Answers
1 PAVIA CO

(a) Financial statement risks

**Tutorial note:** Note the timeframe. Financial statements for the year to 31 December 2006 are draft. Certain misstatements may therefore exist due to year-end procedures not yet having taken place.

**Revenue**
Revenue has increased by 6.4% \((\frac{645.4 - 606.5}{606.5})\). Revenue may be overstated through incorrect accounting treatment/cutoff of consignment sales. For example, if consignment sales to dealers before the year end have been included in 2006 revenue but are unsold at the year end.

**Tutorial note:** Revenue could be understated if consignment sales to dealers before the year end have been excluded from 2006 revenue but are sold at the year end.

Other revenue, $17.9 million, has fallen by 59% \((\frac{17.9 - 43.7}{43.7})\) and may be understated. For example, because the 2006 financial statements are only draft and year-end procedures may still identify sources of other revenue to be accounted for.

**Tutorial note:** An alternative analysis might be to note that other revenue from business activities has fallen to account for only 2.8% of draft revenue (2005 – 7.2%).

Revenue may be overstated in respect of sales under 0% finance arrangements entered into during the year. Revenue recognised from these vehicle sales should be the discounted amount of the receivable in three years time. The difference, that is finance income, should be recognised as a different source of revenue (if material) over three years.

**Other income**
Other income has increased by 8.3% \((\frac{15.6 - 14.4}{14.4})\) and may be overstated as it includes ‘income from the reversal of provision’. A reversal of a provision is not income but a reduction in expense previously recognised. Any reversals should be reflected by a reduction in the line item(s) where the related cost was previously recognised.

**Cost of materials/Change in inventories**
Cost of materials is the largest expense in the income statement. This cost (as adjusted for change in inventories) is steady at 51% of revenue (2005 – 50%) so if revenue is found to be understated this cost may be understated also (e.g. if year-end inventory is overstated due to insufficient allowance being made for slow-moving/damaged parts).

**Tutorial note:** Note that although cost of materials has increased by 16.5%, cost of materials used (i.e. as adjusted for change in inventories) has increased by only 9%. That is, approximately half of the increase is reflected in the replenishment of inventory levels (that fell in the prior period).

**Depreciation/amortisation**
Depreciation may be misstated in respect of assets under construction. For example, depreciation will be overstated if it is charged for a period before which the asset was ready for use or if it reclassified to the wrong category of asset with a higher depreciation rate.

**Employee benefits expense**
Employee benefits expense may be overstated as it has increased by 8.5% \((\frac{91.0 - 83.9}{83.9})\) although the average number of employees have fallen (by just 1%). This may be due to changes in year-end provisions (e.g. for holiday pay accruals) that have not yet been taken account of, or the misclassification of other expenses as employee benefits expense.

**Other expenses**
Other expenses have increased by 15.6% \((\frac{116.3 - 100.6}{100.6})\) and may be overstated if, for example:

- the warranty provision made at 31 December 2006 is overstated;
- period-end adjustments for pre-paid expenditures have still to be made.

**Interest income, net**
The net amount has fallen by 41.1% \((\frac{12.3 - 20.9}{20.9})\). This compounds the effects of interest income having fallen by a third \((\frac{16.8 - 25.1}{25.1})\) and interest expense having increased by 7.1% \((\frac{4.5 - 4.2}{4.2})\). Interest income may be understated as cash and cash equivalents have increased by 29.5% \((\frac{111.4 - 86.0}{86.0})\). This may be because some interest income accruing during the year to 31 December 2006 has still to be accounted for.
Intangible assets

Intangible assets have increased by 18% \((\frac{47.8 - 40.5}{40.5})\). Development costs included in intangible assets will be overstated if:

- any of the IAS 38 Intangible Assets recognition criteria cannot be demonstrated in respect of the $12.7 million costs incurred during the year;
- any impairment in the year has not yet been written off in accordance with IAS 36 Impairment of Assets.

In particular, $19.0 million ($12.7 million + $6.3 million) development expenditure on the Fox may be impaired as the launch of the new model has been postponed to next year and additional costs may have still to be incurred to correct the problems that arose during trials.

Property plant and equipment

Tangible assets have increased by 21.5% \((\frac{124.5 - 102.5}{102.5})\) and will be overstated if, for example:

- revenue expenditure is inappropriately capitalised (e.g. in assets under construction);
- disposals have not yet been accounted for (e.g. on any assets traded-in during the year);
- any depreciation for the year to 31 December 2006 has still to be accounted for (e.g. for the month of December).

Inventories

Inventories may be misstated as a full physical count to ascertain year-end quantities has still to be undertaken. Inventories have increased by 8.6% \((\frac{30.3 - 27.9}{27.9})\) and may be overstated if there is insufficient allowance for slow-moving raw materials.

Trade receivables

Trade receivables have increased by 45.3% \((\frac{73.1 - 50.3}{50.3})\) and may be overstated if:

- the allowance for non-recoverable debts at the end year has still to be assessed;
- 0% finance sales have been recorded at a gross instead of discounted amount.

Tutorial note: The discounted amount recorded during the year should then be ‘unwound’ to amortised cost at the balance sheet date.

Provisions

Provisions have increased by 31.9% \((\frac{160.1 - 121.4}{121.4})\) and will be overstated if items that do not represent liabilities at 31 December 2006 are included. Provision should not be made for future costs of deferred maintenance unless it represents a liability under an onerous contract (e.g. if Pavia took out non-cancellable maintenance contracts on assets that are no longer used).

Similarly, provision cannot be made for a future IT reorganisation as it is highly unlikely to meet the definition of a restructuring (IAS 37 Provisions, Contingent Liabilities and Contingent Assets).

Trade payables

Trade payables have increased by only 5.3% \((\frac{133.5 - 31.8}{31.8})\) and may be understated (as costs have generally increased by more than this) if year-end accruals have still to be accounted for.

Going concern

There does not appear to be any major threat to going concern, for example, substantial cash balances have increased. However, unpredictable supplies of parts for the assembly of Cipeta models could have consequences for assembly schedules generally and then for delivery of vehicles to dealers and customers, with potential loss of sales.

Profit has fallen substantially, by 25.6% \((\frac{61.6 - 82.8}{82.8})\) although revenue increased by 6.4%. There is a risk that overall revenue/income is understated and/or expenses overstated.

Tutorial note: Credit will be awarded for other answer points relevant to Pavia, for example:

- revenue may be overstated if no allowance is made for unrealised profits on parts transferred to assembly;
- disclosure risk arises if trade receivables arising from 0% finance sales are not separately disclosed as due after more than one year.

(b) Illustration of use of analytical procedures as audit evidence

Tutorial note: Note that ‘as audit evidence’ requires consideration of substantive analytical procedures rather than the identification of risks (relevant to part (a)).

Revenue

Analytical procedures may be used in testing revenue for completeness of recording (‘understatement’). The average selling price of a vehicle in 2005 was $68,830 ($526.0 million ÷ 7,642 vehicles). Applying this to the number of vehicles sold in 2006, might be projected to generate $698.8 million ($68,830 × 10,153) revenue from the sale of vehicles. The draft financial statements therefore show a potential shortfall of $110.8 million ($698.8 – 588.0 million) that is, 15.6%.
This should be investigated and substantiated through more detailed analytical procedures. For example, the number of vehicles sold should be analysed into models and multiplied by the list price of each for a more accurate estimate of potential revenue. The impact of discounts and other incentives (e.g., 0% finance) on the list prices should then be allowed for. If recorded revenue for 2006 (as per draft income statement adjusted for cutoff and consignment inventories) is materially lower than that calculated, detailed substantive procedures may be required in order to show that there is no material error.

‘Proof in total’/reasonableness tests

The material correctness, or otherwise, of income statement items (in particular) may be assessed through appropriate ‘proof in total’ calculations (or ‘reasonableness’ tests). For example:

- **Employee benefits costs**: the average number of employees by category (waged/salaried/apprenticed) $\times$ the average pay rate for each might prove that in total $\$91·0$ million (as adjusted to actual at 31 December 2006) is not materially misstated. The average number of employees needs to be checked substantively (e.g., recalculated based on the number of employees on each payroll) and the average pay rates (e.g., to rates agreed with employee representatives).

  **Tutorial note**: An alternative reasonableness might be to take last year’s actual adjusted for 2006 numbers of employees grossed-up for any pay increases during the year (pro-rated as necessary).

- **Depreciation**: the cost (or net book value) of each category of asset $\times$ by the relevant straight-line (or reducing balance) depreciation rate. If a ‘ballpark’ calculation for the year is materially different to the annual charge a more detailed calculation can be made using monthly depreciation calculations. The cost (or net book value) on which depreciation is calculated should be substantively tested, for example by agreeing brought forward balances to prior year working papers and additions to purchase invoices (costings in respect of assets under construction).

  **Tutorial note**: Alternatively, last year’s depreciation charge may be reconciled to this year’s by considering depreciation rates applied to brought forward balances with adjustments for additions/disposals.

- **Interest income**: an average interest rate for the year can be applied to the monthly balance invested (e.g., in deposit accounts) and compared with the amount recognised for the year to 31 December 2006 (as adjusted for any accrued interest per the bank letter for audit purposes). The monthly balances (or averages) on which the calculation is performed should be substantiated to bank deposit statements.

- **Interest expense**: if the cash balances do not go into overdraft then this may be similar expenses (e.g., prompt payment discounts to customers). If this is to particular dealers then a proof in total might be to apply the discount rate to the amounts invoiced to the dealer during the period.

*Immaterial items*

For immaterial items analytical procedures alone may provide sufficient audit evidence that amounts in the financial statements are not materially misstated so that detailed substantive procedures are not required. For example, a comparison of administration and distribution, maintenance and insurance costs for 2006 compared with 2005 may be sufficient to show that material error is highly unlikely. If necessary, further reasonableness tests could be performed. For example, considering insurance costs to value of assets insured or maintenance costs to costs of assets maintained.

*Ratio analysis*

Ratio analysis can provide substantive evidence that income statement and balance sheet items are not materially misstated by considering their inter-relationships. For example:

- **Asset turnover**: Based on the draft financial statements property, plant and equipment has turned over 5-2 times ($\frac{3645·5}{124·5}$) compared with 5-9 times in 2005. This again highlights that income may be overstated, or assets overstated (e.g., if depreciation is understated).

- **Inventory turnover**: Using cost of materials adjusted for changes in inventories this has remained stable at 10-9 times.

  **Tutorial note**: This is to be expected as in (a) the cost in the income statement has increased by 9% and the value of inventories by 8·5%.

Inventories represent the smallest asset value on the balance sheet at 31 December 2006 (7·8% of total assets). Therefore substantive procedures may be limited to agreeing physical count of material items (vehicles) and agreeing cutoff.

- **Average collection period**: This has increased to 41 days ($\frac{73·1}{645·5} \times 365$) from 30 days. Further substantive analysis is required, for example, separating out non-current amounts (for sales on 0% finance terms). Substantive procedures may be limited to confirmation of amounts due from dealers (and/or receipt of after-date cash) and agreeing cutoff of goods on consignment.

- **Payment periods**: This has remained constant at 37 days (2005 – 38 days). Detailed substantive procedures may be restricted to reconciling only major suppliers’ statements and agreeing the cutoff on parts purchased from them.

*(c) Principal audit work*

(i) **Development expenditure on the Fox model**

- Agree opening balance, $\$6·3$ million, to prior year working papers.

- Physically inspect assembly plant/factory where the Fox is being developed and any vehicles so far manufactured (e.g., for testing).
Substantiate costs incurred during the year, for example:
- goods (e.g. components) and services (e.g. consultants) to purchase invoices;
- labour (e.g. design engineers/technicians, mechanics, test drivers) to the payroll analysis;
- overheads (e.g. depreciation of development buildings and equipment, power, consumables) to management’s calculation of overhead absorption and underlying cost accounts.

Review of internal trials/test drive results (e.g. in reports to management and video recordings of events).

Reperform management’s impairment test of development expenditure. In particular recalculate value in use.

Tutorial note: *It is highly unlikely that a reasonable estimate of fair value less costs to sell could be made for so unique an asset.*

Substantiate the key assumptions made by management in calculating value in use. For example:
- the level of sales expected when the car is launched to advance orders (this may have fallen with the delay in the launch);
- the discount rate used to Pavia’s cost of capital;
- projected growth in sales to actual sales growth seen last time a new model was launched.

(ii) **Consignment inventory**
- Agree terms of sale to dealers to confirm the ‘principal – agent’ relationship between Pavia and dealers.
- Inspect proforma invoices for vehicles sent on consignment to dealers to confirm number of vehicles with dealers at the year end.
- Obtain direct confirmation from dealers of vehicles unsold at the year end.
- Physically inspect vehicles sold on consignment before the year end that are returned unsold by dealers after the year end (if any) for evidence of impairment.
- Perform cutoff tests on sales to dealers/trade receivables/vehicle inventory.
- If goods on consignment are treated as inventory agree their unit costs to be the same as for other vehicles in inventory.

(iii) **Warranty provision**
- Agree the principal assumptions in management’s estimate of liabilities under warranties to the terms of warranty as set out in contracts for sale of vehicle. For example:
  - the period for which warranties are given;
  - whether for parts replacement only or parts and labour;
  - exclusion clauses, perhaps for vehicles sold into a particular market, or used in a specified industry (e.g. film-making).
- Agree the reasonableness of management’s assumptions in the calculation of the provision. For example, the proportion of vehicles for which claims are made within three months, three to six months, six to nine months, etc.
- Substantiate the economic reality of the basis of management’s calculations. For example:
  - agree the number of vehicles sold each month to a summary sales report;
  - agree the calculation of average cost of a repair under warranty to job records;
  - test costs of repair on a sample basis (e.g. parts replaced to price lists and labour charges to hours worked (per job records) and charge-out rates).
- Consider the reasonableness of management’s estimate by comparing:
  - the actual cost of after-date repairs (say for three months) against the appropriate proportion of the provision made;
  - current year provision per vehicle sold against prior provision per vehicle sold.
- Assess management’s ability to make reliable estimates in this area by comparing last year’s provision with the actual repairs under warranty costs incurred during the year in respect of sales made in previous years.

Tutorial note: *The basis of management’s estimate may tend to overstate or understate the provision required and should be revised accordingly.*

- Agree the extent to which the provision takes account of (has been reduced by) any recourse to suppliers (e.g. in respect of faulty parts). For example:
  - by reviewing terms of purchases from major suppliers;
  - by examining records of replacement parts received free of charge.
(a) Potential advantages and disadvantages to RBG of outsourcing internal audit services

Advantages
- Affordability as there should be a cost benefit (budget savings) of replacing fixed cost full-time employees with a variable cost service.
- Further, if reliance on internal audit by the external auditors is substantially increased, the external audit fee may be reduced.
- Even if there are some changes in staff within the audit firm providing the internal audit services, there should be greater continuity than currently (as RBG has high employee turnover in this department).
- A wider range of industry-related expertise might be available to RBG from contracted-in auditors that would be too expensive to maintain internally. This may be particularly beneficial for ad hoc needs such as due diligence reviews for acquisitions or business continuity plans in the event of fire or flood.
- Experienced internal auditors will be available as and when needed (as typically the audit firm’s staff will be experienced) whereas RBG is currently losing its experienced employees to other departments. Outsourcing also offers flexibility to provide more staff at busy times.
- Outsourcing to an audit firm can provide geographic coverage and more advanced technology.
- Independent evaluation (e.g. of organisational risk) by the audit firm may provide new ideas for improvements (e.g. enhancing risk management).
- Better recommendations for improvements as the audit firm can suggest practical, tried and tested solutions and not just theoretical ones.
- Greater assistance to management in the evaluation of the performance of the external auditors (because the outsourced internal audit firm should be more experienced to make this assessment).
- Earlier assessment of the impact of changes in financial reporting requirements (because the outsourced internal audit firm should be technically up-to-date).
- Better utilisation of core competencies, for example, management will have more time to focus on strategic objectives.
- The audit firm may provide a customer-focused service that could be lacking in an in-house department.

Disadvantages
- Over time the audit firm may command a greater premium for internal audit services as RBG becomes dependent on the audit firm’s knowledge of the group (i.e. cost savings may be only short term).
- An outsourced department may not be as effective as an in-house department if, for example, the audit firm’s staff assigned to RBG are changed regularly.
- The audit firm’s staff may not understand RBG’s business as well as employed staff if, for example, they work only part-time on the RBG assignment. Employed staff are more likely to have a broader perspective of the group from having worked in other parts of it.
- The internal audit staff’s principle allegiance will be to the audit firm, not RBG. If the services provided by the audit firm are not seen to be an integral part of management, the company may not buy-in to their suggestions.
- If the audit firm plans to schedule internal audit services to RBG in its ‘quiet periods’, they may not always be available when needed.
- RBG will lose a valuable management training ground that provides a source of future managers. The internal audit department’s current loss of high performing employees to other departments is a gain to the other departments.

(b) Principal matters to be included in submission to provide internal audit services
- Introduction/background – details about York including its organisation (of functions), offices (locations) and number of internal auditors working within each office. The office that would be responsible for managing the contract should be stated.
- A description of York’s services most relevant to RBG’s needs (e.g. in the areas of risk management, IT audits, value for money (VFM) and corporate governance).
- Client-specific issues identified. For example, revenue audits will be required routinely for control purposes and to substantiate the contingent rents due. Other areas of expertise that RBG may be interested in taking advantage of, for example, special projects such as acquisitions and mergers.
York’s approach to assessing audit needs including the key stages and who will be involved. For example:

1. Preliminary – review of business, industry and the entity’s operating characteristics
2. Planning – including needs analysis and co-ordination with external audit plan
3. Post-Audit – assurance that activities were effectively and efficiently executed
4. Review – of services provided, reports issued and management’s responses.

A description of internal audit tools used and methodologies/approach to audit fieldwork including use of embedded audit software and programs developed by York.

A description of York’s systems-based audit, the IT issues to be addressed and the technological support that can be provided.

Any training that will be offered to RBG’s managers and staff, for example, in a risk management approach.

A description and quantity of resources, in particular the number of full-time staff, to be deployed in providing services to RBG. An outline of RBG’s track record in human resource retention and development.

Relevant experience – e.g. in internal and external audit in the retail industry. The relative qualifications and skills of each grade of audit staff and the contract manager in particular.

Insurance certifications covering, for example, public liability and professional indemnity insurance.

Work ethic policies relating to health and safety, equal opportunities and race relations.

How York ensures quality throughout the internal audit process including standards to be followed (e.g. Institute of Internal Auditors’ standards).

Sample report templates – e.g. for reporting the results of risk analysis, audit plans and quarterly reporting of findings to the Audit and Risk Management Committee.

Current clients to whom internal audit services are provided from whom RBG will be able to take up references, by arrangement, if York is short-listed.

Any work currently carried out/competed for that could cause a conflict of interest (and the measures to avoid such conflicts).

Fees (daily rates) for each grade of staff and travel and other expenses to be reimbursed. An indication of price increases, if any, over the three-year contract period. Invoicing terms (e.g. on presentation of reports) and payment terms (e.g. the end of the month following receipt of the invoice).

Performance targets to be met such as deadlines for completing work and submitting and issuing reports.

(c) Impact on the audit of the financial statements

Tutorial note: The answer to this part should reflect that it is not the external auditor who is providing the internal audit services. Thus comments regarding objectivity impairment are not relevant.

As Grey & Co is likely to be placing some reliance on RBG’s internal audit department in accordance with ISA 610 Considering the Work of Internal Auditing the degree of reliance should be reassessed.

The appointment will include an evaluation of organisational risk. The results of this will provide Grey with evidence, for example:

– supporting the appropriateness of the going concern assumption;
– of indicators of obsolescence of goods or impairment of other assets.

As the quality of internal audit services should be higher than previously, providing a stronger control environment, the extent to which Grey may rely on internal audit work could be increased. This would increase the efficiency of the external audit of the financial statements as the need for substantive procedures should be reduced.

However, if internal audit services are performed on a part-time basis (e.g. fitting into the provider’s less busy months) Grey must evaluate the impact of this on the prevention, detection and control of fraud and error.

The internal auditors will provide a body of expertise within RBG with whom Grey can consult on contentious matters.

Tutorial note: Appropriate credit will be given for arguing that less reliance may be placed on internal audit in this year of change of provider.
3 SEYMOUR CO

(a) Costs of Tournose

(i) Matters

- Development costs at 30 September 2005 have a carrying value of $3 million (i.e. $4 million less 5 years’ amortisation at 5% p.a.) that represents 7.4% of total assets at that date (5.6% of total assets at 30 September 2006) and are therefore material.

- Straight line annual amortisation based on 20 year estimate of useful life ($200,000) represents 1.5% of 2006 profit before tax (PBT) and is not material. The patent cost, $11,600 is very immaterial.

- Management must review the useful life of the development costs at 30 September 2006 (IAS 38 Intangible Assets).

- The competitor’s announcement during the current year (to 30 September 2006) may provide evidence that:
  - the useful life of the development costs is substantially less than the remaining period covered by the patent;
  - there has been a change in the expected pattern of consumption of future economic benefits;
  - development costs are impaired (i.e. recoverable amount is less than carrying value).

Tutorial note: A ‘timeline’ is useful to visualise the financial statement impact:

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<tr>
<th>Announcement</th>
<th>1/10/05</th>
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<td>Remaining useful life 15 years ⇒ $200,000 amortisation p.a.?</td>
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<td>Or just 3 years ⇒ £1 million amortisation p.a?</td>
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- A change in the estimated useful life should be accounted for as a change in accounting estimate in accordance with IAS 8 Accounting Policies, Changes in Accounting Estimates and Errors. For example, if the development costs have little, if any, useful life after the introduction of the alternative drug (‘worst case’ scenario), the carrying value ($3 million) should be written off over the current and remaining years, i.e. $1 million p.a. The increase in amortisation/decrease in carrying value ($800,000) is material to PBT (6%) and total assets (1.5%).

- Similarly a change in the expected pattern of consumption of the future economic benefits should be accounted for as a change in accounting estimate (IAS 8). For example, it may be that the useful life is still to 2020 but that the economic benefits may reduce significantly in two years time.

- After adjusting the carrying amount to take account of the change in accounting estimate(s) management should have tested it for impairment and any impairment loss recognised in profit or loss.

(ii) Audit evidence

- $3 million carrying amount of development costs brought forward agreed to prior year working papers and financial statements.

- A copy of the press release announcing the competitor’s alternative drug.

- Management’s projections of future cashflows from Tournose-related sales as evidence of the useful life of the development costs and pattern of consumption.

- Reperformance of management’s impairment test on the development costs: Recalculation of management’s calculation of the carrying amount after revising estimates of useful life and/or consumption of benefits compared with management’s calculation of value in use.

- Sensitivity analysis on management’s key assumptions (e.g. estimates of useful life, discount rate).

- Written management representation on the key assumptions concerning the future that have a significant risk of causing material adjustment to the carrying amount of the development costs. (These assumptions should be disclosed in accordance with IAS 1 Presentation of Financial Statements.)
(b) Goodwill

(i) Matters

- Cost of goodwill, $1.8 million, represents 3.4% consolidated total assets and is therefore material.
  
  **Tutorial note:** Any assessments of materiality of goodwill against amounts in Aragon’s financial statements are meaningless since goodwill only exists in the consolidated financial statements of Seymour.

- It is correct that the goodwill is not being amortised (IFRS 3 *Business Combinations*). However, it should be tested at least annually for impairment, by management.

- Aragon has incurred losses amounting to $1.1 million since it was acquired (two years ago). The write-off of this amount against goodwill in the consolidated financial statements would be material (being 61% cost of goodwill, 8.3% PBT and 2.1% total assets).

- The cost of the investment ($4.5 million) in Seymour’s separate financial statements will also be material and should be tested for impairment.

- The fair value of net assets acquired was only $2.7 million ($4.5 million less $1.8 million). Therefore the fair value less costs to sell of Aragon on other than a going concern basis will be less than the carrying amount of the investment (i.e. the investment is impaired by at least the amount of goodwill recognised on acquisition).

- In assessing recoverable amount, value in use (rather than fair value less costs to sell) is only relevant if the going concern assumption is appropriate for Aragon.

- Supporting Aragon financially may result in Seymour being exposed to actual and/or contingent liabilities that should be provided for/disclosed in Seymour’s financial statements in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(ii) Audit evidence

- Carrying values of cost of investment and goodwill arising on acquisition to prior year audit working papers and financial statements.

- A copy of Aragon’s draft financial statements for the year ended 30 September 2006 showing loss for year.

- Management’s impairment test of Seymour’s investment in Aragon and of the goodwill arising on consolidation at 30 September 2006. That is a comparison of the present value of the future cash flows expected to be generated by Aragon (a cash-generating unit) compared with the cost of the investment (in Seymour’s separate financial statements).

- Results of any impairment tests on Aragon’s assets extracted from Aragon’s working paper files.

- Analytical procedures on future cash flows to confirm their reasonableness (e.g. by comparison with cash flows for the last two years).

- Bank report for audit purposes for any guarantees supporting Aragon’s loan facilities.

- A copy of Seymour’s ‘comfort letter’ confirming continuing financial support of Aragon for the foreseeable future.

(c) Discontinued operation

(i) Matters

- Petcare product revenue represents 12% consolidated revenue and is therefore very material. Consolidated PBT would be 10% higher if the loss on the petcare products was excluded – so also material in relation to Seymour’s results.
  
  **Tutorial note:** Consider the ‘picture’:

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<thead>
<tr>
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- The ‘petcare’ operation has been correctly treated as a discontinued operation if all the FRS 3 *Reporting Financial Performance* criteria have been met. In particular, that the termination has ceased permanently before 31 December 2006 (or the date on which the financial statements are approved, if earlier).

- That the revenue and loss/profit have been reported separately indicates that the assets, liabilities, results and operations are clearly distinguishable for financial reporting purposes, as well as physically and operationally.

  **Tutorial note:** In the circumstances it is likely that the termination was occurred immediately or very soon after the announcement on 30 November.
The discontinuation of the product line after the balance sheet date provides additional evidence that, as at the balance sheet date, it was of poor quality. Therefore, as at the balance sheet date:

– an allowance (‘provision’) may be required for credit notes for returns of products after the year end that were sold before the year end;

– goods returned to inventory should be written down to net realisable value (may be nil);

– any plant and equipment used exclusively in the production of the petcare range of products should be tested for impairment;

– any material contingent liabilities arising from legal claims should be disclosed.

(ii) **Audit evidence**

– A copy of Seymour’s announcement (external ‘press release’ and any internal memorandum).

– Credit notes raised/refunds paid after the year end for faulty products returned.

– Condition of products returned as inspected during physical attendance of inventory count.

– Correspondence from customers claiming reimbursement/compensation for poor quality.

– Direct confirmation from legal adviser (solicitor) regarding any claims for customers including estimates of possible payouts.
(a) Reporting non-compliance

Non-compliance refers to acts of omission or commission by the entity being audited, either intentional or unintentional, that are contrary to the prevailing laws or regulations.

To management

Regarding non-compliance that comes to the auditor’s attention the auditor should, as soon as practicable, either:

■ communicate with those charged with governance; or
■ obtain audit evidence that they are appropriately informed.

However, the auditor need not do so for matters that are clearly inconsequential or trivial and may reach agreement in advance on the nature of such matters to be communicated.

If in the auditor’s judgment the non-compliance is believed to be intentional and material, the auditor should communicate the finding without delay.

If the auditor suspects that members of senior management are involved in non-compliance, the auditor should report the matter to the next higher level of authority at the entity, if it exists (e.g. an audit committee or a supervisory board). Where no higher authority exists, or if the auditor believes that the report may not be acted upon or is unsure as to the person to whom to report, the auditor would consider seeking legal advice.

To the users of the auditor’s report on the financial statements

If the auditor concludes that the non-compliance has a material effect on the financial statements, and has not been properly reflected in the financial statements, the auditor expresses a qualified (i.e. ‘except for disagreement’) or an adverse opinion.

If the auditor is precluded by the entity from obtaining sufficient appropriate audit evidence to evaluate whether or not non-compliance that may be material to the financial statements has (or is likely to have) occurred, the auditor should express a qualified opinion or a disclaimer of opinion on the financial statements on the basis of a limitation on the scope of the audit.

Tutorial note: For example, if management denies the auditor access to information from which he would be able to assess whether or not illegal dumping had taken place (and, if so, the extent of it).

If the auditor is unable to determine whether non-compliance has occurred because of limitations imposed by circumstances rather than by the entity, the auditor should consider the effect on the auditor’s report.

Tutorial note: For example, if new legal requirements have been announced as effective but the detailed regulations are not yet published.

To regulatory and enforcement authorities

The auditor’s duty of confidentiality ordinarily precludes reporting non-compliance to a third party. However, in certain circumstances, that duty of confidentiality is overridden by statute, law or by courts of law (e.g. in some countries the auditor is required to report non-compliance by financial institutions to the supervisory authorities). The auditor may need to seek legal advice in such circumstances, giving due consideration to the auditor’s responsibility to the public interest.

(b) (i) Appropriateness of audit opinion given

Tutorial note: The answer points suggested by the marking scheme are listed in roughly the order in which they might be extracted from the information presented in the question. The suggested answer groups together some of these points under headings to give the analysis of the situation a possible structure.

Heading

■ The opinion paragraph is not properly headed. It does not state the form of the opinion that has been given nor the grounds for qualification.
■ The opinion ‘the financial statements do not give a true and fair view’ is an ‘adverse’ opinion.
■ That ‘provision should be made’, but has not, is a matter of disagreement that should be clearly stated as non-compliance with IAS 36. The title of IAS 36 Impairment of Assets should be given in full.
■ The opinion should be headed ‘Disagreement on Accounting Policies – Inappropriate Accounting Method – Adverse Opinion’.

1 ISA 250 does not specify with whom agreement should be reached but presumably with those charged with corporate governance (e.g. audit committee or other supervisory board).
Content

■ It is appropriate that the opinion paragraph should refer to the note(s) in the financial statements where the matter giving rise to the modification is more fully explained. However, this is not an excuse for the audit opinion being ‘light’ on detail. For example, the reason for impairment could be summarised in the auditor’s report.

■ The effects have not been quantified, but they should be quantifiable. The maximum possible loss would be the carrying amount of the non-current assets identified as impaired.

■ It is not clear why the directors have been ‘unable to quantify the amounts’. Since impairments should be quantifiable any ‘inability’ suggest a limitation in scope of the audit, in which case the opinion should be disclaimed (or ‘except for’) on grounds of lack of evidence rather than disagreement.

■ The wording is confusing. ‘Failure to provide’ suggests disagreement. However, there must be sufficient evidence to support any disagreement. Although the directors cannot quantify the amounts it seems the auditors must have been able to (estimate at least) in order to form an opinion that the amounts involved are sufficiently material to warrant a qualification.

■ The first paragraph refers to ‘non-current assets’. The second paragraph specifies ‘tangible and intangible assets’. There is no explanation why or how both tangible and intangible assets are impaired.

■ The first paragraph refers to ‘profit or loss’ and the second and third paragraphs to ‘loss’. It may be clearer if the first paragraph were to refer to recognition in the income statement.

■ It is not clear why the failure to recognise impairment warrants an adverse opinion rather than ‘except for’. The effects of non-compliance with IAS 36 are to overstate the carrying amount(s) of non-current assets (that can be specified) and to understate the loss. The matter does not appear to be pervasive and so an adverse opinion looks unsuitable as the financial statements as a whole are not incomplete or misleading. A loss is already being reported so it is not that a reported profit would be turned into a loss (which is sometimes judged to be ‘pervasive’).

Prior year

■ As the 2005 auditor’s report, as previously issued, included an adverse opinion and the matter that gave rise to the modification:
  – is unresolved; and
  – results in a modification of the 2006 auditor’s report,

  the 2006 auditor’s report should also be modified regarding the corresponding figures (ISA 710 Comparatives).

■ The 2006 auditor’s report does not refer to the prior period modification nor highlight that the matter resulting in the current period modification is not new. For example, the report could say ‘As previously reported and as more fully explained in notes ….’ and state ‘increase the loss by $x (2005 – $y)’.

(ii) Implications for audit opinion on consolidated financial statements of Cleeves

■ If the potential adjustments to non-current asset carrying amounts and loss are not material to the consolidated financial statements there will be no implication. However, as Howard is material to Cleeves and the modification appears to be ‘so material’ (giving rise to adverse opinion) this seems unlikely.

  Tutorial note: The question clearly states that Howard is material to Cleeves, thus there is no call for speculation on this.

■ As Howard is wholly-owned the management of Cleeves must be able to request that Howard’s financial statements are adjusted to reflect the impairment of the assets. The auditor’s report on Cleeves will then be unmodified (assuming that any impairment of the investment in Howard is properly accounted for in the separate financial statements of Cleeves).

■ If the impairment losses are not recognised in Howard’s financial statements they can nevertheless be adjusted on consolidation of Cleeves and its subsidiaries (by writing down assets to recoverable amounts). The audit opinion on Cleeves should then be unmodified in this respect.

■ If there is no adjustment of Howard’s asset values (either in Howard’s financial statements or on consolidation) it is most likely that the audit opinion on Cleeves’s consolidated financial statements would be ‘except for’. (It should not be adverse as it is doubtful whether even the opinion on Howard’s financial statements should be adverse.)

  Tutorial note: There is currently no requirement in ISA 600 to disclose that components have been audited by another auditor unless the principal auditor is permitted to base their opinion solely upon the report of another auditor.
Professional Accountants

- Professional Accountants are members of an IFAC member body. They may be:
  - in public practice or employed professionals;
  - a sole practitioner, partnership or corporate body.

- Professional Accountants in Public Practice (‘practitioners’) are:
  - each partner (or person occupying a position similar to that of a partner); and
  - each employee in a practice providing professional services to a client irrespective of their functional classification (e.g. audit, tax or consulting); and
  - professional accountants in a practice having managerial responsibilities.

  This term is also used to refer to a firm of professional accountants in public practice.

- Employed Professional Accountants are professional accountants employed in industry, commerce, the public sector or education.

FAQs

(i) Information Technology (IT) services

The greatest threats to independence arise from the provision of any service which involves auditors in:
- auditing their own work;
- the decision-making process;
- undertaking management functions of the client.

IT services potentially pose all these threats:
- self-interest threat – on-going services that provide a large proportion of Boleyn’s annual fees will contribute to a threat to objectivity;
- self-review threat – e.g. when IT services provided involve (i) the supervision of the audit client’s employees in the performance of their normal duties; or (ii) the origination of electronic data evidencing the occurrence of transactions;
- management threat – e.g. when the IT services involve making judgments and taking decisions that are properly the responsibility of management.

Thus, services that involve the design and implementation of financial IT systems that are used to generate information forming a significant part of a client’s accounting system or financial statements is likely to create significant ethical threats.

Possible safeguards include:
- disclosing and discussing fees with the client’s audit committees (or others charged with corporate governance);
- the audit client providing a written acknowledgment (e.g. in an engagement letter) of its responsibility for:
  - establishing and monitoring a system of internal controls;
  - the operation of the system (hardware or software); and
  - the data used or generated by the system;
- the designation by the audit client of a competent employee (preferably within senior management) with responsibility to make all management decisions regarding the design and implementation of the hardware or software system;
- evaluation of the adequacy and results of the design and implementation of the system by the audit client;
- suitable allocation of work within the firm (i.e. staff providing the IT services not being involved in the audit engagement and having different reporting lines); and
- review of the audit opinion by an audit partner who is not involved in the audit engagement.

Services in connection with the assessment, design and implementation of internal accounting controls and risk management controls are not considered to create a threat to independence provided that the firm’s personnel do not perform management functions.
It would be acceptable to provide IT services to an audit client where the systems are not important to any significant part of the accounting system or the production of financial statements and do not have significant reliance placed on them by the auditors, provided that:

- a member of the client’s management has been designated to receive and take responsibility for the results of the IT work undertaken; and
- appropriate safeguards are put in place (e.g. using separate partners and staff for each role and review by a partner not involved in the audit engagement).

It would also generally be acceptable to provide and install off-the-shelf accounting packages to an audit client.

(ii) Corporate hospitality

A partner in an audit firm is obviously in a position to influence the conduct and outcome of an audit. Therefore a partner being on ‘too friendly’ terms with an audit client creates a familiarity threat. Other members of the audit team may not exert as much influence on the audit.

A self-interest threat may also be perceived (e.g. if corporate hospitality is provided to keep a prestigious client).

There is no absolute prohibition against corporate hospitality provided:

- the value attached to such hospitality is ‘insignificant’; and
- the ‘frequency, nature and cost’ of the hospitality is reasonable.

Thus, flying the directors of an audit client for weekends away could be seen as significant. Similarly, entertaining an audit client on a regular basis could be seen as unacceptable.

Partners and staff of Boleyn will need to be objective in their assessments of the significance or reasonableness of the hospitality offered. (Would ‘a reasonable and informed third party’ conclude that the hospitality will or is likely to be seen to impair your objectivity?)

If they have any doubts they should discuss the matter in the first instance with the audit engagement partner, who should refer the matter to the ethics partner if in doubt.

(iii) Cross selling services

The practice of cross selling is intended to give incentives to members of audit teams to concentrate their efforts on the selling of non-audit services to audit clients.

It is not inappropriate for an audit firm to cross sell or for members of the audit team to recognise on an ongoing basis the need of a client to have non audit services. However it should not be an aim of the audit team member to seek out such opportunities.

Boleyn should have policies and procedures to ensure that, in relation to each audit client:

- the objectives of the members of the audit team do not include selling of non-audit services to the audit client;
- the criteria for evaluating the performance of members of the audit team do not include success in selling non-audit services to the audit client;
- no specific element of remuneration of a member of the audit team and no decision concerning promotion within the audit firm is based on his or her success in selling non-audit services to the audit client; and
- the ethics partner being available for consultation when needed.

Therefore objectives such as the following are inappropriate:

- to meet a quota of opportunities;
- to specifically make time to discuss with clients which non-audit services they should consider;
- to develop identified selling opportunities.

An audit engagement partner’s performance should be judged on the quality and integrity of the audit only. There are no restrictions on normal partnership profit-sharing arrangements.
6 CERTAIN PRACTICES

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) ‘Lowballing’

Explanation of term

‘Lowballing’ is the ‘loss-leading’ practice in which auditors compete for clients by reducing their fees for statutory audits. Lower audit fees are then compensated by the auditor carrying out more lucrative non-audit work (e.g. consultancy and tax advice). Audits may even be offered for free.

Such ‘predatory pricing’ may undercut an incumbent auditor to secure an appointment into which higher price consultancy services may be sold.

Ethical risks

There is a risk of incompetence if the non-audit work does not materialise and the lowballing firm comes under pressure to cut corners or resort to irregular practices (e.g. the falsification of audit working papers) in order to ‘keep within budget’. However, a lack of audit quality may only be discovered if the situation arises that the company collapses and the auditors are charged with negligence.

If, rather than comprise the quality of the audit, an audit firm substantially increases audit fees, a fee dispute could arise. In this case the client might refuse to pay the higher fee. It could be difficult then for the firm to take the matter to arbitration if the client was misled. Thus an advocacy threat may arise.

Financial dependence is a direct incentive that threatens independence. A self-interest threat therefore arises when, having secured the audit, the audit firm needs the client to retain its services in order to recoup any losses initially incurred.

The provision of many other services gives rise to a self-review threat (as well as a self-interest threat).

Sufficiency of current ethical guidance

In current ethical guidance, the fact that an accountancy firm quotes a lower fee than other tendering firms is not improper, providing that the prospective client is not misled about:

– the precise range of services that the quoted fee is intended to cover; and
– the likely level of fees for any other work undertaken.

This is clearly insufficient to prevent the practice of lowballing.

Legal prohibitions on the provision of many non-audit services (e.g. bookkeeping, financial information systems design and implementation, valuation services, actuarial services, internal audit (outsourced), human resource services for executive positions, investment and legal services) should make lowballing a riskier pricing strategy. This may curb the tendency to lowball.

Lowballing could be eliminated if, for example, auditors were required to act ‘exclusively as auditors’. Although regulatory environments have moved towards this there is not a total prohibition on non-audit services.

(b) ‘Opinion shopping’

Explanation of term

‘Opinion shopping’ occurs when management approach auditing firms (other than their incumbent auditors) to ask their views on the application of accounting standards or principles to specific circumstances or transactions.

Ethical risks

The reasons for ‘opinion shopping’ may be:

■ to find alternative auditors; or
■ to get advice on a matter of contention with the incumbent auditor.

The member who is not the entity’s auditor must be alert to the possibility that their opinion – if it differs from that of the incumbent auditor – may create undue pressure on the incumbent auditor’s judgement and so threaten the objectivity of the audit.

Furthermore, by aligning with the interests of management when negotiating taking on an engagement, an incoming auditor may compromise their objectivity even before the audit work commences. There is a risk that the audit fee might be seen to be contingent upon a ‘favourable’ opinion (that is, the audit judgement coinciding with management’s preferences).

Employed professional accountants (accountants in industry) who support their company’s management in seeking second opinions may call into question their integrity and professional behaviour.
Sufficiency of current ethical guidance

Current ethical guidance requires that when asked to provide a ‘second opinion’ a member should seek to minimise the risk of giving inappropriate guidance, by ensuring that they have access to all relevant information.

The member should therefore:

■ ascertain why their opinion is being sought;
■ contact the auditor to provide any relevant facts;
■ with the entity’s permission, provide the auditor with a copy of their opinion.

The member’s opinion is more likely to differ if it is based on information which is different (or incomplete) as compared with that available to the incumbent auditor. The member should therefore decline to act if permission to communicate with the auditor is not given.

‘Opinion shopping’ might be less prevalent if company directors had no say in the appointment and remuneration of auditors. If audit appointments were made by an independent body ‘doubtful accounting practices’ would (arguably) be less of a negotiating factor. However, to be able to appoint auditors to multi-national/global corporations, such measures would require the backing of regulatory bodies worldwide.

Statutory requirements in this area could also be more stringent. For example, an auditor may be required to deposit a ‘statement of circumstances’ (or a statement of ‘no circumstances’) in the event that they are removed from office or resign. However, disclosure could be made more public if, when a change in accounting policy coincides with a change of auditors, the financial statements and auditor’s report highlight the change and the auditors state their concurrence (or otherwise) with the change. This could be made a statutory requirement and International Standards on Auditing (ISAs) amended to give guidance on how auditors should report on changes.

Further, if the incoming auditor were to have a statutory right of access to the files and working papers of the outgoing auditors they would be able to make a better and informed assessment of the desirability of the client and also appreciate the validity (or otherwise) of any ‘statement’ issued by the outgoing auditor.

(c) Insider dealing

Explanation of term

Insider dealing means using ‘inside information’ (i.e. price-sensitive information relating to the issuer of securities) to gain advantage when ‘dealing’ (i.e. acquiring or disposing) in securities.

Ethical risks

Insider dealing is a potential area of conflict and contention for accountants in industry and commerce (i.e. employed professional accountants) in particular (because of their exposure to price-sensitive information).

Acts of insider dealing contravene the fundamental principles of integrity and confidentiality:

■ integrity – a professional accountant should be honest;
■ confidentiality – a professional accountant should respect the confidentiality of information acquired during the course of performing professional services and should not use or disclose it without proper and specific authority.

Professional accountants in public practice who become privy to price-sensitive information will similarly be in breach of their duties of integrity and confidentiality if they get involved in insider dealing. Also, the reputation of individual practitioners and their firms may be put at risk by allegations of insider dealing even though they have no involvement with the practice. For example, if an auditor does not detect when an entity’s management is involved in insider dealing.

Sufficiency of current ethical guidance

Relevant current ethical guidance, that is covered by the principles of integrity and confidentiality, is sufficient to explain the ethical risks of insider dealing but cannot prevent its practice. Even where there are laws to prosecute insider dealing, penalties (such as seven years in jail and/or unlimited fines) have been ineffective in combating insider dealing.
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) Financial statement risks
Generally \( \frac{1}{2} \) mark for identification +
1 mark each point of explanation
max 14

Ideas
- Revenue/Receivables – potential over/under/misstatement
  (consignment inventory, cutoff, 0% finance)
- Other income – overstated? (reversal of provisions)
- Cost of materials – overstated?/inventory understated?
- Employee benefits – overstated?
- Depreciation/amortisation – overstated?
- Interest income – understated?
- Intangibles – potential overstatement (development impaired?)
- P, P & E – potential overstatement (unrecorded disposals)
- Inventories – understated? (consignment)
- Receivables – overstated? (no year-end allowance)
- Provisions – potential overstatement?
- Trade payables – understatement/unrecorded liabilities
- Going concern – disruption to assembly schedules/fall in profits

(b) Illustration of analytical procedures (as audit evidence)
Generally 1 mark each point
max 7

Ideas
- Revenue – testing for understatement
- 'Proof in total'/reasonableness tests – employee costs, depreciation, investment/interest income
- Immaterial items – may be sufficient
- Ratio analysis – asset turnover, average collection/payment periods

(c) Principal audit work
Generally 1 mark each area of principal audit work,
max 3 each balance sheet item × 3

Ideas
(i) Development expenditure
- Opening balance
- Physical inspection (Fox model)
- Additions to purchase/sub-contractor’s invoices
- Payroll records/analysis
- Overhead absorption
- Internal trial (test drive) results
- Impairment test
- Key assumptions
(ii) Consignment inventory
- Agreements – terms of ‘sale’ to dealers
- Proforma invoices
- Direct confirmation
- Physical inspection – vehicle returns
(iii) Warranty provision
- Agreements – terms of warranty
- Management’s assumptions
- After-date repairs (parts and labour)
- Current year warranty costs v prior year provision
- Recourse to suppliers (e.g. faulty parts)
2 (a) Advantages and disadvantages of outsourcing

Generally 1 mark each suggestion from RBG’s perspective max 6

| Ideas | 
|-----------------|------------------|
| Advantages      | Disadvantages    |
| ■ Cost saving   | ■ Costlier in long run |
| ■ Continuity    | ■ Less effective |
| ■ Expertise     | ■ Less integrated |
| ■ Availability/flexibility | ■ Lack of availability |
| ■ Independent evaluation | ■ Loss of availability |
| ■ Better recommendations/improved quality | ■ Loss of management training |

(b) Principal matters to be included in submission

Generally $\frac{1}{2} mark$ each matter identified up to max 5 and up to 1 mark for description max 10

| Ideas | 
|-----------------|------------------|
| ■ Introduction/background | ■ Services |
| ■ Identification of client issues | ■ Methodologies |
| ■ Resources | ■ Experience |
| ■ Insurance | ■ Work ethics |
| ■ Standards to be followed | ■ Sample work (reports) |
| ■ Potential conflicts | ■ Invoicing and payment |
| ■ Performance targets |  |

(c) Possible impact on audit of financial statements

Generally 1 mark each point of explanation max 4

| Ideas | 
|-----------------|------------------|
| ■ Organisational risk assessment | ■ Internal control assessment |
| ■ Reduction in substantive procedures | ■ Fraud and error risk assessment |
3 (i) Matters

Generally 1 mark each comment

\[
\text{max 6 marks each issue} \times 3
\]

\[\text{max 12}\]

**Ideas**

- materiality (appropriately assessed)
- relevant IFRSs (e.g. IAS 2, 8, 10, 36, 37, 38 & IFRS 3)
- fundamental concepts (accruals/prudence)
- risks (e.g. valuation (impairment)/disclosure)

(ii) Audit evidence

Generally 1 mark each item of audit evidence (source)

\[
\text{max 6 marks each issue} \times 3
\]

\[\text{max 12}\]

**Ideas (ISA 500)**

- documented on WP file – current vs PY
- internal (e.g. CF forecasts) vs external (e.g. press release)
- auditor generated (analytical procedure)
- results of procedures by which obtained (e.g. physical inspection of inventory returns/credit notes raised)

\[\text{max 20}\]

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

\[20\]
4. (a) Auditor’s reporting responsibilities for reporting non-compliance

Generally 1 mark each point of explanation

<table>
<thead>
<tr>
<th>Ideas (ISA 250)</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ Meaning of non-compliance</td>
</tr>
<tr>
<td>To management</td>
</tr>
<tr>
<td>■ communicate with those charged with corporate governance</td>
</tr>
<tr>
<td>■ timing</td>
</tr>
<tr>
<td>■ level of authority</td>
</tr>
<tr>
<td>To users of the auditor’s report</td>
</tr>
<tr>
<td>■ material</td>
</tr>
<tr>
<td>■ not properly reflected ⇒ disagreement ‘except for’/adverse</td>
</tr>
<tr>
<td>■ insufficient evidence ⇒ limitation ‘except for’/disclaimer</td>
</tr>
<tr>
<td>To enforcement authorities</td>
</tr>
<tr>
<td>■ normally precluded by confidentiality</td>
</tr>
<tr>
<td>■ duty may be overridden</td>
</tr>
<tr>
<td>■ take legal advice/consider public interest</td>
</tr>
</tbody>
</table>

(b) (i) Appropriateness of Parr & Co’s audit opinion

Generally 1 mark a comment

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ audit opinion heading</td>
</tr>
<tr>
<td>– what is it? (‘adverse’)</td>
</tr>
<tr>
<td>– reason</td>
</tr>
<tr>
<td>■ reference to notes giving more detail is appropriate</td>
</tr>
<tr>
<td>■ non-compliance (IAS 36) – disagreement</td>
</tr>
<tr>
<td>■ ‘profit or loss’ vs loss – inconsistency</td>
</tr>
<tr>
<td>■ IAS 36 title should be in full</td>
</tr>
<tr>
<td>■ information is light on detail</td>
</tr>
<tr>
<td>– effects not quantified – but should be quantifiable (maximum being carrying amount of non-current assets identified as impaired)</td>
</tr>
<tr>
<td>– why unable to quantify? – limitation in scope?</td>
</tr>
<tr>
<td>– non-current assets vs tangible and intangible (what intangible assets?)</td>
</tr>
<tr>
<td>■ why adverse? vs ‘except for’ – not pervasive</td>
</tr>
<tr>
<td>■ prior year</td>
</tr>
<tr>
<td>– ISA 710 Comparatives</td>
</tr>
<tr>
<td>– not new (no ‘as previously reported’)</td>
</tr>
</tbody>
</table>

(ii) Implications for audit opinion on Cleeves

Generally 1 mark an implication/comment thereon

<table>
<thead>
<tr>
<th>(ii)</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ request adjustment in subsidiary’s financial statements ⇒ unqualified</td>
</tr>
<tr>
<td>■ adjust on consolidation ⇒ unqualified</td>
</tr>
<tr>
<td>■ no adjustment ⇒ ‘except for’</td>
</tr>
<tr>
<td>■ disclosure name of other auditor</td>
</tr>
</tbody>
</table>
5 (a) IFAC’s Code
Generally 1 mark each point max 3

Ideas
■ Professional accountants = IFAC members
■ … in public practice = practitioners (partners/employees/managers/firms)
■ Employed … = in industry, commerce, etc (1/4 mark each)

(b) FAQs
Generally 1 mark each comment

Ideas
Threats to independence
■ self-interest
■ self-review (other services)
■ familiarity
■ management
Possible safeguards
■ prohibition
■ separate partners/staff
■ policies and procedures (specified)
■ disclosure (e.g. to audit committee)

6 Certain practices
Generally 1 mark each explanation/ethical risk/ comment on sufficiency of guidance, each (a), (b) & (c) max 5

Ideas
■ explanation/definition of term
■ ethical risks
  – integrity (why called into question)
  – objectivity (e.g. self-interest threat of financial benefit)
  – professional competence and due care (audit quality) – (a) & (b)
  – professional behaviour – (b)
  – confidentiality – (c)
■ ethical guidance
  – prohibition?
  – change in professional appointment
■ legal requirements (c)
■ current developments/further measures

15
15