Answers
1 YATES CO

(a) Preliminary materiality

<table>
<thead>
<tr>
<th></th>
<th>1%</th>
<th>1%</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Revenue</strong></td>
<td>$0.8m</td>
<td>$1.6m</td>
</tr>
<tr>
<td>2006</td>
<td>$0.7m</td>
<td>$1.4m</td>
</tr>
<tr>
<td><strong>Profit before taxation</strong></td>
<td>10%</td>
<td>5%</td>
</tr>
<tr>
<td>2006</td>
<td>$0.1m</td>
<td>$0.2m</td>
</tr>
<tr>
<td>2005</td>
<td>n/a</td>
<td>n/a</td>
</tr>
<tr>
<td><strong>Total assets</strong></td>
<td>2%</td>
<td>1%</td>
</tr>
<tr>
<td>2006</td>
<td>$1.0m</td>
<td>$2.1m</td>
</tr>
<tr>
<td>2005</td>
<td>$1.1m</td>
<td>$2.1m</td>
</tr>
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A suitable range for preliminary materiality is $1.0m – $1.6m.

**Tutorial note:** As the financial statements are presented to a precision of $0.1m it is meaningless to suggest a preliminary materiality to a greater level of precision since this suggests a level of accuracy that will not be achieved.

**Justification**

- It is not meaningful to base preliminary materiality on a small profit (or a loss) as this will result in over-auditing of the financial statements.
- More than $1.6m revenue is material to the income statement, therefore preliminary materiality is likely to be set so as not to exceed this amount. Less than $0.8m is not material to revenue (or the balance sheet) so preliminary materiality should not be less than this amount.
- A suitable preliminary materiality level is most likely to be one that lies within the overlap of the ranges calculated for revenue and total assets. $1m (1% of total assets) represents 0.6% revenue. This would be a prudent estimate of materiality (resulting in a higher level of audit work).
- $1.6m (1% of revenue) represents 1.5% of total assets. Preliminary materiality might be set at this end of the range had this been a recurring audit. However, as this is a first audit (and caution would generally result in over-auditing) preliminary materiality is likely to be lower.
- Total assets have fallen (marginally) since the prior year, whereas revenue has increased (by 11.8%). As draft figures for the balance sheet appear more stable than for the income statement, preliminary materiality is more likely to be set in relation to balance sheet amounts.
- The 2006 financial statements are draft for an unexpired period of time. Therefore greater errors should be expected than if they were actual. So, relatively, sample sizes for audit testing should be increased (i.e. preliminary materiality should be set at a relatively lower level).

(b) Financial statement risks

**Tutorial note:** Note the timeframe. Financial statements for the year to 30 June 2006 are draft. Certain misstatements may therefore exist due to year-end procedures not yet having taken place.

**Revenue/(Receivables)**

- Revenue has increased by 11.8% \( \left( \frac{161.5 - 144.4}{144.4} \times 100 \right) \). Overstatement could arise if rebates due to customers have not yet been accounted for in full (as they are calculated in arrears). If rebates have still to be accounted for trade receivables will be similarly overstated.

**Materials expense**

- Materials expense has increased by 17.8% \( \left( \frac{88.0 - 74.7}{74.7} \times 100 \right) \). This is more than the increase in revenue. This could be legitimate (e.g. if fuel costs have increased significantly). However, the increase could indicate misclassification of:
  - revenue expenditure (see fall in other expenses below);
  - capital expenditure (e.g. on overhauls or major refurbishment) as revenue;
  - finance lease payments as operating lease.
Depreciation/amortisation

- This has fallen by 10.5% \( \left( \frac{8.5 - 9.5}{9.5} \right) \times 100 \). This could be valid (e.g. if Yates has significant assets already fully depreciated or the asset base is lower since last year’s restructuring). However, there is a risk of understatement if, for example:
  - not all assets have been depreciated (or depreciated at the wrong rates, or only for 11 months of the year);
  - cost of non-current assets is understated (e.g. due to failure to recognise capital expenditure)\(^1\);
  - impairment losses have not been recognised (as compared with the prior year).

**Tutorial note:** Depreciation on vehicles and transport equipment represents only 7% of cost. If all items were being depreciated on a straight-line basis over eight years this should be 12.5%. The depreciation on other equipment looks more reasonable as it amounts to 14% which would be consistent with an average age of vehicles of seven years (i.e. in the middle of the range 3 – 13 years).

Other expenses

- These have fallen by 15.5% \( \left( \frac{19.6 - 23.2}{23.2} \right) \times 100 \). They may have fallen (e.g. following the restructuring) or may be understated due to:
  - expenses being misclassified as materials expense;
  - underestimation of accrued expenses (especially as the financial reporting period has not yet expired).

Intangibles

- Intangible assets have increased by $1m (16% on the prior year). Although this may only just be material to the financial statements as a whole (see (a)) this is the net movement, therefore additions could be material.

- Internally-generated intangibles will be overstated if:
  - any of the IAS 38 recognition criteria cannot be demonstrated;
  - any impairment in the year has not yet been written off in accordance with IAS 36 ‘Impairment of Assets’.

Tangible assets

- The net book value of property (at cost) has fallen by 5%, vehicles are virtually unchanged (increased by just 2.5%) and other equipment (though the least material category) has fallen by 20.4%.

- Vehicles and equipment may be overstated if:
  - disposals have not been recorded;
  - depreciation has been undercharged (e.g. not for a whole year);
  - impairments have not yet been accounted for.

- Understatement will arise if finance leases are treated as operating leases.

Receivables

- Trade receivables have increased by just 2.2% (although sales increased by 11.8%) and may be understated due to a cutoff error resulting in overstatement of cash receipts.

- There is a risk of overstatement if sufficient allowances have not been made for the impairment of individually significant balances and for the remainder assessed on a portfolio or group basis.

Restructuring provision

- The restructuring provision that was made last year has fallen/been utilised by 10.2%. There is a risk of overstatement if the provision is underutilised/not needed for the purpose for which it was established.

Finance lease liabilities

- Although finance lease liabilities have increased (by $1m) there is a greater risk of understatement than overstatement if leased assets are not recognised on the balance sheet (i.e. capitalised).

- Disclosure risk arises if the requirements of IAS 17 ‘Leases’ (e.g. in respect of minimum lease payments) are not met.

Trade payables

- These have increased by only 5.3% compared with the 17.8% increase in materials expense. There is a risk of understatement as notifications (e.g. suppliers’ invoices) of liabilities outstanding at 30 June 2006 may have still to be received (the month of June being an unexpired period).

Other (employee) liabilities

- These may be understated as they have increased by only 7-5% although staff costs have increased by 14%. For example, balances owing in respect of outstanding holiday entitlements at the year end may not yet be accurately estimated.

**Tutorial note:** Credit will be given to other financial statements risks specific to the scenario. For example, ‘time-sensitive delivery schedules’ might give rise to penalties or claims, that could result in understated provisions or undisclosed contingent liabilities. Also, given that this is a new audit and the result has changed significantly (from loss to profit) might suggest a risk of misstatement in the opening balances (and hence comparative information).

\(^1\) **Tutorial note:** This may be unlikely as other expenses have fallen also.
(c) Extent of reliance on analytical procedures as audit evidence

Tutorial note: In the requirement ‘… reliance … as audit evidence’ is a direction to consider only substantive analytical procedures. Answer points concerning planning and review stages were not asked for and earn no marks.

- Although there is likely to be less reliance on analytical procedures than if this had been an existing audit client, the fact that this is a new assignment does not preclude placing some reliance on such procedures.
- Analytical procedures will not be relied on in respect of material items that require 100% testing. For example, additions to property is likely to represent a very small number of transactions.
- Analytical procedures alone may provide sufficient audit evidence on line items that are not individually material. For example, additions to property (less than 1/2% of revenue and less than 1% of total assets) may be shown to be materially correct through analytical procedures on consumable stores (i.e. fuel, lubricants, materials for servicing vehicles etc).
- Substantive analytical procedures are best suited to large volume transactions (e.g. revenue, materials expense, staff costs). If controls over the completeness, accuracy and validity of recording transactions in these areas are effective then substantive analytical procedures showing that there are no unexpected fluctuations should reduce the need for substantive detailed tests.
- The extent of planned use will be dependent on the relationships expected between variables. (e.g. between items of financial information and between items of financial and non-financial information). For example, if material costs rise due to an increase in the level of business then a commensurate increase in revenue and staff costs might be expected also.
- ‘Proofs in total’ (or reasonableness tests) provide substantive evidence that income statement items are not materially misstated. In the case of Yates these might be applied to staff costs (number of employees in each category x wage/salary rates, grossed up for social security, etc) and finance expense (interest rate x average monthly overdraft balance).
- However, such tests may have limited application, if any, if the population is not homogenous and cannot be subdivided. For example, all the categories of non-current asset have a wide range of useful life. Therefore it would be difficult/meaningless to apply an ‘average’ depreciation rate to all assets in the class to substantiate the total depreciation expense for the year. (Although it might highlight a risk of potential over or understatement requiring further investigation.)
- Substantive analytical procedures are more likely to be used if there is relevant information available that is being used by Yates. For example, as fuel costs will be significant, Yates may monitor consumption (e.g. miles per gallon (MPG)).
- Analytical procedures may supplement alternative procedures that provide evidence regarding the same assertion. For example, the review of after-date payments to confirm the completeness of trade payables may be supplemented by calculations of average payment period on a monthly basis.

Tutorial note: Credit will be given for other relevant points drawn from the scenario. For example, the restructuring during the previous year is likely to have caused fluctuations that may result in less reliance being placed on analytical procedures.

(d) Principal audit work

(i) Trade receivables

- Review of agreements to determine the volume rebates terms. For example,
  - the % discounts;
  - the volumes to which they apply;
  - the period over which they accumulate;
  - settlement method (e.g. by credit note or other off-set or repayment).
- Direct positive confirmation of a value-weighted sample of balances (i.e. larger amounts) to identify potential overstatement (e.g. due to discounts earned not being awarded).
- Monitoring of after-date cash receipts and matching against amounts due as shortfalls may indicate disputed amounts.
- Review of after-date credit notes to ensure adequate allowance (accrual) is made for discounts earned in the year to 30 June 2006.
- Credit risk analysis of individually significant balances and assessment of impairment losses (where carrying value is less than the present value of the estimated cash flows discounted at the effective interest rate).

(ii) Vehicles

- Agreeing opening ledger balances of cost and accumulated depreciation (and impairment losses) to the non-current asset register to confirm the comparative amounts.
- Physically inspecting a sample of vehicles (selected from the asset register) to confirm existence and condition (for evidence of impairment). If analytical procedures use management information on mileage records this should be checked (e.g. against kilometers) at the same time.
Agreeing additions to purchase invoices to confirm cost.

- Reviewing the terms of all lease contracts entered into during the year to ensure that finance leases have been capitalised.
- Agreeing the depreciation rates applied to finance lease assets to those applied to similar purchased assets.
- Reviewing repairs and maintenance accounts (included in materials expense) to ensure that there are no material items of capital nature that have been expensed (i.e. a test for completeness).

2 Prescott CO

(a) Terms of engagement – matters to be clarified

Tutorial note: This one-off assignment requires a separate letter of engagement. Note that, at this level, a standard list of contents will earn few, if any, marks. Any ‘ideas list’ must be tailored to generate answer points specific to the due diligence review of this target company.

- Objective of the review: for example, to find and report facts relevant to Prescott’s decision whether to acquire Robson. The terms should confirm whether Prescott’s interest is in acquiring the company (i.e. the share capital) or its trading assets (say), as this will affect the nature and scope of the review.

Tutorial note: This is implied as Prescott ‘has been seeking to acquire … to bring building … in-house’.

- Prescott’s management will be solely responsible for any decision made (e.g. any offer price made to purchase Robson).

- The nature and scope of the review and any standards/guidelines in accordance with which it will be conducted. That investigation will consist of enquiry (e.g. of the directors and the quantity surveyor) and analytical procedures (e.g. on budgeted information and prior period financial statements).

Tutorial note: This is not going to be a review of financial statements. The prior year financial statements have only recently been audited and financial statements for the year end 30 June 2006 will not be available in time for the review.

- The level of assurance will be ‘negative’. That is, that the material subject to review is free of material misstatement. It should be stated that an audit is not being performed and that an audit opinion will not be expressed.

- The timeframe for conducting the investigation (two days next week) and the deadline for reporting the findings.

- The records, documentation and other information to which access will be unrestricted. This will be the subject of agreement between Prescott and Robson.

- A responsibility/liability disclaimer that the engagement cannot be relied upon to disclose errors, illegal acts or other irregularities (e.g. fraudulent financial reporting or misappropriations of Robson’s assets).

Tutorial note: Third party reliance on the report seems unlikely as Prescott has ‘substantial cash resources’ and may not need to obtain loan finance.

(b) Principal additional information

- Any service contracts with the directors or other members of the management team (e.g. the quantity surveyor). These may contain ‘exit’ or other settlement terms in the event that their services are no longer required after a takeover/buyout.

- Prior period financial statements (to 30 June 2005) disclosing significant accounting policies and the key assumptions concerning the future (and other key sources of estimation uncertainty) that have a significant risk of causing a material adjustment to the carrying amounts of assets and liabilities in the year to 30 June 2006.

For example, concerning:
- the outcome on the Sarwar dispute;
- estimates for guarantees/claims for rectification;
- assumptions made in estimating costs to completion (e.g. for increases in costs of materials or labour).

Tutorial note: Under IAS 1 ‘Presentation of Financial Statements’ the judgements made by management that have the most significant effect on amounts recognised in financial statements (other than those involving estimations) should also be disclosed.

- The most recent management accounts and cash flow forecasts to assess the quality of management information being used for decision-making and control. In particular, in providing Robson with the means of keeping its cash flows within its overdraft limit.

Tutorial note: Note that Prescott has substantial cash resources. Therefore Robson’s lack of finance might be a reason why its management are interested in selling the business.

- A copy of the signed bank agreement for the overdraft facility (and any other agreements with finance providers). Any breaches in debt covenants might result in penalties of contingent liabilities that Prescott would have to bear if it acquired Robson.
The standard terms of contracts with customers for construction works. In particular, for:

- guarantees given (e.g. for rectification under warranty);
- penalty clauses (e.g. in the event of overruns or non-completion);
- disclaimers (including conditions for invoking force majeure).

Prescott will want to make some allowance for settlement of liabilities arising on contracts already completed/in-progress when offering a price for Robson.

**Tutorial note:** A takeover might excuse Robson from fulfilling a contract.

Legal/correspondence files dealing with matters such as the claims of the residents of the housing development and Robson's claim against Sarwar Services Co. Also, fee notes rendered by Robson's legal advisers showing the costs incurred on matters referred to them.

Robson's insurer's ‘cover note’ to determine Robson's exposure to claims for rectification work, damages, injuries to employees, etc.

The quantity surveyor’s working papers for the last quarterly count (presumably at 31 March 2006) and the latest available rolling budgets. Particular attention should be given to loss-making contracts and contracts that have not been started. (Prescott might seek to settle rather than fulfil them.) The pattern of taking profits on contracts will be of interest, for example, to determine the accuracy of the quantity surveyor’s estimates.

**Tutorial note:** A regular pattern of taking too much profit too soon might be due to underestimating costs to completion or be evidence of cost overruns due to rectification.

Type and frequency of constructions undertaken. Prescott is interested in the building and refurbishment of hotels and leisure facilities. Robson’s experience in this area may not be extensive.

Non-current asset register showing location of plant and equipment so that some test checking on physical existence might be undertaken (if an agreed-upon-procedure).

(c) Specific inquiries – accounting for construction contracts

**Tutorial note:** This answer is illustrative of the types of inquiry that should be made. Other relevant answer points will be awarded similar credit. For each full mark to be earned an inquiry should address the specifics of Robson (e.g. that its accounting policies are ‘generally less prudent’). The identification of asset overstatement/liability understatement may reduce the purchase price offered by Prescott.

Are any constructions being undertaken without signed contracts?

**Tutorial note:** Any expenditure on constructions without contracts (e.g. of a speculative nature, perhaps to keep the workforce employed) must be accounted for under IAS ‘Inventories’; revenue cannot be recognised nor profit taken.

Is full provision made for future losses foreseen on loss-making contracts?

**Tutorial note:** The information in the brief is that ‘provisions are made’. The level of provision is not indicated and could be less than full.

Which contracts started during the year are likely to be/have been identified as loss-making (for which no provision has yet been made)?

**Tutorial note:** Profits and losses are only determined by contract at each financial year end.

What are management’s assumptions and judgments on the likely future outcome on the Sarwar contract (and other actual and contingent liabilities)?

**Tutorial note:** Robson would be imprudent if it underestimates the probability of an unfavourable outcome (or overestimates the likelihood of successful recourse).

What claims history has Robson experienced? (What proportion of contracts have been subject to claims? What proportion of claims brought have been successful? How have they been settled? Under insurance? Out-of-court settlement?) How effective are the penalty clauses? (Is Robson having to pay penalties for overrunning on contracts?)

What are the actual useful lives of assets used in construction? What level of losses are made on disposal?

**Tutorial note:** If such assets are depreciated over useful lives that are estimated to be too long, depreciation costs incurred to date (and estimated depreciation to be included in costs to completion) will be understated. This will result in too much profit/too little loss being calculated on contracts.

What is the cause of losses on contracts? For example, if due to theft of building supplies Robson’s management is not exercising sufficient control over the company’s assets.
3 KEFFLER CO

Tutorial note: None of the issues have any bearing on revenue. Therefore any materiality calculations assessed on revenue are inappropriate and will not be awarded marks.

(a) Landfill site

(i) Matters

- $1.1m cost of the right represents 3.3% of total assets and is therefore material.
- The right should be amortised over its useful life, that is just 10 years, rather than the 15-year period for which the right has been granted.

Tutorial note: Recalculation on the stated basis (see audit evidence) shows that a 10-year amortisation has been correctly used.

- The amortisation charge represents 1% of profit before tax (PBT) and is not material.
- The amortisation method used should reflect the pattern in which the future economic benefits of the right are expected to be consumed by Keffler. If that pattern cannot be determined reliably, the straight-line method must be used (IAS 38 ‘Intangible Assets’).
- Using an increasing sum-of-digits will ‘end-load’ the amortisation charge (i.e. least charge in the first year, highest charge in the last year). However, according to IAS 38 there is rarely, if ever, persuasive evidence to support an amortisation method that results in accumulated amortisation lower than that under the straight-line method.

Tutorial note: Over the first half of the asset’s life, depreciation will be lower than under the straight-line basis (and higher over the second half of the asset’s life).

- On a straight line basis the annual amortisation charge would be $0.11m, an increase of $90,000. Although this difference is just below materiality (4.5% PBT) the cumulative effect (of undercharging amortisation) will become material.
- Also, when account is taken of the understatement of cost (see below), the undercharging of amortisation will be material.
- The sum-of-digits method might be suitable as an approximation to the unit-of-production method if Keffler has evidence to show that use of the landfill site will increase annually.
- However, in the absence of such evidence, the audit opinion should be qualified ‘except for’ disagreement with the amortisation method (resulting in intangible asset overstatement/amortisation expense understatement).
- The annual restoration provision represents 5% of PBT and 0.3% of total assets. Although this is only borderline material (in terms of profit), there will be a cumulative impact.
- Annual provisioning is contrary to IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’.
- The estimate of the future restoration cost is (presumably) $1.5m (i.e. $0.1 \times 15). The present value of this amount should have been provided in full in the current year and included in the cost of the right.
- Thus the amortisation being charged on the cost of the right (including the restoration cost) is currently understated (on any basis).

Tutorial note: A 15-year discount factor at 10% (say) is 0.239. $1.5m \times 0.239 is approximately $0.36m. The resulting present value (of the future cost) would be added to the cost of the right. Amortisation over 10 years on a straight-line basis would then be increased by $36,000, increasing the difference between amortisation charged and that which should be charged. The lower the discount rate, the greater the understatement of amortisation expense.

Total amount expensed ($120k) is less than what should have been expensed (say $146k amortisation + $36k unwinding of discount). However, this is not material.

- Whether Keffler will wait until the right is about to expire before restoring the land or might restore earlier (if the site is completely filled in 10 years).

(ii) Audit evidence

- Written agreement for purchase of right and contractual terms therein (e.g. to make restoration in 15 years’ time).
- Cash book/bank statement entries in April 2005 for $1.1m payment.
- Physical inspection of the landfill site to confirm Keffler’s use of it.
- Annual dump budget/projection over next 10 years and comparison with sum-of-digits proportions.
- Amount actually dumped in the year (per dump records) compared with budget and as a percentage/proportion of the total available.
Recalculation of current year’s amortisation based on sum-of-digits. That is, $1·1m ÷ 55 = $20,000.

**Tutorial note:** The sum-of-digits from 1 to 10 may be calculated long-hand or using the formula \( \frac{n(n+1)}{2} \) i.e. \( \frac{10 \times 11}{2} = 55 \).

- The basis of the calculation of the estimated restoration costs and principal assumptions made.
- If estimated by a quantity surveyor/other expert then a copy of the expert’s report.
- Written management representation confirming the planned timing of the restoration in 15 years (or sooner).

**Sale of industrial equipment**

**(i) Matters**

- The industrial equipment was in use for nine years (from April 1996) and would have had a carrying value of $660,000 at 31 March 2005 \( (\frac{11}{20} \times 1·2m) \) – assuming nil residual value and a full year’s depreciation charge in the year of acquisition and none in the year of disposal. Disposal proceeds were therefore only $360,000.

- The $0·3m loss represents 15% of PBT (for the year to 31 March 2006) and is therefore material. The equipment was material to the balance sheet at 31 March 2005 representing 2·6% of total assets \( (\frac{0·66}{25·7} \times 100) \).

- Separate disclosure of a material loss on disposal, on the face of the income statement is in accordance with IAS 16 ‘Property, Plant and Equipment’. However, in accordance with IAS 1 ‘Presentation of Financial Statements’, it should not be captioned in any way that might suggest that it is not part of normal operating activities (i.e. not ‘extraordinary’, ‘exceptional’, etc).

  **Tutorial note:** However, note that if there is a prior period error to be accounted for (see later), there would be no impact on the current period income statement requiring consideration of any disclosure.

- The reason for the sale. For example, whether the equipment was:
  - surplus to operating requirements (i.e. not being replaced); or
  - being replaced with newer equipment (thereby contributing to the $8·1m increase (33·8 – 25·7) in total assets).

- The reason for the loss on sale. For example, whether:
  - the sale was at an under-value (e.g. to a related party);
  - the equipment had a bad maintenance history (or was otherwise impaired);
  - the useful life of the equipment is less than 20 years;
  - there is any deferred consideration not yet recorded;
  - any non-cash disposal proceeds have been overlooked (e.g. if another asset was acquired in a part-exchange).

- If the useful life was less than 20 years, tangible non-current assets may be materially overstated in respect of other items of equipment that are still in use and being depreciated on the same basis.

- If the sale was to a related party then additional disclosure should be required in a note to the financial statements for the year to 31 March 2006 (IAS 24 ‘Related Party Disclosures’).

  **Tutorial note:** Since there are no specific pointers to a related party transaction (RPT), this point is not expanded on.

- Whether the sale was identified in the prior year audit’s post balance sheet event review. If so:
  - the disclosure made in the prior year’s financial statements (IAS 10 ‘Events After the Balance Sheet Date’);
  - whether an impairment loss was recognised at 31 March 2005.

- If not, and the equipment was impaired at 31 March 2005, a prior period error should be accounted for (IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’). An impairment loss of $0·3m would have been material to prior year profit (12·5%).

  **Tutorial note:** Unless this was a RPT or the impairment arose after 31 March 2005 a prior period adjustment should be made.

- Failure to account for a prior period error (if any) would result in modification of the audit opinion ‘except for’ non-compliance with IAS 8 (in the current year) and IAS 36 (in the prior period).

**(ii) Audit evidence**

- Carrying amount ($0·66m as above) agreed to the non-current asset register balances at 31 March 2005 and recalculation of the loss on disposal.
- Cost and accumulated depreciation removed from the asset register in the year to 31 March 2006.
- Receipt of proceeds per cash book agreed to bank statement.
- Sales invoice transferring title to Deakin.
- A review of maintenance expenses and records (e.g. to confirm reason for loss on sale).
Post balance sheet event review on prior year audit working papers file.

Management representation confirming that Deakin is not a related party (provided that there is no evidence to suggest otherwise).

(c) Ban on emptying waste water

(i) Matter

- $0.9m provision for upgrading the process represents 45% PBT and is very material. This provision is also material to the balance sheet (2.7% of total assets).
- The provision for penalties is immaterial (2.2% PBT and 0.1% total assets).
- The ban is an adjusting post balance sheet event in respect of the penalties (IAS 10). It provides evidence that at the balance sheet date Keffler was in contravention of local government standards. Therefore it is correct (in accordance with IAS 37) that a provision has been made for the penalties. As the matter is not material inclusion in ‘other provisions’ is appropriate.
- However, even if Keffler has a legal obligation to meet minimum standards, there is no obligation for upgrading the purifying process at 31 March 2006 and the $0.9m provision should be written back.
- If the provision for upgrading is not written back the audit opinion should be qualified ‘except for’ (disagreement).
- Keffler does not even have a contingent liability for upgrading the process because there is no present obligation to do so. The obligation is to stop emptying unclean water into the river. Nor is there a possible obligation whose existence will be confirmed by an uncertain future event not wholly within Keffler’s control.
  
  Tutorial note: Consider that Keffler has alternatives wholly within its control. For example, it could ignore the ban and incur fines, or relocate/close this particular plant/operation or perhaps dispose of the water by alternative means.
- The need for a technological upgrade may be an indicator of impairment. Management should have carried out an impairment test on the carrying value of the water purifying process and recognised any impairment loss in the profit for the year to 31 March 2006.
- Management’s intention to upgrade the process is more appropriate to an environmental responsibility report (if any).
- Whether there is any other information in documents containing financial statements.

(ii) Audit evidence

- Penalty notices of fines received to confirm amounts and period/dates covered.
- After-date payment of fines agreed to the cash book.
- A copy of the ban and any supporting report on the local government’s findings.
- Minutes of board meetings at which the ban was discussed confirming management’s intentions (e.g. to upgrade the process).
  
  Tutorial note: This may be disclosed in the directors’ report and/or as a non-adjusting post balance sheet event.
- Any tenders received/costings for upgrading.
  
  Tutorial note: This will be relevant if, for example, capital commitment authorised (by the board) but not contracted for at the year end are disclosed in the notes to the financial statements.
- Physical inspection of the emptying point at the river to confirm that Keffler is not still emptying waste water into it (unless the upgrading has taken place).
  
  Tutorial note: Thereby incurring further penalties.

4 JOHNSTON CO

(a) Reporting responsibilities specific to initial engagements

For initial audit engagements, the auditor should obtain sufficient appropriate audit evidence that:

- the opening balances do not contain misstatements that materially affect the current period’s financial statements;
- the prior period’s closing balances have been correctly brought forward to the current period (or, where appropriate, have been restated); and
- appropriate accounting policies are consistently applied or changes in accounting policies have been properly accounted for (and adequately presented and disclosed).
If the auditor is unable to obtain sufficient appropriate audit evidence concerning opening balances there will be a limitation on the scope of the audit. The auditor’s report should include:

- a qualified (‘except for’) opinion;
- a disclaimer of opinion; or
- in those jurisdictions where it is permitted, an opinion which is:
  - qualified (or disclaimed) regarding the results of operations (i.e. on the income statement); and
  - unqualified regarding financial position (i.e. on the balance sheet).

If the effect of a misstatement in the opening balances is not properly accounted for and adequately presented and disclosed, the auditor should express a qualified (‘except for’ disagreement) opinion or an adverse opinion, as appropriate.

If the current period’s accounting policies have not been consistently applied in relation to opening balances and if the change has not been properly accounted for and adequately presented and disclosed, the auditor should similarly express disagreement (‘except for’ or adverse opinion as appropriate).

However, if a modification regarding the prior period’s financial statements remains relevant and material to the current period’s financial statements, the auditor should modify the current auditor’s report accordingly.

(b) Tiltman Co

Tiltman’s total assets at 31 March 2006 represent 29% \((\frac{16.1}{55.2} \times 100)\) of Johnston’s total assets. The subsidiary is therefore material to Johnston’s consolidated financial statements.

Tutorial note: Tiltman’s profit for the year is not relevant as the acquisition took place just before the year end and will therefore have no impact on the consolidated income statement. Calculations of the effect on consolidated profit before taxation are therefore inappropriate and will not be awarded marks.

(i) Inventory overvaluation

This should have been written off to the income statement in the year to 31 March 2005 and not spread over three years (contrary to IAS 2 ‘Inventories’).

At 31 March 2006 inventory is overvalued by $0·9m. This represents all Tiltman’s profit for the year and 5·6% of total assets and is material. At 31 March 2005 inventory was materially overvalued by $1·8m ($1·7m reported profit should have been a $0·1m loss).

Tutorial note: \(\frac{1}{3}\) of the overvaluation was written off in the prior period (i.e. year to 31 March 2005) instead of $2·7m.

That the prior period’s auditor’s report was unmodified means that the previous auditor concurred with an incorrect accounting treatment (or otherwise gave an inappropriate audit opinion).

As the matter is material a prior period adjustment is required (IAS 8 ‘Accounting Policies, Changes in Accounting Estimates and Errors’). $1·8m should be written off against opening reserves (i.e. restated as at 1 April 2005).

(ii) Restructuring provision

$2·3m expense has been charged to Tiltman’s profit and loss in arriving at a draft profit of $0·7m. This is very material. (The provision represents 14·3% of Tiltman’s total assets and is material to the balance sheet date also.)

The provision for redundancies and onerous contracts should not have been made for the year ended 31 March 2006 unless there was a constructive obligation at the balance sheet date (IAS 37 ‘Provisions, Contingent Liabilities and Contingent Assets’). So, unless the main features of the restructuring plan had been announced to those affected (i.e. redundancy notifications issued to employees), the provision should be reversed. However, it should then be disclosed as a non-adjusting post balance sheet event (IAS 10 ‘Events After the Balance Sheet Date’).

Given the short time (less than one month) between acquisition and the balance sheet it is very possible that a constructive obligation does not arise at the balance sheet date. The relocation in May was only part of a restructuring (and could be the first evidence that Johnston’s management has started to implement a restructuring plan).

There is a risk that goodwill on consolidation of Tiltman may be overstated in Johnston’s consolidated financial statements. To avoid the $2·3 expense having a significant effect on post-acquisition profit (which may be negligible due to the short time between acquisition and year end), Johnston may have recognised it as a liability in the determination of goodwill on acquisition.

However, the execution of Tiltman’s restructuring plan, though made for the year ended 31 March 2006, was conditional upon its acquisition by Johnston. It does not therefore represent, immediately before the business combination, a present obligation of Johnston. Nor is it a contingent liability of Johnston immediately before the combination. Therefore Johnston cannot recognise a liability for Tiltman’s restructuring plans as part of allocating the cost of the combination (IFRS 3 ‘Business Combinations’).

Tiltman’s auditor’s report

The following adjustments are required to the financial statements:

- restructuring provision, $2·3m, eliminated;
- adequate disclosure of relocation as a non-adjusting post balance sheet event;
- current period inventory written down by $0·9m;
- prior period inventory (and reserves) written down by $1·8m.
Profit for the year to 31 March 2006 should be $3.9m ($0.7 + $0.9 + $2.3).

If all these adjustments are made the auditor’s report should be unmodified. Otherwise, the auditor’s report should be qualified ‘except for’ on grounds of disagreement. If none of the adjustments are made, the qualification should still be ‘except for’ as the matters are not pervasive.

**Johnston’s auditor’s report**

If Tiltman’s auditor’s report is unmodified (because the required adjustments are made) the auditor’s report of Johnston should be similarly unmodified. As Tiltman is wholly-owned by Johnston there should be no problem getting the adjustments made.

If no adjustments were made in Tiltman’s financial statements, adjustments could be made on consolidation, if necessary, to avoid modification of the auditor’s report on Johnston’s financial statements.

The effect of these adjustments on Tiltman’s net assets is an increase of $1.4m. Goodwill arising on consolidation (if any) would be reduced by $1.4m. The reduction in consolidated total assets required ($0.9m + $1.4m) is therefore the same as the reduction in consolidated total liabilities (i.e. $2.3m). $2.3m is material (4.2% consolidated total assets). If Tiltman’s financial statements are not adjusted and no adjustments are made on consolidation, the consolidated financial position (balance sheet) should be qualified ‘except for’. The results of operations (i.e. profit for the period) should be unqualified (if permitted in the jurisdiction in which Johnston reports).

Adjustment in respect of the inventory valuation may not be required as Johnston should have consolidated inventory at fair value on acquisition. In this case, consolidated total liabilities should be reduced by $2.3m and goodwill arising on consolidation (if any) reduced by $2.3m.

**Tutorial note:** The effect of any possible goodwill impairment has been ignored as the subsidiary has only just been acquired and the balance sheet date is very close to the date of acquisition.

5 FOX & STEEPLE – THREE AUDIT ASSIGNMENTS

(i) Threats to independence

**Self-interest**

**Tutorial note:** This threat arises when a firm or a member of the audit team could benefit from a financial interest in, or other self-interest conflict with, an assurance client.

- A self-interest threat could potentially arise in respect of any (or all) of these assignments as, regardless of any fee restrictions (e.g. per IFAC’s ‘Code of Ethics for Professional Accountants’), the auditor is remunerated by clients for services provided.
- This threat is likely to be greater for Huggins Co (larger/listed) and Gray Co (requires other services) than for Blythe Co (audit a statutory necessity).
- The self-interest threat may be greatest for Huggins Co. As a company listed on a recognised stock exchange it may give prestige and credibility to Fox & Steeple (though this may be reciprocated). Fox & Steeple could be pressurised into taking evasive action to avoid the loss of a listed client (e.g. concurring with an inappropriate accounting treatment).

**Self-review**

**Tutorial note:** This arises when, for example, any product or judgment of a previous engagement needs to be re-evaluated in reaching conclusions on the audit engagement.

- This threat is also likely to be greater for Huggins and Gray where Fox & Steeple is providing other (non-audit) services.
- A self-review threat may be created by Fox & Steeple providing Huggins with a ‘thorough examination’ of its computerised systems if it involves an extension of the procedures required to conduct an audit in accordance with International Standards on Auditing (ISAs).
- Appropriate safeguards must be put in place if Fox & Steeple assists Huggins in the performance of internal audit activities. In particular, Fox & Steeple’s personnel must not act (or appear to act) in a capacity equivalent to a member of Huggins’ management (e.g. reporting, in a management role, to those charged with governance).
- Fox & Steeple may provide Gray with accounting and bookkeeping services, as Gray is not a listed entity, provided that any self-review threat created is reduced to an acceptable level. In particular, in giving technical advice on financial reporting, Fox & Steeple must take care not to make managerial decisions such as determining or changing journal entries without obtaining Gray’s approval.
- Taxation services comprise a broad range of services, including compliance, planning, provision of formal taxation opinions and assistance in the resolution of tax disputes. Such assignments are generally not seen to create threats to independence.

**Tutorial note:** It is assumed that the provision of tax services is permitted in the jurisdiction (i.e. that Fox and Steeple are not providing such services if prohibited).

- The due diligence reviews for Gray may create a self-review threat (e.g. on the fair valuation of net assets acquired). However, safeguards may be available to reduce these threats to an acceptable level.
If staff involved in providing other services are also assigned to the audit, their work should be reviewed by more senior staff not involved in the provision of the other services (to the extent that the other service is relevant to the audit).

The reporting lines of any staff involved in the audit of Huggins and the provision of other services for Huggins should be different. (Similarly for Gray.)

**Familiarity**

**Tutorial note:** This arises when, by virtue of a close relationship with an audit client (or its management or employees) an audit firm (or a member of the audit team) becomes too sympathetic to the client’s interests.

- Long association of a senior member of an audit team with an audit client may create a familiarity threat. This threat is likely to be greatest for Huggins, a long-standing client. It may also be significant for Gray as Fox & Steeple have had dealings with this client for seven years now.
- As Blythe is a new audit client this particular threat does not appear to be relevant.
- Senior personnel should be rotated off the Huggins and Gray audit teams. If this is not possible (for either client), an additional professional accountant who was not a member of the audit team should be required to independently review the work done by the senior personnel.
- The familiarity threat of using the same lead engagement partner on an audit over a prolonged period is particularly relevant to Huggins, which is now a listed entity. IFAC’s 'Code of Ethics for Professional Accountants' requires that the lead engagement partner should be rotated after a pre-defined period, normally no more than seven years. Although it might be time for the lead engagement partner of Huggins to be changed, the current lead engagement partner may continue to serve for the 2006 audit.

**Tutorial note:** Two additional years are permitted when an existing client becomes listed, since it may not be in the client's best interests to have an immediate rotation of engagement partner.

**Intimidation**

**Tutorial note:** This arises when a member of the audit team may be deterred from acting objectively and exercising professional skepticism by threat (actual or perceived), from the audit client.

- This threat is most likely to come from Blythe as auditors are threatened with a tendering process to keep fees down.
- Peter may have already applied pressure to reduce inappropriately the extent of audit work performed in order to reduce fees, by stipulating that there should not be an interim audit.
- The audit senior allocated to Blythe will need to be experienced in standing up to client management personnel such as Peter.

**Tutorial note:** 'Correct' classification under 'ethical', 'other professional', 'practical' or 'staff implications' is not as important as identifying the matters.

(ii) **Other professional and practical matters**

**Tutorial note:** 'Other professional' includes quality control.

- The experience of staff allocated to each assignment should be commensurate with the assessment of associated risk. For example, there may be a risk that insufficient audit evidence is obtained within the budget for the audit of Blythe. Huggins, as a listed client, carries a high reputational risk.
- Sufficient appropriate staff should be allocated to each audit to ensure adequate quality control (in particular in the direction, supervision, review of each assignment). It may be appropriate for a second partner to be assigned to carry out a ‘hot review’ (before the auditor’s report is signed) of:
  - Blythe, because it is the first audit of a new client; and
  - Huggins, as it is listed.
- Existing clients (Huggins and Gray) may already have some expectation regarding who should be assigned to their audits. There is no reason why there should not be some continuity of staff providing appropriate safeguards are put in place (e.g. to overcome any familiarity threat).
- Senior staff assigned to Blythe should be alerted to the need to exercise a high degree of professional skepticism (in the light of Peter’s attitude towards the audit).
- New staff assigned to Huggins and Gray would perhaps be less likely to assume unquestioned honesty than staff previously involved with these audits.

**Logistics (practical)**

- All three assignments have the same financial year end, therefore there will be an element of ‘competition’ for the staff to be assigned to the year-end visits and final audit assignments. As a listed company, Huggins is likely to have the tightest reporting deadline and so have a ‘priority’ for staff.
- Blythe is a local and private company. Staff involved in the year-end visit (e.g. to attend the physical inventory count) should also be involved in the final audit. As this is a new client, staff assigned to this audit should get involved at every stage to increase their knowledge and understanding of the business.
Huggins is a national operation and may require numerous staff to attend year-end procedures. It would not be expected that all staff assigned to year-end visits should all be involved in the final audit.

Time/fee/staff budgets

- Time budgets will need to be prepared for each assignment to determine manpower requirements (and to schedule audit work).

(iii) Implications for allocating staff

- Fox & Steeple should allocate staff so that those providing other services to Huggins and Gray (that may create a self-review threat) do not participate in the audit engagement.

Competence and due care (Qualifications/Specialisation)

- All audit assignments will require competent staff.
- Huggins will require staff with an in-depth knowledge of their computerised system.
- Gray will require senior audit staff to be experienced in financial reporting matters specific to communications and software solutions (e.g. in revenue recognition issues and accounting for internally-generated intangible assets).
- Specialists providing tax services and undertaking the due diligence reviews for Gray may not be required to have any involvement in the audit assignment.

6 DEVELOPMENTS AND CERTIFIED CHARTERED ACCOUNTANTS

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) IFAC’s ‘Code of Ethics for Professional Accountants’

Since its issue in 1996, IFAC’s ‘Code of Ethics for Professional Accountants’ (‘The Code’) has undergone several revisions (1996, 1998, 2001, 2004 and 2005). IFAC holds the view that due to national differences (of culture, language, legal and social systems) the task of preparing detailed ethical requirements is primarily that of the member bodies in each country concerned (and that they also have the responsibility to implement and enforce such requirements).

In recognizing the responsibilities of the accountancy profession, IFAC considers its own role to be in providing guidance and promoting harmonization. IFAC has established ‘The Code’ to provide a basis on which the ethical requirements for professional accountants in each country should be founded.

IFAC’s conceptual approach is principles-based. It provides a route to convergence that emphasises the profession’s integrity. This approach may be summarised as:

- identifying and evaluating circumstances and relationships that create threats (e.g. to independence); and
- taking appropriate action to:
  - eliminate these threats; or
  - reduce them to an acceptable level by the application of safeguards.

If no safeguards are available to reduce a threat to an acceptable level an assurance engagement must be refused or discontinued.

This approach was first introduced to Section 8 of The Code, on independence, and is applicable to assurance engagements when the assurance report is dated on or after 31 December 2004.

Further to the cases of Enron, Worldcom and Parmalat, IFAC issued a revised Code in July 2005 that applies to all professional accountants, whether in public practice, business, industry or government2.

A member body of IFAC may not apply less stringent standards than those stated in the Code. The Code is effective from 30 June 2006.

Practicing accountants and members in business must maintain the high standards of professional ethics that are expected by their professional bodies (such as ACCA). These developments codify current best practice in the wake of the aforementioned recent corporate scandals.

The developments in The Code have wider application in that it:

- applies to all assurance services (not just audit);
- considers the standpoints of the firm and of the assurance team.

Since ACCA is a member-body of IFAC the elevation of The Code to a standard will affect all Chartered Certified Accountants.

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2 Part A is applicable to all professional accountants, Part B to professional accountants in public practice and Part C to employed professional accountants.
(b) International Standards on Auditing (ISAs)

The groundwork for an international set of auditing standards began in 1969 with a number of reports published by the Accountants International Study Group that compared the situation in Canada, the UK, and US. The establishment of the International Accounting Standards Committee (IASC), in 1973, generated calls for a similar body to be set up for auditing.

In the late 1970s the Council of International Federation of Accountants (IFAC) created the International Auditing Practices Committee (IAPC) as a standing committee of the IFAC Council. (Subsequently the IFAC Board.)

Tutorial note: The IFAC Council was renamed the IFAC Board in May 2000.

The first ISA was issued in 1991. The codified core set released in 1994, which has remained the series to the present day, has been increasingly accepted by national standard setters and auditors involved in global reporting and cross-border financing transactions.

In July 2001, IFAC sought comment on the role of IASC and the future of ISAs. As a result of the review, in 2002, the IAPC was renamed the International Auditing and Assurance Standards Board (IAASB). IAASB has made available, on its website, the full text of ISAs since 2003.

Further, the growth of non-audit assurance services has led to the development of a new framework (The International Framework for Assurance Engagements) effective for assurance reports issued on or after 1 January 2005.

The hope that the take up of ISAs should follow the lead set by International Accounting Standards (IASs), following their endorsement by IOSCO (the International Organization of Securities Commissions), has been expressed by many professional bodies including ACCA and FEE (the Fédération des Experts Comptables Européens). FEE has been leading the debate on the future of ISAs in Europe since 2001.

ISAs provide for the international harmonisation of national standards and the adoption of a global framework approach. As a member of CCAB (the Consultative Committee of Accountancy Bodies) ACCA is committed to consulting its members on the adoption of ISAs in the UK, and working with FEE, the European Commission (EC) and others.

In response to the move in the profession, away from the ‘traditional audit risk’ model, to a business risk model, IAASB issued ISA 315 ‘Understanding the Entity and Its Environment and Assessing the Risks of Material Misstatement,’ ISA 330 ‘The Auditor’s Procedures in Response to Assessed Risks’ and ISA 500 (Revised) ‘Audit Evidence’. These standards (and conforming amendments) are effective for audits of financial statements for periods beginning on or after 15 December 2004. That is, they will be applicable to financial statements for periods beginning on or after 1 January 2005 that in the European Economic Area (EEA) and elsewhere will be adopting International Financial Reporting Standards (IFRSs) for the first time.

The adoption of ISAs has been welcomed by professional bodies as providing a robust approach to risk, fraud and quality control that is particularly important in the light of recent events (Enron/Worldcom/Parmalat). For example, ISA 315 provides additional guidance on the assessment of risks of material misstatement at the financial statement level and at the assertion level.

Tutorial note: Recent developments could validly be illustrated with reference to other standards. For example, ISA 240 (Revised) ‘The Auditor’s Responsibility to Consider Fraud in an Audit of Financial Statements’ that became effective from 1 January 2005 has raised auditor awareness of earnings management and the greater need for professional skepticism.

ISA 700 (Revised) ‘The Independent Auditor’s Report on a Complete Set of General Purpose Financial Statements’ is effective for audits of financial statements for periods beginning on or after 15 December 2005. This proposed significant changes to the auditor’s report to help promote consistency in reporting practices worldwide.

The International Organization of Securities Commissions (IOSCO) is in discussion with IAASB about the possible endorsement of ISAs (similar to its endorsement of IASs).

Practicing professionals must keep themselves up to date on auditing standards if they are to provide quality audits. Failure to do so could result in negligence claims and/or disciplinary action (e.g. by ACCA’s disciplinary committee). A survey by FEE has demonstrated that the European accountancy bodies broadly comply with ISAs. However, an earlier survey of IFAC member bodies showed that 14% had some significant differences (usually relating to reporting). IFAC needs to require its member bodies to act rather than merely encourage implementation. A set of global ethical requirements will help improve the implementation of ISAs as well as reduce the expectation gap in performing audits of financial statements.

(c) Continuing Professional Development (CPD)

CPD is defined as ‘the continuous maintenance, development and enhancement of the professional and personal knowledge and skills which members of ACCA require throughout their working lives’.

All professional accountants need to maintain their competence and develop new skills to be effective in their current and future employment. CPD helps keep accountants in practice employable and maintains their reputation with employers, clients and the public. It also helps maintain the accounting profession’s reputation for producing and supporting high calibre individuals. Therefore, CPD is something which professional accountants should take personal responsibility for, and be doing as part of their everyday work.

3 Predecessor body to the International Accounting Standards Board (IASB).
4 Of 65 countries in 1998
5 ACCA definition
Mandatory CPD for active members of IFAC member bodies (such as ACCA) was introduced with effect from 1 January 2005 onwards. ACCA has introduced CPD as a requirement for all active members, subject to the phasing-in dates (and waivers).

**Tutorial note:** IFAC issued International Education Standard (IES) 7, which requires the introduction of CPD for all active members of IFAC member bodies.

ACCA practising certificate and insolvency licence holders are still required to participate in technical CPD training. All other members will also be asked to state on their annual CPD return that they maintain competence in professional ethics.

The scheme is being introduced in phases:

- phase 1 (2005) – members admitted since 1 January 2001, and all practising certificate and insolvency licence holders;

**Tutorial note:** However, ACCA encouraged all members to adopt the scheme from 1 January 2005.

Affiliates join the CPD scheme on 1 January following their date of admittance to membership.

There are two routes to participation in ACCA’s CPD scheme:

1. the unit scheme route (40 units approximate to 40 hours required each year); and
2. the approved CPD employer route (i.e. where employers are recognised as effectively providing ACCA members with CPD).

**Tutorial note:** Alternatively, if an ACCA member is also a member of another IFAC accounting body and that CPD scheme is compliant with IFAC’s CPD IES 7, they may choose to follow that body’s route.
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 1/2 a mark for a point of knowledge, increased to 1 mark for the application of knowledge and 1 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) Preliminary materiality

For ‘rule of thumb’ calculations \[ \text{max } 2 \]
For appropriate degree of precision (not more than $0.1 \text{m}) \[ \text{max } 1 \]
For a suitable conclusion \[ \text{max } 1 \]
Generally 1 mark each comment in justification of assessment \[ \text{max } 4 \]

**Ideas**
- Suitable range(s)
- Unsuitable PBT-based assessment
- Risk of over/under auditing income statement/balance sheet
- Draft financial statements
- New audit

## (b) Financial statement risks

Generally $\frac{1}{2}$ mark for identification + 1 mark each point of explanation \[ \text{max } 12 \]

**Ideas**
- Revenue/Receivables – potential overstatement (rebates)
- Materials expense – overstated? vs
- Depreciation/amortisation/other – understated?
- Intangibles – potential overstatement (internally-generated criteria not met/impaired)
- Tangible assets – potential overstatement (unrecorded disposals/impairment)
- – potential understatement (finance leases omitted)
- Receivables – overstated? (impairment allowance)
- Restructuring provision – potential overstatement (underutilised?)
- Finance lease liabilities – potential understatement/disclosure risk (IAS 17)
- Trade payables – understatement/unrecorded liabilities
- Employee liabilities – potential understatement

## (c) Extent of reliance on analytical procedures (as audit evidence)

Generally 1 mark each point of explanation \[ \text{max } 6 \]

**Ideas**
- Caveat – first audit
- Material items requiring 100% testing
- Immaterial items (e.g. inventory)
- Suitability of SAPs – large volume transactions (revenue, materials expense, staff costs)
- Expectation of relationships
- ‘Proof in total’ – staff costs, depreciation, finance
- Relevance of available information
- Efficiency and effectiveness of alternative procedures
(d) Principal audit work
Generally 1 mark each area of principal audit work

max 3 marks each (i) and (ii) 6

Ideas

(i) Trade receivables
■ Agreements – volume rebate terms
■ Direct confirmation
■ After-date cash
■ After-date credit notes
■ Credit risk analysis/impairment assessment
(ii) Vehicles
■ Opening balances – non-current asset register
■ Physical inspection (existence/condition/milometer)
■ Additions to purchase invoices
■ New lease contracts
■ Repair and maintenance accounts

2 (a) Terms of engagement – specific matters to be clarified
Generally 1/2 mark each matter identified (max 4 marks)
and up to 1 1/2 marks for explanation max 6

Ideas (ISRE 24006)
■ Objective/purpose of the assignment
■ Management’s responsibility
■ Nature/scope of review (Investigation = enquiry + analytical procedures)
■ Level of assurance – negative (Not an audit/no audit opinion)
■ Timeframe
■ Unrestricted access to information requested
■ Disclaimer

(b) Principal additional information
Generally 1/2 mark each principal item identified (max 3 marks)
and up to 1 mark a point explaining its relevance max 8

Ideas
■ Prior period financial statements (accounting policies)
■ Management accounts/cash flow forecasts
■ Signed bank (overdraft facility) and other agreements with lenders
■ Standard contract terms (guarantees/disclaimers, etc)
■ Legal/correspondence file (Sarwar contract)
■ Quantity surveyor’s working papers (last quarterly count/rolling budgets)
■ Type and frequency of constructions undertaken

(c) Specific inquiries – accounting for construction contracts
Generally 1/2 – 1 mark each enquiry max 6

Ideas
Concerning
■ loss-making contracts
■ contingent liabilities/outcome on Sarwar
■ claims history/effectiveness of penalty clauses
■ useful lives of assets used in construction
■ nature of losses (e.g. theft of building supplies)

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6 ISRE ‘Engagements to Review Financial Statements’ (formerly ISA 910). ISA 210 ‘Terms of Audit Engagements’ could also provide a suitable ‘ideas list’.
3  (i)  Matters
Generally 1 mark each comment
  max 6 marks each issue \times 3

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ materiality (appropriately assessed)</td>
</tr>
<tr>
<td>■ relevant IASs (e.g. 1, 8, 10, 16, 24, 36, 37, 38)</td>
</tr>
<tr>
<td>■ fundamental concepts (accruals/prudence)</td>
</tr>
<tr>
<td>■ risks (e.g. valuation/existence/disclosure)</td>
</tr>
<tr>
<td>■ responsibilities (e.g. environmental)</td>
</tr>
</tbody>
</table>

(ii) Audit evidence
Generally 1 mark each item of audit evidence (source)
  max 6 marks each issue \times 3

<table>
<thead>
<tr>
<th>Ideas (ISA 500)</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ oral vs written</td>
</tr>
<tr>
<td>■ internal vs external</td>
</tr>
<tr>
<td>■ auditor-generated</td>
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<tr>
<td>■ procedures</td>
</tr>
</tbody>
</table>

\[ \text{max 20} \]

(a) max 9
(b) max 6
(c) max 5
\[ \text{20} \]
4  (a) Auditor’s reporting responsibilities for initial engagements

Generally 1 mark each point of explanation

<table>
<thead>
<tr>
<th>Ideas (ISA 510)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sufficient appropriate evidence</td>
</tr>
<tr>
<td>■ opening balances</td>
</tr>
<tr>
<td>■ prior period’s closing balances</td>
</tr>
<tr>
<td>■ appropriate accounting policies</td>
</tr>
<tr>
<td>If insufficient ⇒ limitation</td>
</tr>
<tr>
<td>■ qualified opinion (‘except for’)</td>
</tr>
<tr>
<td>■ disclaimer</td>
</tr>
<tr>
<td>■ if permitted, qualified/disclaimed on results</td>
</tr>
<tr>
<td>(unqualified on financial position)</td>
</tr>
<tr>
<td>Disagreement ⇒ qualified opinion/adverse</td>
</tr>
<tr>
<td>■ misstatement not properly accounted for</td>
</tr>
<tr>
<td>■ inconsistent accounting policies</td>
</tr>
<tr>
<td>Prior period modification</td>
</tr>
<tr>
<td>■ modify again if still relevant</td>
</tr>
</tbody>
</table>

(b) Implications for auditor’s reports

Generally 1/2 mark each implication + 1 mark each comment

<table>
<thead>
<tr>
<th>Ideas</th>
</tr>
</thead>
<tbody>
<tr>
<td>■ materiality of Tiltman to Johnston</td>
</tr>
<tr>
<td>(i) Inventory overvaluation</td>
</tr>
<tr>
<td>■ non-compliance (IAS 2)</td>
</tr>
<tr>
<td>■ materiality to Tiltman</td>
</tr>
<tr>
<td>■ prior year report unmodified ⇒ auditor concurred?</td>
</tr>
<tr>
<td>■ prior period adjustment needed (IAS 8)</td>
</tr>
<tr>
<td>(ii) Restructuring</td>
</tr>
<tr>
<td>■ materiality to Tiltman</td>
</tr>
<tr>
<td>■ constructive obligation? (IAS 37)</td>
</tr>
<tr>
<td>■ reverse unless employees validly expect</td>
</tr>
<tr>
<td>■ disclose non-adjusting event (IAS 10)</td>
</tr>
<tr>
<td>■ risk of goodwill overstatement</td>
</tr>
<tr>
<td>■ non-compliance (IFRS 3)</td>
</tr>
<tr>
<td>■ not a contingent liability of Johnston</td>
</tr>
<tr>
<td>Overall</td>
</tr>
<tr>
<td>■ adjustments needed in Tiltman ⇒ unmodified Tiltman</td>
</tr>
<tr>
<td>(also Johnston)</td>
</tr>
<tr>
<td>■ materiality (combined effect) to Johnston</td>
</tr>
<tr>
<td>■ adjust on consolidation ⇒ unmodified Johnston</td>
</tr>
<tr>
<td>■ no adjustments ⇒ ‘except for’ (disagreements)</td>
</tr>
</tbody>
</table>
5 Ethical, other professional and practical matters
Generally $\frac{1}{2}$ mark each matter relevant to staffing identified + 1 mark each comment contributing to comparison/contrast of three clients

<table>
<thead>
<tr>
<th>Ideas</th>
<th>Ethical</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>Objectivity/threats to independence</td>
</tr>
<tr>
<td></td>
<td>- self-interest</td>
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<tr>
<td></td>
<td>- self-review (other services Huggins/Gray)</td>
</tr>
<tr>
<td></td>
<td>- familiarity (Huggins/Gray)</td>
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<td></td>
<td>- intimidation (Peter/Blythe)</td>
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<td></td>
<td>Possible safeguards (some are staffing implications)</td>
</tr>
<tr>
<td>Other professional</td>
<td></td>
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<td></td>
<td>Risk management (of assignments)</td>
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<td></td>
<td>Quality control (direction, supervision, review)</td>
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<td></td>
<td>Client management</td>
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<td></td>
<td>Professional skepticism</td>
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<tr>
<td>Practical</td>
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</tr>
<tr>
<td></td>
<td>Logistics (timing/deadlines/locations)</td>
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<tr>
<td></td>
<td>Time/fee/staff budgets</td>
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<tr>
<td>Staffing implications</td>
<td></td>
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<tr>
<td></td>
<td>Competence and due care (Qualifications/Specialisation)</td>
</tr>
</tbody>
</table>

6 Effect of recent developments on Certified Chartered Accountants
Generally 1 mark a point of explanation

(a) IFAC's Code of Ethics

<table>
<thead>
<tr>
<th>Ideas (illustrative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>need for</td>
</tr>
<tr>
<td>when published/effective from</td>
</tr>
<tr>
<td>developments outlined – framework v rulebook</td>
</tr>
<tr>
<td>impact on practicing professionals v members in business</td>
</tr>
</tbody>
</table>

(b) International Standards on Auditing (ISAs)

<table>
<thead>
<tr>
<th>Ideas (illustrative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>need for (harmonisation)</td>
</tr>
<tr>
<td>history</td>
</tr>
<tr>
<td>following IAS example</td>
</tr>
<tr>
<td>when published/effective from</td>
</tr>
<tr>
<td>developments outlined</td>
</tr>
<tr>
<td>impact on practicing professionals v members in business</td>
</tr>
</tbody>
</table>

(c) Continuing professional development (CPD)

<table>
<thead>
<tr>
<th>Ideas (illustrative)</th>
</tr>
</thead>
<tbody>
<tr>
<td>definition (e.g. ACCA's)</td>
</tr>
<tr>
<td>need for</td>
</tr>
<tr>
<td>when published/effective from (phasing in)</td>
</tr>
<tr>
<td>developments outlined (two routes)</td>
</tr>
<tr>
<td>impact on practicing professionals v members in business</td>
</tr>
</tbody>
</table>