 3*

**Ideas**
- materiality (assessed)
- relevant IASs (e.g. 10, 16, 18, 36, 37, 38 & IFRS 3) & ‘The Framework’
- risks (e.g. FS assertions – capital vs revenue, existence)
- responsibilities (e.g. environmental)

(ii) **Audit evidence**

Generally 1 mark each item of audit evidence (source)

*max 6 marks each issue x 3*

**Ideas (ISA 500)**
- oral vs written
- internal vs external
- auditor generated
- procedures

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**Marks**

max 12

(a) max 7
(b) max 6
(c) max 7

20
(a) **Auditor’s responsibilities for other information**

**Generally 1 mark each comment**

<table>
<thead>
<tr>
<th>Ideas (ISA 720)</th>
</tr>
</thead>
<tbody>
<tr>
<td>To read it</td>
</tr>
<tr>
<td>Material inconsistency</td>
</tr>
<tr>
<td>Statutory obligation (e.g. Management Report) vs</td>
</tr>
<tr>
<td>No such obligation (e.g. chairman’s statement)</td>
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<tr>
<td>Access to other information</td>
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<tr>
<td>Need for amendment</td>
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<tr>
<td>Implications for audit opinion …</td>
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<tr>
<td>… disagreement vs</td>
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<tr>
<td>… emphasis of matter</td>
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<tr>
<td>Material misstatement of fact</td>
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(b) **Implications for auditor’s report**

**Generally 1 mark a comment**

<table>
<thead>
<tr>
<th>Ideas</th>
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<tbody>
<tr>
<td>Management Report vs Statement of Changes in Equity</td>
</tr>
<tr>
<td>materiality assessed (up to 2 marks)</td>
</tr>
<tr>
<td>conclusion (material inconsistency)</td>
</tr>
<tr>
<td>no amendment to Management Report</td>
</tr>
<tr>
<td>amendments needed in financial statements</td>
</tr>
<tr>
<td>if no amendment ⇒ qualified opinion</td>
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<tr>
<td>if amended ⇒ unmodified report</td>
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**Chairman’s statement**

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<tbody>
<tr>
<td>other info not statutorily required</td>
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<tr>
<td>material misstatement of fact/misleading presentation</td>
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<tr>
<td>justification (status/activity/revenue, etc)</td>
</tr>
<tr>
<td>chairman’s statement to be amended</td>
</tr>
<tr>
<td>no grounds for qualification</td>
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<tr>
<td>emphasis of matter modification</td>
</tr>
</tbody>
</table>
Ethical and other professional issues
Generally 1 mark each ethical/professional issue/implication for continuation with assignment

Ideas
(a) Senior audit staff leaving for employment with client
   ■ objectivity (Leon)/self-interest threat
   ■ integrity (James and/or Leon)
   ■ professional courtesy
   ■ implications for staffing final audit
   ■ review of interim audit working paper
(b) Unmodified auditor’s reports
   ■ meaning of – no emphasis of matter (e.g. re going concern)
   ■ sufficiency of evidence (Ayora and Chatam)
   ■ reliance on management representations (and wider implications)
   ■ familiarity threat
   ■ self-interest threat
   ■ undue influence
(c) Threatened legal action
   ■ advocacy threat
   ■ integrity of Bartolome
   ■ industry practice?
   ■ legal obligation?
   ■ terms of engagement

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

15
6 (a) Money laundering
Generally 1 mark a point in explanation of the term up to max 3

Ideas (illustrative)
■ process … concealing … proceeds of criminal activity
■ possessing/dealing with/concealing 'criminal property'
■ attempt/conspiracy/incitement to commit offence
■ failure to inform FIU of knowledge or suspicion

(b) Need for ethical guidance for accountants
Generally 1 mark a point up to max 4

Ideas (illustrative)
■ Legal responsibilities
■ Risk of offence
■ Confidentiality
■ Other reporting responsibilities
■ Professional etiquette
■ Accountants working in other jurisdictions

(c) Preventative measures
(i) Generally 1/2 mark each measure stated, max 2
(ii) Up to max 2 marks each description of measures max 8

Ideas (any FOUR from)
■ Developing programmes/Internal controls and policies
■ Compliance officer
■ Employee training
■ Customer due diligence (CDD)
■ Record keeping
■ Client identification
■ Suspicious transaction reports (STRs)
■ 'Shell banks'