
Answers

1 Briefing notes

To: Kerry Dunker, audit engagement partner
From: Audit manager
Subject: Bassett Group audit planning

Introduction

These briefing notes relate to the audit planning of the Bassett Group (the Group) for the year ending 30 April 2018. As requested, the notes contain an evaluation of the audit risks which should be considered in planning the Group audit, including an initial assessment of specific areas where the audit team should exercise professional scepticism. The notes also assess whether Borzoi Co, the Group's foreign subsidiary, is a significant component of the Group. We will be working with a component auditor, Saluki Associates, and these notes discuss the extent of involvement which our firm should have with the audit risk assessment to be performed by Saluki Associates on Borzoi Co.

Audit risk and application of professional scepticism

New audit client

This is the first year that our firm has audited the Group. This gives rise to detection risk, as our firm does not have experience with the client, making it more difficult for us to detect material misstatements. However, this risk can be mitigated through rigorous audit planning, including obtaining a thorough understanding of the business of the Group.

In addition, there is a risk that opening balances and comparative information may not be correct. There is no reason for this to be a particularly high risk, as the previous auditor's opinions have been unmodified for the last four years. However, because the prior year figures were not audited by Whippet & Co, we should plan to audit the opening balances carefully, in accordance with ISA (UK) 510 *Initial Audit Engagements – Opening Balances*, to ensure that opening balances and comparative information are both free from material misstatement.

Pressure on results

The Group is a listed entity, and the results of the preliminary analytical review indicate that there is a reduction in total Group revenue of 3.2%. The book publication operating segment has the most significant reduction in revenue of 6.7%. Pressure from shareholders for the Group to return a better performance creates an incentive for management bias, especially given the significant investment in new software which has been made – shareholders will want to see a return on that investment. This means that management may use earnings management techniques, or other methods of creative accounting, to create a healthier picture of financial performance than is actually the case. This creates an inherent risk of material misstatement, at the financial statement level.

This means that the audit team should apply professional scepticism to areas of the audit where the accounting is subject to management's judgement, especially if the accounting treatment which has been applied results in the acceleration or inflation of revenue, or the deferral of expenditure.

Operating segments

As the Group is a listed entity, it will be required to disclose information in the notes to the financial statements in accordance with IFRS® 8 *Operating Segments*. There is an audit risk that the disclosure may be inaccurate, or incomplete, or that it does not reflect the way information on financial performance is monitored internally by the chief operating decision maker, as required by IFRS 8. For instance, the fact that two of the three reported operating segments are showing a drop in performance while the other shows improvement could indicate inaccuracy in the information. In addition, if management is monitoring separately the performance of digital and non-digital sources of income, and if digital sales become significant in their own right, then this may need to be disclosed as a separate operating segment.

Professional scepticism should be applied to the audit of operating segments; due to management bias the allocation of revenue, expenses and assets between segments could be subject to manipulation, for example, to mask the declining performance of the book and newspaper and magazine operating segments. Allocation is determined by management, and this judgement should be approached with scepticism, especially given the potential lack of integrity displayed by the CFO as indicated by the communication from Grey & Co.

Internally developed software

The group financial statements recognise £10 million which has been capitalised in respect of internally developed software. This is equivalent to 10.5% of Group assets and the amount is therefore material to the financial statements. An audit risk arises in that the requirements of IAS® 38 *Intangible Assets* might not have been followed. Software development costs can only be capitalised if they meet the capitalisation criteria, including that a future economic benefit can be demonstrated and that technical and commercial feasibility of the asset have been established. If these criteria have not been met, then the development costs should be expensed. In addition, the Group may not have distinguished appropriately between research and development costs. If research costs have been included in the amount capitalised then it is overstated, because research costs must always be expensed.

This is an area where professional scepticism should be applied, both in relation to management's assertion that the software costs meet the necessary conditions for capitalisation, and in relation to the distinction, if any, which has been made between research and development costs. There is a risk that profit is overstated by a material amount if the accounting treatment is incorrect.

Impairment

Management is not planning to test the cash generating units for impairment, giving rise to a significant audit risk. Regardless of impairment indicators, goodwill must be tested for impairment each year according to IAS 38, and given that the Group has over 20 subsidiaries, it is likely that there is goodwill recognised in the consolidated statement of financial position and allocated into the cash generating units, meaning that they must be tested for impairment on an annual basis.

In addition, the reduction in revenue for the Group as a whole, and for the newspapers and magazines and books operating segments specifically, is an indicator of potential impairment. This should trigger an impairment review even if there is no goodwill allocated to the cash generating units. Management's justification for not conducting an impairment review is wholly inappropriate and if an impairment review is not conducted and any necessary impairment loss not recognised, then profit and assets will be overstated, possibly by a material amount.

Again, this is an area where the audit team will need to apply professional scepticism, and challenge management on their assumption that an impairment review is not needed. Management's reluctance to conduct an impairment review could be due to management bias and the pressure to return a healthy profit to shareholders.

Publication rights

The publication rights are recognised as an intangible asset with a carrying amount of £7.9 million, representing 8.3% of total assets. This is material to the financial statements. It is appropriate that the publication rights are amortised, as they have a finite life. However, the period over which they are amortised may not be appropriate. The Group accounting policy is to amortise over an average of 25 years, but the actual period to which the rights relate varies from five to 30 years. Therefore while it may be appropriate to use an average for the basis of an accounting policy, it means that some rights are being amortised over much too long a period, overstating intangible assets and understating expenses.

Management could be using this 25-year average period as a way of smoothing profits and managing earnings. The accounting policy may not be appropriate, and the audit team will need to be sceptical in relation to the appropriateness of the policy, and challenge management on its use.

Author royalty advances

The royalty advances recognised within current assets amount to £3.4 million, which is material at 3.6% of total assets. Deferring the cost, effectively treating it as a prepayment, seems to be appropriate. However, the Group accounting policy should be challenged by the audit team. Releasing the cost over a ten-year period seems to have no suitable justification and appears to be quite simplistic. While industry practice can be used to develop accounting policies, the Group must consider the specific period of amortisation relevant to its publications, and not shape its accounting policies simply based on the actions of its competitors in the market, who might have very different types of publications providing economic benefit over a different period. Presumably some books published by the Group will have a much shorter life than ten years, in which case the advance royalty payment should be spread over a shorter period.

Similar to the point raised previously in relation to the accounting treatment of the publication rights, management could be using this ten-year average period as a way of smoothing profits and managing earnings. Again, the accounting policy may not be appropriate, and the audit team will need to be sceptical in relation to the appropriateness of the policy, and challenge management on its use.

Borzoï Co – foreign currency retranslation

In order to be consolidated into the Group, the financial statements of Borzoï Co will need to be retranslated from its local currency, the Oska, into £, in accordance with IAS 21 *The Effects of Changes in Foreign Exchange Rates*. IAS 21 requires that assets and liabilities are translated at the closing exchange rate at the reporting date, while income and expenses are translated at the exchange rates at the dates of the transactions. The fact that the currency has been volatile over the last six months and could remain volatile for the rest of the year means that the retranslation of income and expenses is problematical; it is potentially complex and prone to contain errors, giving rise to risk of material misstatement given that Borzoï Co is a significant component of the Group (this will be discussed in more detail later in these briefing notes).

Transfer of software

The transfer of software gives rise to several audit risks. First, there is a risk that the software was overvalued when it was transferred from Bassett plc to Borzoï Co. The fair value which was recognised in the parent company accounts immediately prior to the transfer of the asset was determined by Group management, and while revaluation is permitted by IAS 38 where an active market for the asset exists, this fair value could be inappropriate. In the absence of an active market, it is unlikely the revaluation should have been recognised at all. There is a significant difference between the carrying amount of the software and the fair value determined by management, £1 million and £5.4 million respectively, giving rise to a revaluation of £4.4 million which was recognised by Bassett plc immediately prior to the transfer. The audit risk is that in the parent company, the revaluation should not have been recognised, or, if revaluation is appropriate, the amount recognised was based on an inappropriate value. In the individual financial statements of Borzoï Co, the asset could be overstated in value. Any overstatement of the asset has implications for subsequent amortisation charges, which would also be overstated in the financial statements of Borzoï Co.

The audit team should approach this issue with appropriate professional scepticism – the revaluation of the software will need to be justified by management as it could be a mechanism being used by Group management to inflate the assets of Borzoï Co and the Group as a whole. The audit team should also challenge the assertion made by management that a sufficiently active market exists to enable a reliable and realistic fair value to be determined for the software.

At Group level, the transfer is an intercompany transaction and the consolidated financial statements should be prepared as if the transaction had not occurred. This is an additional and separate audit risk from the risk that the valuation of the asset is not appropriate. There is an audit risk if the elimination of the intercompany transaction does not take place as part of the consolidation

process. Adjustments should be made to cancel out the intercompany payable and receivable in respect of the £5.4 million which is outstanding between Borzoi Co and Basset plc.

Corporate governance arrangements

The Group CFO blocking access to the audit committee is not acceptable. The *UK Corporate Governance Code* and *Guidance on Audit Committees* provide guidance on the role of the audit committee in relation to the external auditor, and effective communication between the audit committee and the external auditors is fundamental to good corporate governance practice. One of the requirements is that the audit committee should, at least annually, meet the external auditors, without management, to discuss matters relating to its remit and any issues arising from the audit. Therefore the CFO should not be blocking access and preventing communication between the audit committee and the audit firm.

In addition, ISA (UK) 260 *Communication With Those Charged With Governance* specifies that the auditor should determine the appropriate persons within the entity's governance structure with whom to communicate and as per ISA (UK) 210 *Agreeing the Terms of Audit Engagements* providing unrestricted access to persons within the entity is one of the preconditions for the audit. As such, the CFO is potentially imposing a limitation on the scope of the audit by not facilitating unrestricted and effective communication with the audit committee and the CFO should not interfere with these communications.

This situation could also indicate that the CFO has something to hide, and that the control environment within the Group is not strong and this risk is augmented by the points already raised in relation to management bias. Certainly there would not seem to be a good ethical culture if the CFO is acting in this way. In line with the *UK Corporate Governance Code*, the audit committee is required to assess the effectiveness of the external audit process and a key part of this is likely to be done via the direct communication the auditor and the audit committee have. As such, it would appear as though the CFO may lack integrity or possibly does not understand the principles of the *UK Corporate Governance Code* and *Guidance on Audit Committees* and is potentially disrupting the audit committee's ability to discharge its responsibilities. All of these issues increase audit risk and the need for approaching the audit with professional scepticism, especially when dealing with estimates and judgements which have been determined by the CFO.

Tutorial note: Credit will be awarded for other relevant audit risks and associated matters relating to professional scepticism, for example, whether an appropriate amortisation policy has been applied to the software in which the Group had invested during the year, and whether Borzoi Co (and any other subsidiaries) has different accounting policies to the rest of the Group which would require adjustment at consolidation.

Assessment of whether Borzoi Co is a significant component of the Group

ISA (UK) 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* requires the Group auditor to determine whether a component is a significant component. One of the reasons for this is because it determines the type and extent of involvement which the Group auditor should have with the work of the component auditor.

ISA (UK) 600 defines a significant component as a component identified by the group engagement team which is of individual financial significance to the group, or which, due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

ISA (UK) 600 suggests that benchmarks such as profit and assets should be assessed when determining significance but it does not require a specific threshold to be used. The standard does suggest that 15% could be an appropriate cut-off point for determining significance. The total assets of Borzoi Co are 68 million Oska and if retranslated using the current exchange rate of 4 Oska:1£, its assets are £17 million. This represents 17.9% of Group assets and therefore based on the information at today's date, Borzoi Co is a significant component of the Group.

It is important to note that given the volatility of the Oska currency, the value of the subsidiary may change by the reporting date meaning that it is no longer significant due to its size. However, Borzoi Co could be significant due to its specific nature or circumstances, being the Group's only foreign subsidiary, which brings specific risks of material misstatement as outlined earlier in these briefing notes. There may also be regulatory or economic issues specific to the company, especially due to the political difficulties in its jurisdiction, which also impact on the Group and give rise to risks. Therefore regardless of its monetary size, it is likely that Borzoi Co will be considered to be a significant component of the Group.

The extent of involvement which our firm should have with the work of Saluki Associates

When working with a component auditor, the group engagement team should obtain an understanding on a number of matters as required by ISA (UK) 600. These matters include the competence of the component auditor, whether the component auditor understands the ethical framework relevant to the Group audit and is independent, and the regulatory environment in which the component auditor operates. The extent of involvement which our firm will have with Saluki Associates depends to an extent on the evaluation of these matters. If there are concerns over the competence, independence or diligence of Saluki Associates or the jurisdiction in which they operate, the level of involvement with their work should be increased in response.

According to ISA (UK) 600, if a component auditor performs an audit of the financial information of a significant component, the group engagement team is required to be involved in the component auditor's risk assessment to identify significant risks of material misstatement to the group financial statements. The nature, timing and extent of this involvement are affected by the group engagement team's understanding of the component auditor, but at a minimum should include the following:

- Discussing with the component auditor or component management the component's business activities which are significant to the group;
- Discussing with the component auditor the susceptibility of the component to material misstatement of the financial information due to fraud or error;

- Reviewing the component auditor's documentation of identified significant risks of material misstatement of the group financial statements. Such documentation may take the form of a memorandum which reflects the component auditor's conclusion with regard to the identified significant risks;
- Evaluating the component auditor's communication on matters relevant to the group audit and discuss any significant matters arising from that evaluation with the component auditor, component management or group management as appropriate; and
- Determining whether it is necessary to review other relevant parts of the component auditor's audit documentation.

The Group audit team may need to have further involvement in the audit of the component where significant risks of material misstatement of the Group financial statements have been identified in a component. In this case, the Group audit team shall evaluate the appropriateness of the further audit procedures to be performed to respond to the identified significant risks of material misstatement of the Group financial statements. Based on its understanding of the component auditor, the Group audit team will then determine whether it is necessary to be involved in the further audit procedures.

Conclusion

These briefing notes indicate a range of audit risks to be considered in planning the Group audit. In particular, there are significant risks of misstatement in relation to intangible assets and a foreign subsidiary. There is also a significant risk of management bias, and the audit will need to be planned and performed with appropriate levels of professional scepticism, especially given that this is a new audit client. Borzoi Co, a foreign subsidiary, is a significant component of the Group and we must have involvement with risk assessment in relation to the planning of its audit.

2 (a) (i) Ethical and other matters to be considered before accepting Setter Ltd as a client of the firm

Requirements and guidance relevant to accepting and continuing client relationships is contained in ISQC 1 (UK) *Quality Control for Firms that Perform Audits and Reviews of Financial Statements and Other Assurance and Related Services Engagements*. The fundamental requirements are that a firm must consider:

- Its competence to perform the engagement and whether the firm has the capabilities, including time and resources to do so,
- Whether the relevant ethical requirements can be complied with, and
- The integrity of the client, and whether there is information which would lead it to conclude that the client lacks integrity.

Competence and resources

Looking at each consideration in turn, there seems no reason why Pointer & Co would not have the competence to carry out the assignment, which is a limited assurance review of historical financial statements. Being a firm of Chartered Certified Accountants, and performing assurance services such as the audit of Vizsla Ltd, means that the firm has the relevant knowledge and experience to perform a high quality limited assurance review.

It should be confirmed that a limited assurance review of the financial statements is appropriate. The company's revenue is stated as £8 million, which is below the audit exemption threshold of £10.2 million. However, according to the Companies Act 2006, to be exempt from audit, two out of three of the following criteria must be met:

- Annual turnover of no more than £10.2 million
- Assets worth no more than £5.1 million
- 50 or fewer employees on average

It is possible, though perhaps unlikely, that the company's assets and number of employees exceed the criteria, in which case a full audit would be necessary. In addition, the £8 million stated revenue should be confirmed, in case the actual amount of revenue is higher.

However, the pressure to perform the audit for a low fee could impact on Pointer & Co's ability to perform a high quality limited assurance review if insufficient resources are made available, given the potential restriction on the fee which can be charged to provide the service. ISQC 1 also mentions that where the client is aggressively concerned with maintaining the firm's fees as low as possible, this can indicate a lack of integrity of the client.

Ethical issues

In terms of ethics there are several matters to consider. First, it appears that Vizsla Ltd is putting pressure on Pointer & Co to accept the engagement. Vizsla Ltd is a relatively significant client of Pointer & Co, providing 10% of the firm's annual practice income, and there is an intimidation threat in that Vizsla Ltd has threatened to move to another audit provider if Pointer & Co does not accept Setter Ltd as a client and perform the work for a low fee. This could also be perceived as a self-interest threat in that Pointer & Co has a financial interest in maintaining a good relationship with Vizsla Ltd.

In relation to the self-interest threat created by potential fee dependency, the FRC *Ethical Standard* requires that where it is expected that the total fees for services receivable from a non-listed audit client will regularly exceed 10% of the annual fee income of the firm but will not regularly exceed 15%, the engagement partner shall disclose that expectation to the firm's ethics partner and to those charged with governance of the audited entity and the firm shall arrange an external independent quality control review of the engagement to be undertaken before the firm's report is finalised.

A further ethical issue arises from the suggestion that Pointer & Co should provide tax planning advice to Setter Ltd and prepare its tax submissions. The FRC *Ethical Standard* suggests that this type of work could give rise to a range of threats

to independence including management, advocacy, self-interest. A self-review threat could also rise if the tax figures are material to the financial statements because Pointer & Co would have some input to the tax figures which form part of the financial statements which would then be subject to the limited assurance review. Providing the tax planning advice could also be seen as acting on behalf of management, further impairing the objectivity of the limited assurance provided on the financial statements. An advocacy threat may arise should the firm represent the client's interests, for example, when presenting the tax submissions to HMRC.

However, the firm may be able to provide such services, provided that there is informed management and appropriate safeguards are applied to reduce the self-review threat to a level where independence is not compromised, for example, through the use of separate teams to provide the limited assurance review and the tax services and by having an independent second partner to review the work performed. If safeguards do not reduce the threats to an acceptable level, then the tax service should not be carried out in addition to the limited assurance review.

Client integrity

Preparing the personal tax computations of Gordon Potts is less of an ethical issue in terms of objectivity as his personal tax is a separate issue and not reflected in the company's financial statements, but there may be other issues with providing this advice, linked to integrity, which will be discussed next.

The integrity of Gordon Potts will need to be carefully evaluated. There is nothing wrong with him having business interests in several companies, though information about each of these will need to be obtained. The key issues with integrity relate to the breach of employment law and his taking money from a company pension plan to set up a business which is managed by his son. The breach of employment law indicates that Gordon Potts has a questionable reputation and possibly that he has been involved in criminal activity, depending on what laws have been breached, and the seriousness of the non-compliance. The information comes from a newspaper article, so it may not be very credible and may not even be true, and more information will need to be sought on this issue.

Taking money from the company pension plan is likely to be a breach of the relevant regulations, and it would seem that this was done for the benefit of his son. The fact that this business is located in a foreign country makes the business arrangements complicated, and while it could be completely innocent, it could also mean that there is something more sinister behind the connections between the companies, for example, it could be an arrangement to facilitate money laundering.

Pointer & Co must obtain sufficient information to carefully evaluate the appropriateness of accepting Setter Ltd as a client, and they must document the acceptance decision in accordance with ISQC 1.

(ii) The importance of performing know your client procedures and the information which should be obtained

Know your client (KYC) procedures are performed as part of anti-money laundering regulations, which all audit firms should have in place when accepting new clients. It refers to the firm obtaining information to be able to identify who the prospective client is and verify identity by reference to independent and reliable source material. This is a crucial part of risk assessment when taking on a new client and allows the firm to understand not only the identity of the prospective client, but also the nature of the business and its source of funds.

Specifically, the firm should perform the following procedures:

- Identify the customer and verify their identity using documents, data or information obtained from a reliable and independent source.
- Confirm the identities of all shareholders, including the specific family members who collectively own 90% of the company's share capital, and the other shareholder(s) who own the remaining 10%.
- Identify any beneficial owner who is not the client. This is the individual (or individuals) behind the client who ultimately own or control the client or on whose behalf a transaction or activity is being conducted.
- Where a business relationship is established, understand the purpose and intended nature of the relationship, for example, details of the customer's business or the source of the funds.

Businesses must also conduct ongoing monitoring to identify large, unusual or suspicious transactions as part of KYC. All of the documents obtained for the purpose of carrying out KYC checks must be retained for a minimum of five years from the end of the business relationship.

In this scenario, the information which should be obtained includes:

- To confirm the identity of Gordon Potts, photographic evidence, for example his passport, should be seen and a copy taken, along with other means of identification showing his address, for example, recent utility bills or bank statements.
- In relation to Setter Ltd, the company certificate of incorporation should be seen, to confirm its legal status and the date and place of incorporation.
- A Companies House search on Setter Ltd should take place, this will confirm the existence of the company, the shareholders and directors and will provide some financial information. This will confirm that Gordon Potts is the 'beneficial owner' of the entity – i.e. that he is the person who owns or controls, directly or indirectly, more than 25% of the shares or voting rights or who otherwise exercises control over the directors.

- The identity of the other companies controlled by Gordon Potts should also be found, and searches on them conducted, to confirm their existence and the nature of the relationship with Setter Ltd.
- The latest financial statements of Setter Ltd, and the other companies in which Gordon Potts has an interest should be reviewed. This will help Pointer & Co to understand the businesses and their relationship with each other, identify the sources of income and whether there are significant transactions between the companies.
- Identify the source of funding for the company, whether there are bank loans or other providers of finance, and the nature of the finance provided in terms of when it is repayable, whether any company assets are provided as collateral for the debt, and whether Gordon Potts or other shareholders have made personal guarantees in respect of any sources of company finance.
- While not strictly part of confirming the identity of Gordon or his companies, Pointer & Co would clearly need to obtain further information about the breach of employment law, and confirm the facts surrounding the situation. Currently the only information available is from a newspaper article and this may not be a credible source.

(b) Examination procedures on the operating profit forecast of Vizsla Ltd

General procedures:

- Enquire as to the identity of the preparer of the operating profit forecast, and assess their competence, especially given that interest costs have been included as part of operating profit which is incorrect.
- Obtain an understanding as to the procedures and controls which have been followed in the preparation of the forecast, for example, has the forecast been approved by a senior member of the company's accounting team.
- Confirm that the accounting policies applied in Vizsla Ltd's financial statements have been consistently applied in the preparation of the operating profit forecast, for example, that design costs are expensed rather than capitalised as a development cost.
- Confirm that the assumptions underpinning the forecast are in line with knowledge of the business obtained from performing the company's audit, for example, the seasonality of the sales can be confirmed by looking at the audit evidence obtained in the audit of revenue.
- Re-cast the forecast to ensure it is arithmetically correct.

Specific procedures:

- Enquire whether a more detailed profit forecast is available, or ask management to prepare one, for example, detailing out cost of sales and other expenses. In addition, request a forecast statement of financial position and statement of cash flows.

Tutorial note: *There could be matters which make the profit forecast unachievable revealed through assessment of the statement of financial position and statement of cash flows, e.g. the timing of the working capital cycle may make achieving the profit forecast unachievable if funds are not available at certain points of time especially given the seasonal nature of the business.*

- Request that management prepare a profit forecast in the same format as audited financial statements and in accordance with IFRS Standards, i.e. the interest cost should be shown below the operating profit line.
- Having obtained the cost of sales figure for each six-month period, recalculate the gross profit figures given in the forecast. Compare this to gross profit margins in the prior year audited financial statements and investigate any anomalies.
- Having obtained a break down showing the components of cost of sales and other expenses, for each significant category of expense, perform analytical review to confirm that the forecast costs appear to be in line with expectations, and discuss any unusually high or low forecast costs with management.
- Based on the above, assess whether there are any missing categories of expenditure which have not been included in the forecast, e.g. there is no depreciation included in the forecast.
- For revenue, which is forecast to increase by a significant amount (e.g. 11.8% increase comparing the six months ending 31 March 2019 and 31 March 2020), consider whether the forecast appears overly optimistic. For instance, there is not a corresponding increase in marketing costs to support the forecast increase in revenue.
- Compare revenue in the year forecast to 30 September 2019 with revenue from prior years' audited financial statements. Investigate any unusual trends through discussion with management.
- Review any marketing plans and discuss with an appropriate senior member of staff, for example, the sales director, to establish the rationale for forecasting a significant increase in revenue, for example, there may be plans to introduce new product lines. Consider this in light of the fact that design costs and marketing are not forecast to increase by a significant amount.
- Review the design costs as they appear to be fairly static with just a small increase to achieve a much bigger % increase in revenue. Discuss with management and assess if such an increase in revenue can be achieved with such a small increase in design costs.
- Confirm costs to appropriate supporting documentation, e.g. staff costs to human resources projected costs, marketing costs to advertising budgets.

- Assess whether the overdraft is likely to be repaid in September 2019, for example, by obtaining and reviewing the cash flow forecast prepared for the same period as the operating profit forecast.
- Discuss with management the rationale for using 30% of revenue as a basis for determining the amount of other expenses. In addition, compare this to the results of audit procedures performed on expenses to gauge whether 30% appears to be a reasonable basis.

3 Evaluation of quality control issues, implications for audit completion and further actions

(i) Controls testing on payables

The absence of evidence of authorisation by the procurement manager in relation to the three purchase orders represents an exception to the effective operation of an internal control on which the auditor intends to place reliance. The review of the supporting documentation and the conclusion that the items were legitimate business expenditure do not resolve the exception in the effective operation of the control. There is a risk that other exceptions and further unauthorised purchases may have occurred which may not have been for legitimate business purposes. The audit procedures therefore appear to have been inadequate. The audit assistant should have reported the matter to the manager and partner for them to decide if further work or risk analysis was required and who it should be reported to, i.e. those charged with governance, etc. This should have also been picked up during the review of the working papers.

Prior to finalising the audit, the audit team needs to assess the extent and significance of the internal control deficiency and should consider increasing the original sample size and extending the audit testing. If the extended testing identifies further exceptions in the effective operation of the control, the auditor should review whether a controls based approach is appropriate and consider whether more substantive testing on the payables component is required. The auditor should also consider including the matter in the report to management.

In line with ISA (UK) 260 *Communication With Those Charged With Governance*, the auditor is required to communicate significant findings from the audit to those charged with governance. These include significant difficulties encountered during the audit and any extensive unexpected effort required to obtain sufficient appropriate audit evidence. The absence of authorisation by the procurement manager in relation to the three purchase orders requires extended audit testing and represents a potentially significant deficiency in the operation of internal controls. It therefore represents a potentially significant audit finding which should be communicated to those charged with governance.

(ii) Petty cash fraud

The personal taxi fares represent a fraudulent transaction by the petty cashier and should be reviewed in the light of the auditor's and management's respective responsibilities in relation to the prevention and detection of fraud. ISA (UK) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* states that the primary responsibility for the prevention and detection of fraud rests with both those charged with governance of the entity and management. The existence of the fraud may also be further indication of a weak control environment. The auditor is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error. The amount of £175 is clearly immaterial to the financial statements and therefore does not represent a potential source of material error caused by fraud. The auditor should review the petty cash records for evidence of any further irregularities and discuss the matters identified with management. However, if the auditor concludes that the matter increases the overall assessment of fraud and control risk, management should be informed.

In spite of the immateriality of the amounts involved, however, the relationship of the audit assistant to the petty cashier represents a familiarity threat. The failure of the audit assistant to highlight the matter prior to the discussion with the engagement quality control reviewer may indicate a lack of professional integrity on the part of the audit assistant. In line with ISA (UK) 220 *Quality Control for an Audit of Financial Statements*, the auditor, primarily the audit engagement partner, has responsibility to monitor ethical requirements throughout the audit process. The firm's procedures for assigning staff to audit teams and for reporting personal relationships with client staff should be reviewed in light of this responsibility.

If the auditor concludes that the petty cash fraud and any additional issues identified on review of the petty cash records increases the overall assessment of fraud and control risk, the matter should be reported to management with a recommendation that all petty cash transactions should be adequately reviewed and authorised.

(iii) Cut-off testing on revenue

IFRS 15 *Revenue from Contracts with Customers* requires that an entity recognises revenue when or as the entity satisfies a performance obligation by transferring a promised good or service (i.e. an asset) to a customer. An asset is transferred when or as the customer obtains control of that asset. On this basis therefore, revenue has been recognised too early and as a result revenues, receivables and profits are overstated.

The error identified is in isolation immaterial to the financial statements at 0.2% of revenue (17,880/8.7 million). The error should be extrapolated based on the incidence of errors identified and the level of sales to this particular customer in order to assess the potential for a material misstatement. Based on this assessment, the auditor should extend cut-off testing in order to assess further the potential for a material error. The auditor should also confirm with management that the invoicing procedure is isolated to this particular customer and consider extending their assessment and testing to any other customers as necessary. The auditor should also review last year's cut-off procedures in order to investigate whether there were any compensating errors in the prior year.

All misstatements identified should be communicated to management and the auditor should request that they are corrected. ISA (UK) 260 requires the auditor to communicate to those charged with governance his or her views about significant qualitative aspects of the entity's accounting practices including accounting policies. The non-compliance with the recognition criteria of IFRS 15 represents a significant finding from the audit and should be communicated to those charged with governance according to ISA (UK) 260.

(iv) Tax advice

As already noted in (ii) above, the auditor has responsibility to monitor ethical requirements throughout the audit process. The provision of assistance in calculating the company's income tax payable for the year represents a self-review threat as the tax calculation forms the basis of the tax payable in the statement of financial position and the tax charge in the statement of profit or loss for the year. This risk is increased by the listed status of Davis plc.

According to the FRC *Ethical Standard*, the provision of tax services may give rise to a number of threats to the integrity and objectivity, including the self-interest threat, the management threat, the advocacy threat and, where the work involves a significant degree of subjective judgement and has a material effect on the financial statements, the self-review threat. The *Ethical Standard* also states that where an entity relevant to the engagement is a listed entity, the firm shall not provide a service to prepare current or deferred tax calculations which are or may reasonably be expected to be used by the entity when preparing accounting entries which are material to the financial statements. Davis plc is a listed client and therefore, as auditors, the firm should not perform the tax calculations which have been requested by the client.

According to ISA (UK) 260, the significant audit findings which the auditor is required to communicate to those charged with governance include matters which, in the auditor's professional judgement, are significant to the oversight of the financial reporting process. The auditor should therefore report the lack of skill and up-to-date knowledge of the finance director and the implications of this for the recruitment and training procedures at the client. The auditor should also report the independence issues identified above in relation to the finance director's request for the auditor to calculate the tax payable.

4 Dilley plc

Matters

The key matter to be considered is the status of the investment in Dilley plc in the consolidated financial statements of the Group. Although the 40% holding falls within the usual percentage presumption range for an associate following IAS 28 *Investments in Associates and Joint Ventures*, the existence of the share options over the remaining 60% is indicative of control following IFRS 10 *Consolidated Financial Statements*. IFRS 10 contains specific guidance on situations where control may exist when the investor does not hold a majority of the voting rights. According to IFRS 10, control and therefore status as a subsidiary may be based on potential voting rights provided such rights are substantive. In the case of Dilley plc, the potential voting rights are exercisable in the near future (within one month of the reporting date) and the 10% discount on market price makes them commercially attractive to the Group. The options therefore represent substantive potential voting rights and Dilley plc's statement of profit or loss should be consolidated line by line from the date of acquisition.

The 40% holding in Dilley plc has been held for 11 months of the current reporting period. The time apportioned revenue of £82.5 million (£90 million x 11/12) is therefore material to the consolidated financial statements at 1.1%. On the same basis, the time apportioned loss before tax is £11 million (£12 million x 11/12) which is £6.6 million greater than the loss recognised under the equity method of £4.4 million. The difference is also material to the financial statements at 12% of the Group's profit before tax. Given the loss making status of Dilley plc, there is an incentive not to consolidate the entity. The auditor should exercise professional scepticism and consider whether there are any implications in relation to management integrity.

Evidence

- A copy of the legal documents supporting the acquisition of the shares and the options including the voting rights and the terms of exercise for the options.
- A review of the audit working papers for Dilley plc, including details of the issued share capital and the associated voting rights attached to shares.
- The group board minutes relating to the acquisition and the intentions of management in relation to Dilley plc.
- Written representations from management on the degree of influence exercised over Dilley plc and the future intentions of management in relation to the share options.

Willis Ltd

Matters

The fair value of the derivatives of £6.1 million is material to consolidated profit before tax at 11.1% but in isolation, it is immaterial to consolidated assets at 0.4%.

IFRS 9 *Financial Instruments* requires the recognition of derivatives on the statement of financial position at fair value with the associated gains and losses being recognised in profit or loss for the period. The fair value of £6.1 million should therefore be included in current assets on the Group's consolidated statement of financial position and given that the options were entered into in the last three months of the period at no initial net investment, a fair value gain of £6.1 million should also be recorded in the Group's consolidated statement of profit or loss for the year. The treatment of the derivatives under local GAAP is acceptable in Willis Ltd's individual entity financial statements. For group purposes, however, accounting policies must be consistent and the profit before tax in the draft consolidated financial statements is materially understated.

The auditor must also exercise professional scepticism with regard to whether the directors have the required expertise to value the derivatives and should consider the need for independent, external evidence of the fair value of the options at the reporting date.

Evidence

- Details of the fair value of the options based on prices derived from an active market or, if this is not available, an independent expert valuation.
- Audit documentation of the review of derivative contracts and confirmation of the terms and maturity dates.
- Notes of a discussion with management in relation to the basis of their valuation and the accounting treatment required in the consolidated financial statements.

Knott Ltd

Matters

Consolidated financial statements are prepared from the group perspective and intra-group transactions and balances must be eliminated on consolidation. The sales value of £77 million is material to consolidated revenue at 1% and to consolidated assets at 4.9%. The unrealised profit of £7.7 million (£77m x 10%) is also material to consolidated profit before tax for the year at 14% (£7.7m/£55m). Group revenue, receivables and profit before tax are therefore materially overstated. The transactions should be verified in the accounting records of the individual entities to confirm that Knott Ltd has included the sale in its financial statements and that the parent company has not included the purchase in its financial statements. However, given that the goods are still in transit at the reporting date, group inventory will be understated by £69.3 million (£77m x 90%) which is also material to group assets at 4.4%. Consolidated retained earnings will be overstated by £6.16 million (£7.7 million x 80%) and non-controlling interests will be overstated by £1.54 million (£7.7 million x 20%). The accounting for the transaction within the individual entity financial statements will also be misstated.

The failure to identify and adjust for the intra-group trading transaction indicates a deficiency in internal control within the group and therefore increased control risk for the audit of the consolidated financial statements.

Tutorial note: *Credit will also be given to candidates who discuss the impact of the inter-company transactions on the financial statements of the individual entities.*

Evidence

- Agreement of the transaction details to underlying documents such as sales invoices, goods despatch notes at Knott Ltd and goods received notes, purchase invoices at its parent company.
- The cost of the inventory in transit should have been confirmed to production records at Knott Ltd to confirm the 10% profit margin.
- A copy of the goods received note dated 2 April 2018 raised by the parent company confirming details of the inventory in transit and the transaction being recorded in inventory and the purchase ledger after the year end.
- A copy of the sales invoice traced to Knott Ltd's sales ledger agreeing details of the sales value.
- The adjustments required to eliminate the transaction should be noted on a schedule of uncorrected misstatements for discussion with the client.

- 5 (a) Key audit matters (KAM) are the matters which, in the auditor's judgement, were of most significance in the audit of the financial statements. They were introduced by ISA (UK) 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, to enhance the auditor's report issued in respect of listed entities by providing more relevant information to the users of those reports.

Benefits

The principal reason for the disclosure of KAM in the auditor's report was to provide increased transparency in response to requests from users of the financial statements for more information in relation to significant judgements made by both management and the auditor. This should lead to increased focus on the uncertainties created by judgements in the reporting process and help to improve users' understanding of the financial statements. This in turn will serve to increase confidence in the audit process and the perception of audit quality.

The audit expectation gap is the difference between the actual role of the external auditor and the role which the public believes the auditor performs. In this context, the inclusion of KAM within the auditor's report represents an important step in the process of informing and educating the public about the auditor's role in evaluating areas of high risk, judgements and significant events or transactions which occurred during the period. Furthermore, auditors are expected to discuss how they addressed KAM during the course of the audit and the provision of detail in relation to the procedures performed will also go some way to provide greater transparency on how the audit is performed.

Difficulties

The determination of which audit matters to report as 'key' is subjective and requires auditor judgement. As a result, this may reduce the consistency and comparability of auditor reporting. In order to assist with this, ISA (UK) 701 provides a decision making framework to help auditors determine which matters are KAM. This should help reduce ambiguity and promote consistency across audits.

The inclusion of KAM in the auditor's report may lead to a significant increase in the volume of detail contained in the report thereby obscuring which of the matters are of the greatest significance. This increase in volume may deter users from reading

the auditor's report in full and therefore undermine its role in closing the audit expectation gap. There are also concerns that the lack of specific guidance may lead to standardised 'boilerplate' disclosures which add little value to the auditor's report.

- (b) There are a number of issues to consider in critically appraising the auditor's report extract which has been drafted by the audit senior. These include the following:

Key audit matters (KAM)

The section should include an introductory paragraph explaining the concept of KAM in order for users of the auditor's report to understand its importance and significance. The introduction should also clearly state that the auditor is not forming a separate opinion on the items identified as KAM.

Valuation of financial instruments

This is an area of significant audit judgement with a high risk of material misstatement, hence inclusion as KAM is appropriate although the disclosure should explain the factors which led the auditor to determine the matter was a KAM. It would also aid user understanding further if the auditor's report quantified the size and significance of the issue and explained its impact on the nature and extent of the audit effort.

The auditor should describe how the KAM was addressed in the audit, and although this is a matter for auditor judgement, the auditor may describe aspects of the auditor's response or approach, provide a brief overview of the procedures performed and an indication of the outcome of the procedures. Based on the current wording, the users of the auditor's report would have no clear indication of how the auditor has gathered evidence over this key area.

There are also several issues in relation to the detailed drafting of the paragraph. The report should not refer to the Group's finance director by name and should not imply criticism of him as result of his inexperience. The use of the word 'guesswork' is inappropriate and undermines the credibility of the audit and financial reporting process.

Customer liquidation

The amount owed by the customer of £287,253 is material to the loss before tax at 13.1% and to assets at 2%. The 'except for' qualification on the grounds of material misstatement is therefore appropriate. However, the details of the material misstatement should not be included in the KAM section at all but should be given in the basis for qualified opinion paragraph. This should also be clearly cross referenced within the opinion paragraph itself. Furthermore, the wording of the report currently references reducing the profit before tax when it should refer to increasing the loss before tax.

Opinion paragraph

This is incorrectly positioned and incorrectly titled. It should be at the start of the auditor's report and should simply be titled 'Qualified Opinion'. The opinion paragraph should be clearly cross referenced to the 'Basis for Qualified Opinion' paragraph which should be placed immediately below the opinion paragraph and should clearly describe the issue which has given rise to a qualified opinion. As above, the 'except for' qualification on the grounds of materiality is appropriate.

Going concern – Emphasis of matter

Following ISA (UK) 570 *Going Concern*, the use of an emphasis of matter paragraph to refer to uncertainties in relation to going concern disclosures in the financial statements is no longer appropriate. The auditor's report should now include a specific section headed 'Material Uncertainty Related to Going Concern' immediately after the basis for opinion paragraph and before the KAM section. The material uncertainty related to going concern should be cross referenced clearly to the disclosure note where the directors have given details of the uncertainty. If the matter has not been adequately disclosed by the directors in the financial statements, the auditor should give full details of the uncertainties in relation to going concern and the audit opinion should be qualified 'except for' the material misstatement in relation to this lack of disclosure.

Marks

1 Audit risk evaluation and identification and explanation of matters where professional scepticism should be applied

Up to 2 marks for each audit risk identified and explained. Up to 1½ marks for each identification and explanation of matters where professional scepticism should be applied. Allow 1 mark for each correct calculation and comment on materiality (to a maximum of 3 marks).

- Detection risk due to this being a new audit client
- Management bias due to pressure on results
- Operating segments – potential for inaccurate or incomplete disclosure
- Decline in revenue – lack of impairment review means assets and profit could be overstated
- Software development costs – risk that research and development not distinguished and that development inappropriately capitalised
- Publication rights – risk that amortisation is not appropriate affecting assets and profit
- Author royalty advances – risk that expenses are inappropriately deferred
- Borzoi Co – risk in retranslation of the income statement
- Software revaluation – risk that the fair value is not appropriate
- Transfer of software – risk that intercompany transaction is not eliminated on consolidation
- Corporate governance – principles not being followed, increased risk of management bias, need to be sceptical when dealing with the CFO
- Requirement for the auditor to evaluate the effectiveness of communication process between audit firm and audit committee
- Management imposed limitation in scope and breach of pre-conditions for audit due to restriction on communication with audit committee

Assessment of whether Borzoi Co is a significant component

Up to 2 marks for each relevant point/comment explained:

- Explanation of significance being based on either individual financial significance to the group, or due to its specific nature or circumstances
- Application to the scenario – determine that Borzoi Co's total assets are above the 15% threshold
- Explanation that Borzoi Co also has specific circumstances which mean it is a significant component

Extent of involvement of Group auditor with Saluki Associates

Up to 2 marks for each relevant point/comment explained:

- Evaluation of component auditor independence, competence and regulatory environment in which they operate
- Group auditor must be involved with assessment of risk of material misstatement of Group financial statements
- Involvement can include discussion with the component auditor or review of their risk assessment
- Where significant risk of misstatement to the Group accounts is identified, the Group auditor may be involved with further audit procedures

Maximum marks

31

Professional marks

Generally 1 mark for heading, 1 mark for introduction, 1 mark for use of headings within the briefing notes, 1 mark for clarity of comments made

Maximum marks

4

Maximum

35

2 (a) (i) Ethical and other matters to be considered before accepting Setter Ltd as a client of the firm

Up to 1½ marks for each ethical or other professional issue explained:

- General requirements of ISQC 1
- Competence to perform the work – this should not be a problem
- Verify that a limited assurance review is appropriate, i.e. the company meets the audit exemption criteria
- Intimidation and self-interest threat from Vizsla Ltd
- Level of fees from Visla Ltd needs to be discussed with ethics partner and the client
- Low fees potentially impair quality of work
- Pressure on fees from Setter Ltd indicates lack of integrity
- Self-review, self-interest, advocacy and management threats from performing tax planning for the company
- Issue of whether there is informed management at the client, if not the threats are more severe
- Safeguards should be used to reduce threats to an acceptable level, if this is not possible the tax planning should not be performed
- Providing personal tax advice not ethically wrong but may not want to accept work due to integrity issues
- Breach of employment law and taking money from pension plan indicates lack of integrity/criminal activity/poor reputation

(ii) Know your customer – procedures and recommended information

Up to 1½ marks for each point explained/recommended:

- Part of anti-money laundering regulations (up to 3 marks for detailed explanation of regulations)
- Identity of Gordon Potts – passport, recent utility bills or bank statements
- Identity of other shareholders including the other family members and other 10% shareholders
- Setter Ltd – the company certificate of incorporation, to confirm legal status, date and place of incorporation
- A Companies House search (or equivalent) on Setter Ltd – confirm the existence of the company, the shareholders and directors, beneficial owners
- Other companies controlled by Gordon Potts – confirm their existence and the nature of the relationship with Setter Ltd
- Review of the latest financial statements of Setter Ltd, and the other companies in which Gordon Potts has an interest should be reviewed
- Identify the source of funding, when funding is repayable and the existence of any security provided by the company or by personal guarantee of owners
- Facts surrounding the breach of employment law as reported by the newspaper

Maximum marks

16

(b) Examination procedures

Up to 1 mark for each procedure explained. In addition, ½ mark for relevant calculations, e.g. trend analysis, up to a maximum of 2 marks:

General procedures:

- Identity of the preparer of the operating profit forecast, and assess their competence
- Understanding the procedures/controls which have been followed in the preparation of the forecast
- Confirm the consistency of accounting policies applied
- Confirm that the assumptions underpinning the forecast are in line with knowledge of the business obtained from performing the company's audit
- Re-cast the forecast to ensure it is arithmetically correct

Specific procedures:

- Ask management to prepare a more detailed profit forecast in an appropriate format and to provide forecast statement of financial position and statement of cash flows
- Recalculate the gross profit margins and compare with gross profit margins from audited financial statements
- Obtain a break down showing the components of cost of sales and other expenses; perform analytical review and discuss results
- Assess whether there are any missing categories of expenditure
- For revenue, consider whether the forecast appears overly optimistic – allow credit for calculation of appropriate trends from the forecast
- Compare revenue forecast with revenue from prior years' audited financial statements. Investigate any unusual trends through discussion with management
- Review any marketing plans and discuss with an appropriate senior member of staff, for example, the sales director

- Review design costs, discuss with management and assess if such an increase in revenue can be achieved with such a small increase in design costs
- Confirm costs to appropriate supporting documentation, e.g. staff costs to human resources projected costs, marketing costs to advertising budgets
- Obtain and review the cash flow forecast prepared for the same period as the operating profit forecast
- Discuss with management the rationale for using 30% of revenue as a basis for determining the amount of other expenses

Maximum marks

Marks

9

Maximum

25

- 3** Generally up to 1½ marks for each issue and implication/action identified. Also, up to 1 mark for each matter identified for communication to management/TCWG.

(i) Controls testing on payables

- Deficiency in internal control, risk of unauthorised purchases
- Inadequate audit procedures, need to increase sample size and extend audit testing to assess extent and significance of deficiency
- Controls based audit approach may be inappropriate, consider more substantive approach

Management/TCWG:

- Include control weaknesses as point in the report to management
- Potentially significant difficulty encountered during the audit resulting in unexpected effort required to obtain sufficient appropriate audit evidence
- Potential significant deficiency in internal controls
- Hence may represent significant audit finding which should be communicated to TCWG

Maximum marks

4

(ii) Petty cash fraud

- Amount clearly immaterial to financial statements
- Personal taxi fares represent fraudulent transaction by petty cashier
- Auditor and management respective responsibilities re prevention and detection of fraud
- Independence threat given relationship of audit assistant with petty cashier, lack of professional integrity on part of audit assistant
- Familiarity threat given close relationship between audit team member and petty cashier
- Review firm's procedures for assigning staff to audit teams and for reporting personal relationships with staff
- Audit partner has responsibility per ISA (UK) 220 to monitor ethical requirements throughout audit process

Management/TCWG:

- Illegal act represents non-compliance with legislation and may be further indication of weak control environment
- Threat to auditor independence represents possible non-compliance with ethical code and ISA (UK) 260
- Despite the amounts involved being immaterial, the potential non-compliance should be reported to management with recommendation that all petty cash transactions should be adequately reviewed and authorised

Maximum marks

6

(iii) Cut-off testing on revenues

- Amount identified immaterial to revenue (with supporting calculation)
- Non-compliance with IFRS 15, revenue recognised at inappropriate point, i.e. before control has passed to customer
- Overstatement of revenues, receivables and profits
- Inadequate audit procedures, error should be extrapolated and/or cut-off testing should be extended to identify any further errors
- Auditor should also review last year's cut-off procedures to investigate whether any compensating error in prior year

Management/TCWG:

- All misstatements communicated to management and request they are corrected
- Non-compliance with IFRS Standards/GAAP
- Inappropriate accounting policy is example of significant finding from audit and should be communicated to TCWG per ISA (UK) 260

Maximum marks

6

(iv) Tax advice

- Self-review threat as tax calculation forms basis of tax payable and tax charge in financial statements
- Risk is increased by listed status of client
- Auditor should not prepare financial statements of listed client
- Hence not acceptable here for auditor to calculate tax payable for Davis plc

Management/TCWG:

- Lack of appropriate skill and knowledge of client's financial staff
- Implications for recruitment and/or training procedures at client

Maximum marks

4

Maximum

20

- 4 Generally up to 1½ marks for each matter and up to 1 mark for each evidence point explained.

Dilley plc

Matters

- Materiality
- IFRS 10 definition of subsidiary is based on control and contains specific guidance on situations where control may exist when investor does NOT hold majority of voting rights
- Control and subsidiary status may be based on potential voting rights; following IFRS 10 rights do not have to be currently exercisable but must be 'substantive'
- Here potential voting rights are exercisable in near future and are 'in the money', hence likely to be subsidiary; consolidated SOCI should therefore include line by line consolidation for 11 months and a loss of £11 million in relation to Dilley plc
- Difference of £6.6 million is material to group SOCI; management has incentive not to consolidate (especially in light of declining profitability)
- Group revenue should include £82.5 million for Dilley plc and will therefore also be materially understated

Evidence

- Copy of legal documents supporting acquisition of shares and options including voting rights and terms of exercise for options
- Audit working papers for Dilley plc confirming details of issued share capital and associated voting rights
- Board minutes relating to acquisition and management intentions in relation to Dilley plc
- Management representations on degree of influence and future intentions
- Copy of the adjusting journal required to reflect the correct treatment in the financial statements

Willis Ltd

Matters

- Materiality
- Group accounting policies should be consistent
- Treatment is acceptable in individual entity financial statements but not for Group accounts
- IFRS 9 requires recognition of derivatives on SOFP at fair value with gains and losses in profit or loss for period
- Fair value of derivatives is material to group profit (with supporting calculation)
- Directors may not have expertise required for valuation of the options
- Need for external independent evidence of fair value at reporting date

Evidence

- Fair value based on market prices or if not available, independent expert valuation
- Audit documentation of review of derivative contracts and confirmation of terms and maturity dates
- Notes of discussion with management in relation to the basis of their valuation and the accounting treatment
- Copy of the adjusting journal required to reflect the correct treatment in the financial statements

Knott Ltd

Matters

- Materiality
- Consolidated accounts are prepared from group perspective, inter-company transactions and balances must be eliminated on consolidation
- Details of the transactions need to be verified for individual entity financial statements
- Sales value of £77 million is material to group revenue and assets
- Unrealised profit of £7.7 million is material to group profit before tax
- Group receivables, revenue and profit therefore materially overstated
- Goods in transit: group inventory will be understated by £69.3 million (material to group assets)
- Group retained earnings will be overstated by £6.16 million and NCI by £1.54 million

Evidence

- Transaction agreed to underlying documents – sales invoices, goods despatch notes at Knott Ltd and goods received notes, purchase invoices at its parent company
- Cost of inventory confirmed to production records
- Confirmation of goods received note at parent dated 2 May 2018 confirming details of inventory in transit
- Workings for the unrealised profit in stock calculation
- Sales invoice traced to sales ledger and details of sales value, etc agreed
- Copy of adjusting journal noted on errors schedule

Maximum

20

5 (a) In general up to 1 mark for each well explained point:

Benefits:

- Response to users' requests about significant judgements
- Possible increase in confidence in audit process and perception of audit quality
- Improved understanding of financial statements and audit
- Increased focus on management judgement
- Explanation of what expectation gap is
- Role of KAMs in educating public re audit processes

Difficulties:

- Auditor judgement may reduce consistency and comparability of reporting
- Potential increase in volume of reports may obscure most significant matters
- Information provided may lack clarity
- Danger of standardised 'boilerplate' disclosures

Maximum marks

8

(b) In general up to 1 mark for each well explained point:

KAM section

- KAM section should include introductory paragraph explaining what KAMs are
- Auditor not forming separate opinion on KAM

Valuation of financial instruments

- Area of significant audit judgement with high risk of material misstatement, hence inclusion as KAM potentially appropriate
- Would aid user understanding if:
 - quantified size/significance of issue
 - explained impact on nature and extent of audit effort
- Inappropriate drafting of paragraph:
 - should not refer to FD by name
 - should not imply criticism of him as result of inexperience
 - choice of language 'guesswork' undermines credibility of audit and financial reporting process

Customer liquidation

- Material to profit and assets (with calculation)
- Details of material misstatement should not be included in KAM section at all but should be given in basis for qualified opinion paragraph and should be clearly cross referenced to opinion paragraph
- Wording refers to reducing profit before tax when it should refer to increasing the loss before tax

Opinion paragraph

- Incorrectly positioned, should now be at start of auditor's report and should be clearly cross referenced to basis of opinion paragraph below which details the material misstatement
- Incorrect title, it should be headed simply 'Qualified Opinion'
- Except for qualification appropriate on grounds of material misstatement

Going concern

- Following ISA (UK) 570 (revised), use of an EoM paragraph no longer appropriate
- Auditor's report should now include section headed 'Material Uncertainty Related to Going Concern'
- Section should be immediately after basis for opinion but before KAM section
- Should cross reference clearly to disclosure note where directors have given details of uncertainty
- If not adequately disclosed by directors, opinion should be qualified 'except for' lack of disclosure

Maximum marks

12

Maximum

20