Answers

1 Briefing notes

To: Maya Crag, Audit engagement partner

From: Audit manager

Subject: Eagle Group – Audit planning

Introduction

These briefing notes are prepared to assist with planning the audit of the Eagle Group (the Group) for the financial year ending 31 December 20X8. The notes contain an evaluation of the audit risks which should be considered in planning the Group audit. The notes also recommend the principal audit procedures to be used in the audit of the goodwill which has arisen in respect of a newly acquired subsidiary. The notes then go on to evaluate an extract from the audit strategy which has been prepared by a component auditor. Finally, the Group finance director has requested our firm to provide a non-audit service in relation to the Group's integrated report, and the notes discuss the professional and ethical implications of this request.

Evaluation of audit risk

Selected analytical procedures and associated audit risk evaluation

	20X8	20X7
Operating margin	350/5,770 = 6·1%	270/5,990 = 4·5%
Return on capital employed	350/2,245 + 650 = 12·1%	270/2,093 + 620 = 10%
Current ratio	1,450/597 = 2·4	1,420/547 = 2·6
Debt/equity	539/2,245 = 24%	500/2,093 = 23·9%
Interest cover	350/28 = 12·5	270/30 = 9
Effective tax rate	64/322 = 19·9%	60/240 = 25%

Operating margin and operating expenses

The Group's operating margin has increased from 4·5% to 6·1% despite a fall in revenue of 3·7%. This is due to a reduction in operating expenses of 4·5% and increase in other operating income of 50%. Return on capital employed shows a similar positive trend, despite the fall in revenue. There is an audit risk that expenses are understated, with the reduction in expenses being proportionately more than the reduction in revenue.

Within operating expenses the trends for each component are different – cost of raw materials consumables and supplies has decreased by 3·1%, which appears reasonable given the decline in revenue of 3·7%. However, staff costs have increased slightly by 1·1% which seems inconsistent with the revenue trend and with the increased automation of operations which has led to 5,000 staff being made redundant, which presumably means less payroll cost this year. Expenses could have been misclassified into staff costs in error.

Depreciation, amortisation and impairment has increased by 3·6%, which is not a significant change, but will need to be investigated to consider how each element of the category has changed in the year. The most noticeable trend within operating expenses is that the other operating expenses category has reduced very significantly. The amount recognised this financial year is only 7·4% of the amount recognised the previous year; this appears totally inconsistent with the other trends noted. It could be that some costs, for example, accrued expenses, have not yet been accounted for, or that the 20X7 figure was unusually high.

Other operating income

There is also an audit risk that other operating income is overstated. According to the information in note 6, during the year a credit of £60 million has been recognised in profit for reversals of provisions, this is 50% greater than the amount recognised in the previous year. In addition, a credit of £30 million has been recognised for reversals of impairment losses. There is a risk that these figures have been manipulated in order to boost profits, as an earnings management technique, in reaction to the fall in revenue in the year.

The risk of management bias is high given the listed status of the Group, hence expectations from shareholders for a positive growth trend. The profit recognised on asset disposal and the increase in foreign currency gains could also be an indication of attempts to boost operating profit this year.

Current ratio and gearing

Looking at the other ratios, the current ratio and gearing ratio do not indicate audit risks; however, more detail is needed to fully conclude on the liquidity and solvency position of the Group, and whether there are any hidden trends which are obscured by the high level analysis which has been performed with the information provided.

The interest cover has increased, due to both an increase in operating profit and a reduction in finance charges. This seems contradictory to the increase in borrowings of £42 million; as a result of this an increase in finance charges would be expected. There is an audit risk that finance charges are understated.

Effective tax rate

The effective tax rate has fallen from 25% to 19·9%. An audit risk arises in that the tax expense and associated liability could be understated. This could indicate management bias as the financial statements suggest that accounting profit has increased, but the profit chargeable to tax used to determine the tax expense for the year appears to have decreased. There could be alternative explanations, for instance a fall in the rate of tax levied by the authorities, which will need to be investigated by the audit team.

Consolidation of foreign subsidiaries

Given that the Group has many foreign subsidiaries, including the recent investment in Lynx Co, audit risks relating to their consolidation are potentially significant. Lynx Co has net assets with a fair value of £300 million according to the goodwill calculation provided by management, representing 8·6% of the Group's total assets and 13·4% of Group net assets. This makes Lynx Co material to the Group and possibly a significant component of the Group. Audit risks relevant to Lynx Co's status as a foreign subsidiary also attach to the Group's other foreign subsidiaries.

According to IAS® 21 *The Effects of Changes in Foreign Exchange Rates*, the assets and liabilities of Lynx Co and other foreign subsidiaries should be retranslated using the closing exchange rate. Its income and expenses should be retranslated at the exchange rates at the dates of the transactions. The risk is that incorrect exchange rates are used for the retranslations. This could result in over/understatement of the assets, liabilities, income and expenses which are consolidated, including goodwill. It would also mean that the exchange gains and losses arising on retranslation and to be included in Group other comprehensive income are incorrectly determined.

In addition, Lynx Co was acquired on 1 March 20X8 and its income and expenses should have been consolidated from that date. There is a risk that the full year's income and expenses have been consolidated. This would lead to a risk of understatement of Group profit, given that Lynx Co is forecast to be loss making this year, according to the audit strategy prepared by Vulture Associates.

Measurement and recognition of exchange gains and losses

The calculation of exchange gains and losses can be complex, and there is a risk that it is not calculated correctly, or that some elements are omitted, for example, the exchange gain or loss on goodwill may be missed out of the calculation.

IAS 21 states that exchange gains and losses arising as a result of the retranslation of the subsidiary's balances are recognised in other comprehensive income. The risk is incorrect classification, for example, the gain or loss could be recognised incorrectly as part of profit for the year, for example, included in the £28 million foreign currency gains which form part of other operating income, which would be incorrect. The amount recognised within other operating income has increased, as only £23 million foreign currency gains were recognised the previous year, indicating a potential risk of overstatement.

Goodwill

The total goodwill recognised in the Group statement of financial position is £1,100 million, making it highly material at 31·5% of total assets.

Analytical review shows that the goodwill figure has increased by £130 million during the year. The goodwill relating to the acquisition of Lynx Co is £100 million according to management's calculations. Therefore there appears to an unexplained increase in value of goodwill of £30 million during the year and there is an audit risk that the goodwill figure is overstated, unless justified by additional acquisitions or possibly by changes in value on the retranslation of goodwill relating to foreign subsidiaries, though this latter point would seem unlikely given the large size of the unexplained increase in value.

According to IFRS® 3 *Business Combinations*, goodwill should be subject to an impairment review on an annual basis. Management has asserted that while they will test goodwill for impairment prior to the financial year end, they do not think that any impairment will be recognised. This view is based on what could be optimistic assumptions about further growth in revenue, and it is likely that the assumptions used in management's impairment review are similarly overoptimistic. Therefore there is a risk that goodwill will be overstated and Group operating expenses understated if impairment losses have not been correctly determined and recognised.

Initial measurement of goodwill arising on acquisition of Lynx Co

In order for goodwill to be calculated, the assets and liabilities of Lynx Co must have been identified and measured at fair value at the date of acquisition. Risks of material misstatement arise because the various components of goodwill each have specific risks attached. The goodwill of £100 million is material to the Group, representing 2·9% of Group assets.

A specific risk arises in relation to the fair value of net assets acquired. Not all assets and liabilities may have been identified, for example, contingent liabilities and contingent assets may be omitted.

A further risk relates to measurement at fair value, which is subjective and based on assumptions which may not be valid. The fair value of Lynx Co's net assets according to the goodwill calculation is £300 million, having been subject to a fair value uplift of £12 million. This was provided by an independent firm of accountants, which provides some comfort on the validity of the figure.

There is also a risk that the cost of investment is not stated correctly, for example, that the contingent consideration has not been determined on an appropriate basis. First, the interest rate used to determine the discount factor is 18% – this seems high given that the Group's weighted average cost of capital is stated to be 10%. Second, the contingent consideration is only payable if Lynx Co reaches certain profit targets. Given that the company, according to Vulture Associates' audit strategy, is projected to be loss making, it could be that the contingent consideration need not be recognised at all, or determined to be a lower figure than that currently recognised, based on a lower probability of it having to be paid. The results of the analytical review have indicated that the other side of the journal entry for the contingent consideration is not described as a component of non-current liabilities. The accounting for this will need to be clarified as there is a risk that it has been recorded incorrectly perhaps as a component of equity.

Intangible assets

In relation to expenditure on intangible assets during the year, which totals £60 million, there are several audit risks. First, there is a question over whether all of this amount should have been capitalised as an intangible asset. Capitalisation is only appropriate where an asset has been created, and specifically in relation to development costs, the criteria from IAS 38 *Intangible Assets* must all be met. There is a risk that if any criteria have not been met, for example, if there is no probable future economic benefit from research into the new technology, then the amount should be expensed. There is a risk that intangible assets are overstated and operating expenses understated.

There is also an unexplained trend, in that intangible assets has increased by £30 million, yet expenditure on intangible assets, according to management information, is £60 million. More information is needed to reconcile the expenditure as stated by management to the movement in intangible assets recognised in the Group statement of financial position.

Second, there is a risk that the amortisation period is not appropriate. It seems that the same useful life of 15 years has been applied to all of the different categories of intangible assets; this is not likely to be specific enough, for example, the useful life of an accounting system will not be the same as for development of robots. Fifteen years also seems to be a long period – usually technology-related assets are written off over a relatively short period to take account of rapid developments in technology. In respect of amortisation periods being too long, there is a risk that intangible assets are overstated and operating expenses understated.

Detection risk in relation to Lynx Co

Lynx Co is the only subsidiary which is not audited by Bison & Co. This gives rise to a risk that the quality of the audit of Lynx Co may not be to the same standard as Bison & Co, as Vulture Associates may not be used to auditing companies which form part of a listed group. This results in increased detection risk at the Group level. The risk is increased by the problems with the audit strategy prepared by Vulture Associates, which will be discussed later in these briefing notes, which indicate that the audit of Lynx Co has not been appropriately planned in accordance with ISA and *Ethical Standard* requirements. Since our firm has not worked with Vulture Associates previously, we are not familiar with their methods and we may have issues with the quality of their work; therefore the detection risk is high in relation to Lynx Co's balances which will form part of the consolidated financial statements.

Principal audit procedures on the goodwill arising on the acquisition of Lynx Co

- Obtain the legal documentation pertaining to the acquisition, and review to confirm that the figures included in the goodwill calculation relating to consideration paid and payable are accurate and complete. In particular, confirm the targets to be used as the basis for payment of the contingent consideration in four years' time.
- Also confirm from the purchase documentation that the Group has obtained an 80% shareholding and that this conveys control, i.e. the shares carry voting rights and there is no restriction on the Group exercising their control over Lynx Co.
- Agree the £80 million cash paid to the bank statement and cash book of the acquiring company (presumably Eagle plc as the parent company of the Group).
- Review the board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.
- For the contingent consideration, obtain management's calculation of the present value of the £271 million, and evaluate assumptions used in the calculation, in particular to consider the probability of payment by obtaining revenue and profit forecasts for Lynx Co for the next four years.
- Discuss with management the reason for using an 18% interest rate in the calculation, asking them to justify the use of this interest rate when the Group's weighted average cost of capital is stated at 10%.
- Evaluate management's rationale for using the 18% interest rate, concluding as to whether it is appropriate.
- Confirm that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition. Agree the share price used in management's calculation to stock market records showing the share price of Lynx Co at the date of acquisition.
- Obtain a copy of the due diligence report issued by Sidewinder & Co, review for confirmation of acquired assets and liabilities and their fair values.
- Evaluate the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13 *Fair Value Measurement*.
- Review the calculation of net assets acquired to confirm that Group accounting policies have been applied.

Evaluation of the extract of the audit strategy prepared by Vulture Associates in respect of their audit of Lynx Co

The extract from the audit strategy covers two areas – reliance on internal controls and the valuation of the company's pension plan. It appears that ISA requirements and ethical principles have not been followed, meaning that the quality of the audit planned by Vulture Associates is in doubt.

Controls effectiveness

In relation to reliance on internal controls, ISA 330 (UK) *The Auditor's Responses to Assessed Risks* contains requirements in relation to relying on work performed during previous audits on internal controls. ISA 330 states that if the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and if there have been changes which affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit.

If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely on a single audit period with no testing of controls in the subsequent two audit periods.

Therefore, in order to comply with ISA 330, Vulture Associates needs to do more than simply accept management's assertion that there have been no changes to controls. There needs to be some observation or inspection of controls, to confirm that there have been no changes, and this work and an appropriate conclusion need to be documented in the audit working papers.

In addition, there should be some testing of internal controls each year, so Vulture Associates should plan to perform some tests of controls each year, so that over a three-year cycle, all controls are tested to confirm that controls are still operating effectively and therefore can continue to be relied upon.

The Group audit team should discuss this issue with Vulture Associates to ensure that adequate controls testing is performed. If, for some reason, Vulture Associates does not amend its audit strategy, then the Group audit team may decide to perform additional testing, given that Lynx Co is material to the Group.

Pension plan valuation

In relation to the valuation of the pension plan, it is not appropriate for a partner in Vulture Associates to have provided the pension plan valuation, as this creates several significant threats to auditor objectivity. In particular, a self-review threat arises due to the pension plan forming part of the financial statements on which the auditor expresses an opinion as the audit team may be reluctant to highlight errors or concerns on the work carried out by the partner. Performing the valuation may also result in a management threat whereby the audit firm may be perceived to be taking on the responsibilities of management, resulting in the firm becoming closely aligned with the views and interest of management and the partner not applying an appropriate degree of scepticism to the valuation.

ISA 600 (UK) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* requires the group auditor to obtain an understanding as to whether the component auditor understands and will comply with the ethical requirements which are relevant to the group audit and, in particular, is independent. This is because when performing work on the financial information of a component for a group audit, the component auditor is subject to ethical requirements which are relevant to the group audit. Therefore, the audit of Lynx Co should be conducted subject to UK principles and requirements as contained in the FRC *Ethical Standard*.

The *Ethical Standard* prohibits the external auditor from providing valuation services where the valuation would have a material effect on the financial statements. The pension plan is in deficit by £11 million, and the deficit is material to Lynx Co's financial statements, representing 3·7% of its net assets (according to management's goodwill calculation). Therefore, if the FRC *Ethical Standard* is applied to the situation, Vulture Associates should not have performed the valuation service.

The audit strategy also indicates that other significant non-audit services are provided by Vulture Associates, with fees amounting to £100,000. This indicates that there could be a self-interest threat to the objectivity of the audit firm, due to fee dependency. This has implications for the quality of the audit work performed.

It could be that Vulture Associates follows a local ethical code or standard which permits such valuation services to be provided. However, the situation is not acceptable for the purpose of the Group audit. The Group audit committee should be made aware of the situation, and if a separate valuation is not provided at the level of the individual company, then the Group audit strategy should consider including additional, independent work on the valuation of Lynx Co's pension plan. On a net basis, the pension plan deficit is less than 1% of Group total assets, however, the plan assets and the plan liabilities on an individual basis represent 1·1% and 1·4% of Group total assets, so are borderline in terms of materiality to the Group.

In conclusion, from the evaluation of this extract from the audit strategy, it seems that Vulture Associates is planning to carry out the audit of Lynx Co in a manner which does not comply with ISA and relevant *Ethical Standard* requirements. This is a concern, given the materiality of the subsidiary to the Group, and our firm should liaise with Vulture Associates as soon as possible to discuss their audit planning and their compliance with ethical standards.

Ethical and professional implications of the request to provide a non-audit service on the Group's integrated report

There are several issues to consider with regard to providing this service.

A significant issue relates to auditor objectivity. The FRC *Ethical Standard* provides requirements and guidance on situations where the auditor is asked by the client to provide non-assurance services. Bison & Co needs to evaluate the significance of the threat and consider whether any safeguards can reduce the threat to an acceptable level.

While the integrated report is not part of the audited financial statements, the report will contain financial key performance indicators (KPIs), and the Group has asked for input specifically relating to the reconciliations between these KPIs and financial information contained in the financial statements. There is therefore a potential self-review threat to objectivity in that the audit firm has been asked to provide assurance on these KPIs which are related to figures which have been subject to external audit by the firm. The team performing the work will be reluctant to raise queries or highlight errors which have been made during the external audit when assessing the reconciliations of KPIs to audited financial information.

It could also be perceived that Bison & Co is taking on management responsibility by helping to determine content to be included in the integrated report, which is a threat to objectivity. The audit firm should not assume management responsibility for an audit client where the threats created are so significant that safeguards cannot reduce them to an acceptable level. While the *Ethical Standard* does not specifically state that helping the client to determine the content of its integrated report is taking on management responsibility, certainly there could be that perception as the auditor will be involved in setting measurements which the company will benchmark itself against. Additionally, working with management on the integrated report could create a familiarity threat to objectivity whereby close working relationships are formed, and the auditor becomes closely aligned with the views of management and is unable to approach the work with an appropriate degree of professional scepticism.

There is a potential problem in terms of compliance with ISA 720 (UK) *The Auditor's Responsibilities Relating to Other Information*, should Bison & Co accept the engagement. ISA 720 requires that auditors read other information in order to identify any material inconsistencies between the financial statements and information in the other information. ISA 720 applies only to other information in the annual report, and it is not stated whether the Group's integrated report will be included in the annual report, or as a standalone document.

Tutorial note: *Credit will be awarded for candidates who discuss the ISA 720 (UK) requirements in relation to statutory other information to confirm that the integrated report is currently not a statutory requirement.*

Based on the above, it would seem unlikely that Bison & Co can provide this service to the Group, due to the threats to objectivity created. However, should the firm decide to take on the engagement, safeguards should be used to minimise the threats. For example, a partner who is independent should be involved in reviewing the audit work performed.

Aside from ethical issues, Bison & Co must also consider whether they have the competence to perform the work. Advising on the production of an integrated report is quite a specialist area, and it could be that the audit firm does not have the appropriate levels of expertise and experience to provide a quality service to the Group. The fact that the Group wants to highlight its technological achievements, and presumably will select a range of non-financial KPIs and technological issues to discuss in the integrated report, makes the issue of competence more significant, as the audit firm may not have the necessary technical knowledge to provide advice in this area. Aside from competence, the firm should also consider whether it has resources in terms of staff availability to complete the work to the desired deadline and to perform appropriate reviews of the work which has been completed.

Finally, given that the Group is a listed entity, it should comply with the requirements of the UK Corporate Governance Code. The audit committee should apply the Group's policy on the engagement of the external auditor to supply non-audit services, the objective of which should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. The Group's audit committee will need to pre-approve the provision of the service, and in making this decision they should consider a number of matters, for instance, the audit committee should consider whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service, whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and the level of fees to be incurred relative to the audit fee.

Conclusion

These briefing notes indicate that there are a large number of audit risks to be considered in planning the audit, and that management needs to supply the audit team with a range of additional information for more thorough audit planning to be carried out. The audit of goodwill, and in particular the goodwill arising on the acquisition of Lynx Co, is an area of significant audit risk, and the notes recommend the principal audit procedures which should be conducted. An evaluation of the audit strategy prepared by Vulture Associates indicates that their audit of Lynx Co might not be a high quality audit and that there is a threat to audit objectivity. These issues need to be considered in developing the Group audit strategy. Finally, our firm needs to discuss the request to assist in preparing the Group's integrated report with the Group audit committee, and it seems unlikely given the threat of management involvement that we would be able to carry out this work for the Group.

2 (a) Clark Ltd

Matters to be discussed with management in relation to the audit supervisor's proposed adjustments

(i) Lease of testing equipment

The lease at Clark Ltd's largest site is material to the statement of financial position at 2·2% of total assets. The leases at the other two sites are also material at 2·8% of total assets.

The general recognition and measurement requirements of IFRS 16 *Leases* require lessees to recognise a right-of-use asset and a lease liability at the commencement date of the lease at the present value of the lease payments. The standard defines the commencement date as the date the asset is available for use by the lessee. Given that the commencement date is 31 May 20X8 therefore, it is appropriate on this basis to recognise the lease on the statement of financial position as at this date.

It is significant, however, that IFRS 16 also contains an optional exemption for short-term leases of less than 12 months' duration with no purchase option. If Clark Ltd elects to apply this exemption, it does not recognise the leased assets or lease liabilities on the statement of financial position but rather, it recognises the lease payments associated with those leases as an expense in the statement of profit or loss for the year on either a straight-line basis over the lease term or another systematic basis. However, IFRS 16 also requires that if this exemption is taken, it must be applied consistently by each class of underlying asset. Hence in this case, the client must either capitalise the leases across all three of the sites or apply the exemption consistently and not capitalise the leases across any of the sites. On either of these bases, as the commencement date of the lease coincides with the reporting date, there would not yet be any impact on Clark Ltd's statement of profit or loss for the year.

The audit manager should discuss the option of taking the short-term lease exemption with the finance director at tomorrow's meeting:

(i) if the client elects not to take the exemption across the three sites, assets and liabilities will be materially understated. Hence the audit supervisor's proposed adjustment is correct and a right-of-use asset and lease liability of £475,000 should be recognised on the statement of financial position.

(ii) Alternatively, if the client does elect to take the exemption across all three sites, then assets and liabilities are materially overstated and right-of-use assets and lease liabilities of £625,000 should be derecognised on the statement of financial position.

Impact on audit opinion:
If the client does not make any adjustment to the financial statements, the statement of financial position is materially misstated on the basis of misapplication of an accounting standard and the audit opinion should be qualified on this basis with an 'except for' opinion.

(ii) Legal claim

The legal claim is material to the statement of financial position being 5·5% of Clark Ltd's total assets.

Following the requirements of IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised when: an entity has a present obligation (legal or constructive) as a result of a past event; it is probable that an outflow of resources embodying economic benefits will be required to settle the obligation; and a reliable estimate can be made of the amount of the obligation. In this case the customer has already won the action against the company, the amount of the claim has been agreed by the courts and settlement is still outstanding at the reporting date. Hence, a provision of £1·2 million should be recognised on the statement of financial position.

IAS 37 also states that contingent assets are not recognised in financial statements since this may result in the recognition of income which may never be realised. However, the standard continues by stating that when the realisation of income is virtually certain, then the related asset is not a contingent asset and its recognition is appropriate. With respect to Clark Ltd's insurance claim therefore and the verified letter dated 25 May 20X8, the settlement of the claim as at the reporting date is virtually certain and an asset should be recognised separately on the statement of financial position.

The audit supervisor's proposed adjustment is correct and the finance director should therefore be requested to adjust the financial statements to include the separate recognition of the asset and the provision. If the adjustment is not made, both assets and liabilities will be materially misstated. There is no net impact on the statement of profit or loss for the year.

The finance director should also be advised that the financial statements should include full disclosure of the facts and amounts surrounding the provision for the legal claim together with full details of the expected reimbursement from the insurance company recognised as an asset.

Impact on audit opinion:
If the client does not make any adjustment to the financial statements, the statement of financial position is materially misstated and the audit opinion should be qualified on this basis with an 'except for' opinion.

(iii) Asset impairment

The asset impairment of £85,000 is not material in isolation to either the statement of financial position (0·4% of total assets) or the statement of profit or loss for the period (3·7% of profit before taxation).

According to IAS 36 *Impairment of Assets*, an entity should assess at the end of each reporting period whether there is any indication that an asset or a cash generating unit may be impaired. If any such indication exists, the entity shall estimate the recoverable amount of the asset. The standard states that potential impairment indicators include external sources of information such as significant changes in the market in which the entity operates. As each of Clark Ltd's sites is considered a cash generating unit for impairment review purposes, it seems appropriate therefore for the company to have conducted an impairment review at this site.

IAS 36 states that an asset or cash generating unit is impaired when the carrying amount exceeds the recoverable amount and it defines recoverable amount as the higher of the fair value less costs of disposal and the value in use. In the case of Clark Ltd, the auditor has agreed figures for carrying value and value in use and the key issue is the correct calculation of fair value less costs of disposal. Following IAS 36, the costs of disposal should include legal costs, transaction taxes and the costs of removing the assets but should exclude the costs associated with reorganising a business. The correct amount for fair value less costs of disposal is therefore £3,515,000 (£3·9 million – £126,000 – £174,000 – £85,000). Given that this is higher than the value in use of £2·9 million, the recoverable amount of the assets is also £3,515,000 and therefore the assets are impaired by £85,000 (£3·6 million – £3,515,000). The client appears to have incorrectly omitted the costs of removing the assets from its calculation of fair value less costs of disposal and as a result the statement of financial position and the statement of profit or loss for the year are both overstated by £85,000.

The audit supervisor's proposed adjustment is therefore correct and the finance director should be advised of this error at tomorrow's meeting. Even though the amount is immaterial to both the statement of financial position and statement of profit or loss for the year, it is appropriate to request that the adjustment is made to the financial statements.

Impact on audit opinion:
Given that assets and profits are both immaterially overstated, if no adjustment is made to the financial statements, it follows that there will be no impact on the audit opinion in relation to this matter in isolation.

(b) Turner plc

Ethical and professional issues and actions to be taken by the audit firm

Loan to member of the audit team

According to the FRC *Ethical Standard*, a loan to a member of the audit team may create a threat to the auditor's independence. If the loan is not made under normal lending procedures and terms and conditions, a self-interest threat would be created as a result of Janette Stott's financial interest in the audit client. The self-interest threat arises because of the potential personal benefit derived which may motivate the audit team member to behave in a manner aimed at protecting that benefit. In addition, an intimidation threat to objectivity may arise where a loan is made from the audit client to a member of the audit team. The threat arises because of a fear that the audit client may, for example, change the terms of the loan or recall the loan, thus influencing the behaviour of the auditor.

These threats to objectivity are normally considered to be so significant that no safeguards could reduce the threat to an acceptable level. It follows therefore that in most cases the audit team member should not accept such a loan or guarantee.

However, the *Ethical Standard* also states that a loan from an audit client which is a bank or similar institution to a member of the audit team which is made under normal business terms and conditions is acceptable. Examples of such loans include home mortgages, car loans and credit card balances.

It is possible therefore that the secured loan may be ethically acceptable and the key issue is whether 'the very best terms which the bank can offer' fall within Turner plc's normal business terms and conditions. The bank's standard lending terms and conditions should be obtained and reviewed alongside the documentation for Janette Stott's loan. Ultimately, the audit engagement partner is responsible for ensuring that ethical principles are not breached, so the partner should be involved with the discussions. The matter should be discussed with Janette and the client's business manager in order to establish whether the loan is to be made under the bank's normal lending procedures. Janette should be advised of the outcome of this review and Turner plc's business manager should be advised of this decision, explaining the rationale and ethical rules behind it.

Temporary staff assignment

The FRC *Ethical Standard* states that the lending of staff to an audit client may create a self-review threat to auditor independence. The self-review threat arises when an auditor reviews work which they themselves have previously performed – for example, if the external auditor is involved in the process of preparing the payroll figures for inclusion in the financial statements and then audits them. As a result, there is a risk that the auditor would not be sufficiently objective in performing the audit and may fail to identify any shortcomings in their own work. In addition, a management threat may arise if the employee undertakes work which involves making judgements and taking decisions in relation to accounting for payroll which are properly the responsibility of management.

Such assistance can only therefore be given for a short period of time and the audit firm's staff must not assume management responsibilities and must not be involved in any activities specifically prohibited. According to the *Ethical Standard*, a short period of time is generally expected to be no more than a small number of months. The client has requested staff for six months, which may be considered too long a period to avoid ethical threats from arising.

The nature of the work to be performed by the loaned staff is also an important consideration. In this case, Turner plc is a listed bank and is therefore a public interest entity. According to the *Ethical Standard*, an audit firm cannot provide payroll services to an audit client which is a public interest entity.

Therefore, the audit manager should decline the proposed staff assignment in relation to payroll services, explaining to the client the reasons why the *Ethical Standard* prohibits the provision of this service.

3 (a) Narley Ltd

(i) Matters to be considered before acceptance of engagement

When considering acceptance of the engagement to review Narley Ltd's prospective financial information (PFI), Jansen & Co must consider whether it is ethically acceptable to perform the review. The review of the PFI represents a non-assurance service and providing this service in addition to the audit may create an advocacy threat. An advocacy threat arises when the auditor is asked to promote or represent their client in some way. In this situation there is a risk of the auditor being seen to promote the interests of the client with a third party such as a bank. As a result, there is a danger that the auditor will be biased in favour of the client and therefore cannot be fully objective. Accepting the assignment may also create a self-interest threat as a result of the auditor being perceived to have an interest in the outcome of negotiations with a third party and which may motivate the auditor to behave in order to protect that interest. A self-review threat may also arise because the negotiations may result in facts and amounts which will form part of the audited financial statements. As a result, the auditor will be auditing financial statements which in part at least represent work which they themselves have performed. It follows that there is a risk that the auditor will not be sufficiently objective in performing the audit and may fail to identify any shortcomings in their own work.

In the case of Narley Ltd, the advocacy threat appears to be particularly significant as the audit firm could be seen to be promoting the interests of the audit client to the bank. The auditor should therefore only accept the engagement if adequate safeguards can be put in place to manage the threat to independence to an acceptable level. Potential safeguards might include the following:

- The use of separate teams of suitably experienced staff for the audit and the review of the PFI;
- Independent senior review of the PFI working papers;
- Discussion of the potential ethical issues and threats to auditor independence with those charged with governance at Narley Ltd.

It should be noted, however, that it would not be possible to manage a significant advocacy threat through such safeguards and in such a case the appointment should not be accepted.

Jansen & Co should also consider the following matters in making their acceptance decision:

- The intended use of the information – for example, whether it will be used solely for the purpose of the proposed loan finance;
- Whether the information will be for general or limited distribution – the auditor needs to consider who will receive the report and potentially rely upon it;
- The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions – in this case it seems likely that they will be best estimate assumptions as Narley Ltd expects to obtain finance in order to fund its planned expansion;
- The elements to be included in the information – Jansen & Co needs to clarify the exact content of the PFI which they are being asked to report on, for example, whether it only includes the forecast statements of profit or loss or whether it also includes forecast statements of financial position and forecast cash flow statements; and
- The period covered by the information – shorter term forecasts are likely to be more reliable than projections over a longer period.

Jansen & Co must also consider whether the firm has sufficient staff available with the appropriate skills and experience to perform the review engagement in line with the client's required reporting deadlines.

Overall, the auditor must assess the risks associated with the review engagement and should not accept an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

(ii) Examination procedures to be performed

The examination procedures which should be performed in respect of Narley Ltd's forecast statements of profit or loss include the following:

- The arithmetic accuracy of the forecast statements of profit or loss should be confirmed;
- Confirmation that the accounting policies used in the forecast statements are consistent with those used in the audited financial statements and that they comply with IFRS Standards;
- Discuss the key assumptions which have been made by the client in the preparation of the forecast statements with management assessing their reasonableness and consistency with the audit firm's cumulative knowledge and understanding of the client;
- Review of market research documentation in Narley Ltd's existing markets and the new market and discuss it with management to assess whether the growth patterns being forecast represent reasonable and realistic expectations;
- Obtain copies of any new customer contracts for existing and new markets to confirm the reasonableness of the projected growth in revenue;
- Obtain a written representation from management confirming the reasonableness and completeness of the assumptions they have made in preparing the forecasts;
- The competence and experience of the client staff who have prepared the forecasts should be assessed; the assessment should include the accuracy of PFI which has been prepared in previous periods and the reasons for any significant variances compared to actual outcomes;
- Recalculation of depreciation to ensure the correct inclusion of depreciation on the new HGVs and warehousing facilities within the forecast statements;
- Obtain and review a breakdown of operating expenses in order to ensure that all items have been appropriately included, for example: advertising and marketing costs; additional staff costs for the new drivers including recruitment expenses; any trading tariffs relevant to operating in the new market and any foreign currency and exchange implications;
- Recent utility bills should be inspected and an assessment of the reasonableness of forecast utility overheads should be performed;
- Obtain and review the supporting documentation for Narley Ltd's existing loan agreements with the bank as well as the draft documentation for the new loan; the forecast finance costs should be recalculated and agreed to the forecast statements;

– Perform analytical review, followed by discussion with management to seek corroborating evidence of key trends and ratios including:
  – Growth in revenue (26% from 20X8 to 20X9; 29% from 20X9 to 20Y0)
  – Cost of sales as a percentage of revenue (75·5% in 20X8; 71·3% in 20X9; 69·7% in 20Y0)
  – The declining trend in administrative expenses (decrease of 4·2% from 20X8 to 20X9; 5·6% from 20X9 to 20Y0)
  – The increase in the net profit margin (6·9% in 20X8; 15·2% in 20X9; 20·4% in 20Y0).

(b) Krupt Ltd

Potential liability and penalties as a result of actions for fraudulent and wrongful trading

Fraudulent trading:
Fraudulent trading is defined by the Insolvency Act 1986 (IA 1986) as carrying on the business of an insolvent company with the intent to defraud the company's creditors. Actions for fraudulent trading can be brought against any person who is knowingly a party to the fraudulent trading.

Fraudulent trading is a criminal offence and, as such, the burden of proof in a court action requires the prosecution's evidence to have established its case beyond reasonable doubt. In this regard, it is key to a successful action that the prosecution has established that intent was present in the defendant's actions.

The penalties and liability which may result from a successful action for fraudulent trading are imprisonment for up to 10 years, personal (civil) liability for the debts of company and disqualification from being a company director for up to 15 years.

Wrongful trading:
Wrongful trading is defined by IA 1986 as carrying on the business of an insolvent company when it ought to have been concluded that there was no reasonable prospect of the company avoiding insolvent liquidation and that the creditors of the company would therefore suffer losses. In contrast to fraudulent trading, it is not necessary to establish intent and wrongful trading is a civil wrong rather than a criminal offence. It is also significant that an action for wrongful trading can only be brought against company directors (including shadow directors).

As a civil wrong, the burden of proof for wrongful trading is the weaker test of the balance of probabilities. The penalties and liability which may result from a successful action for wrongful trading are personal (civil) liability of the directors for the debts of the company and disqualification from being a company director for up to 15 years.

Implications for Krupt Ltd:
Mr and Mrs Krupt appear to have bought a substantial quantity of goods on credit in order to ensure that the bank will have sufficient secured assets to cover its debt without having to call in the personal guarantee on the directors' house. The amounts involved in this transaction may be grounds for additional suspicion that the directors' actions were intended to defraud creditors – the inventory balance is now £1,250,000 (£750,000 + £500,000) which is just enough to cover the bank's secured loan. The transaction will thereby effectively transfer the losses which the directors would otherwise suffer under their personal guarantees to the bank onto the company's unsecured creditors. If the transaction has been intentionally designed to achieve this outcome, the actions of Mr and Mrs Krupt would constitute fraudulent trading. The key issue in proving this would therefore be whether the evidence establishes this intent beyond reasonable doubt. If a court were to conclude beyond reasonable doubt that it was intentional, imprisonment for up to 10 years, personal liability for the debts of the company and disqualification from being a company director for up to 15 years will all be possible penalties which the court may impose on Mr and Mrs Krupt.

Alternatively, if there is insufficient evidence of fraudulent trading, it may still be possible for creditors to bring a successful action for wrongful trading as a result of the weaker evidence test of the balance of probabilities and the fact that there is no need to establish intent. Moreover, it seems likely that an action for wrongful trading would succeed against Mr and Mrs Krupt. They are both directors of the company and there appears to be clear evidence based on the audit supervisor's findings that they ought to have realised that the creditors of the company would suffer losses. As a result of a successful action for wrongful trading, it follows that the liquidator will be able to seize Mr and Mrs Krupt's domestic residence and other assets in order to swell the pool of assets available to distribute to all of the creditors of the company (including the unsecured creditors).

Marks

1 Audit risk evaluation

Up to 3 marks for each audit risk identified and explained. Marks may be awarded for other, relevant audit risks not included in the marking guide.

In addition, 1 mark for relevant ratios and ½ mark for relevant trends which form part of analytical review (max 5 marks).

Materiality calculations should be awarded 1 mark each (max 4 marks).

– Operating margin and ROCE changes – risk understated expenses/overstated revenue
– Trends within operating expenses and related audit risks, e.g. misclassification of expenses
– Other operating income – risk of overstatement
– Risk of management bias due to listed status (max 2 marks)
– Current ratio and gearing and related audit risks, e.g. understated finance costs
– Effective tax rate and risk of tax expense being understated (max 2 marks)
– Consolidation of foreign subsidiaries
– Recognition and measurement of foreign exchange gains and losses
– Goodwill – audit risk regarding measurement, specifically lack of impairment review
– Goodwill on acquisition of Lynx Co (max 4 marks for detailed discussion)
– Intangible assets – audit risks in relation to unexplained movement in year, whether amounts should have been capitalised and amortisation period (max 5 marks)
– Increased detection risk regarding Lynx Co due to being audited by a component auditor

Maximum marks 24

Audit procedures on the goodwill recognised on acquisition of Lynx Co

Up to 1 mark for each well described procedure:

– Obtain and review the legal documentation, in particular, confirm the targets to be used as the basis for payment of the contingent consideration
– Confirm that the Group has obtained an 80% shareholding and that this conveys control
– Agree the £80 million cash paid to the bank statement and cash book of the acquiring company
– Review the board minutes for relevant discussions including the minute of board approval
– Obtain management's calculation of contingent consideration, and evaluate assumptions used
– Discuss the 18% interest rate used in determining the discount factor and evaluate the justification given by management
– Confirm that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition by agreeing to stock market records
– Obtain a copy of the due diligence report issued by Sidewinder & Co, review for confirmation of acquired assets and liabilities and their fair values
– Evaluation the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13 *Fair Value Measurement*
– Review the calculation of net assets acquired to confirm that Group accounting policies have been applied

Maximum marks 6

Evaluation of Vulture Associate's audit strategy

Up to 2 marks for each issue evaluated:

– Controls – evidence needs to be obtained to confirm that controls have not changed
– Controls should be tested in a three-year cycle in order to place continued reliance on them
– Group audit team may decide to perform additional tests of control if Vulture Associates does not amend their strategy
– Performing pension plan valuation creates self-review and management threat to objectivity
– Audit of Lynx Co should comply with Group-wide ethical policies
– Given materiality to the Group, additional audit work to be performed on the pension plan
– Conclusion on audit quality and ethics (1 mark)

Maximum marks 10

	Marks
Ethical issues relating to request to assist management in preparing an integrated report	
Up to 2 marks for each relevant point explained, and 1 mark for relevant safeguard or action:	
– Explain the threats to objectivity created – self-review, familiarity and management involvement (1 mark each)	
– Conclusion as to whether service can be provided, following on from justification	
– Suggest appropriate safeguards if engagement accepted, e.g. independent review (1 mark each)	
– Explain that audit committee would need to pre-approve the engagement	
– Bison & Co to consider competence and resource availability	
– Discuss with audit committee (1 mark)	
Maximum marks	6
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	**50**

Marks

2 (a) Clark Ltd

Matters to be discussed and individual impact on financial statements

Generally up to 2 marks for each matter and impact.

(i) Lease of testing equipment

- Lease at largest site is material to SOFP at 2·2% of total assets; leases at other two sites are also material at 2·8% of total assets (max 1 mark)
- General requirement of IFRS 16 to capitalise all leases on SOFP as right-of-use assets at PV of lease payments from commencement date (i.e. date asset is available for use)
- IFRS 16 exemption (optional) for short-term leases of less than 12 months with no purchase option hence if client elects, no need to recognise lease on SOFP (n.b. no P/L effect yet as commencement date at year end)
- Short-term lease exemption must be made by class of underlying asset, hence treatment across three sites must be consistent
- To discuss exemption with FD at meeting: if elects not to take exemption across the three sites, assets and liabilities are materially understated; hence the proposed adjustment is correct and a right-of-use asset and lease liability of £475,000 should be recognised
- Alternatively, if client does elect to take exemption across all three sites, then assets and liabilities are materially overstated and right-of-use assets and lease liabilities of £625,000 should be derecognised

Impact on audit opinion:

- If client makes no adjustment, the statement of financial position is materially misstated and the audit opinion should be qualified on this basis with an 'except for' opinion

(ii) Legal claim

- Claim is material to SOFP at 5·5% of total assets (max 1 mark)
- Provision should be recognised per IAS 37 as unpaid, probable liability at reporting date
- Asset should also be recognised as payment by insurance company is virtually certain
- The asset and liability should be shown separately on the SOFP and not offset; there is no net impact on P/L; as a result both assets and liabilities are materially understated
- Full details of both provision and contingent asset should be disclosed in notes to financial statements

Impact on audit opinion:

- If client makes no adjustment, the statement of financial position is materially misstated and the audit opinion should be qualified on this basis with an 'except for' opinion

(iii) Asset impairment

- Impairment of £85,000 is not material in isolation to either SOFP or P/L (max 1 mark)
- New competitor is significant change in site's market and therefore impairment indicator; site is CGU (per intro to question) and therefore appropriate to conduct impairment test at this level
- Recoverable amount is higher of value in use and fair value less selling costs; fair value less costs of disposal is £3,515,000 and therefore asset is impaired by £85,000 (client appears to have incorrectly excluded cost of removing assets from calculation but correctly excluded the costs of business reorganisation)

Impact on audit opinion:

- Assets and profits are both (immaterially) overstated; hence if no adjustment made, there will be no impact on the audit opinion in relation to this issue in isolation

Maximum marks 17

Marks

(b) Turner plc

Ethical and professional issues and actions to be taken by audit firm

Generally up to 1 mark for each issue and action.

Loan to member of the audit team
Issues:
- Potential self-interest and intimidation threats to auditor independence
- Key issue is whether 'the very best deal which the bank can offer' is made under normal lending procedures, terms and conditions
- If not, self-interest threat created would be so significant that no safeguards could reduce it to acceptable level and Janette should be told not to take loan
- If it is made under bank's normal lending procedures, terms and conditions, the loan does not create a threat to auditor's independence and Janette may accept the loan

Actions:
- Discuss terms and conditions of loan with Janette and business manager
- Inform audit engagement partner, who is responsible for ethical compliance
- Obtain draft loan documents and review details in order to establish whether under normal lending procedures, terms and conditions
- Advise Janette on outcome of review and whether she can accept loan and advise business manager of decision explaining rationale/ethical rules

Temporary staff assignment
Issues:
- Potential self-review threat to auditor independence
- Must not assume management responsibilities or provide non-assurance services prohibited by FRC *Ethical Standard*
- Cannot provide payroll services to audit client which is a public interest entity

Actions:
- Advise client of outcome of these enquiries/decision; will have to decline assignment of staff member as payroll supervisor

Maximum marks	8
Maximum	**25**

Marks

3 (a) Narley Co

(i) Matters to be considered before acceptance of engagement

Up to 2 marks for each matter explained:

- Auditor independence including potentially significant advocacy threat and possible self-review and self-interest threats
- Intended use of report, e.g. solely for bank or wider distribution
- Nature of assumptions and time period covered (in this case two years)
- Availability of experienced, competent staff and time frame for assurance work
- Appropriate safeguards to reduce risks to acceptable level
- Details of PFI to be given to bank, e.g. forecast SOCIs only?

Maximum marks 6

(ii) Examination procedures to be performed

Generally up to 1 mark for each described procedure. Also allow 1 mark for each relevant analytical procedure used to max of 3 marks:

- Check arithmetic accuracy of forecast
- Agree accounting policies consistent with financial statements and comply with IFRS Standards
- Discuss key assumptions with management and assess reasonableness
- Review market research documentation and discuss with management
- Obtain and review customer contracts for new customers to confirm projected growth in revenue
- Obtain written representations from management on reasonableness and completeness of assumptions
- Assess competence and experience of client staff preparing forecasts including accuracy of PFI prepared in previous periods and reasons for any significant variances
- Perform analytical review of key trends; up to 3 marks for analysis of key trends by candidates including:
  - Growth in revenue
  - Cost of sales as % of revenue
  - Declining trend in admin expenses
  - Increase in net profit margin
- Review of capex forecasts and agreement to invoices/supplier quotations
- Recalculate depreciation and ensure correct inclusion of depreciation on new HGVs and warehousing facilities
- Obtain and review breakdown of operating expenses; ensure all items appropriately included, e.g. advertising/marketing costs; additional staff costs for new drivers including recruitment expenses; any trading tariffs with overseas market and any forex implications
- Inspect recent utility bills and assess reasonableness of forecast utility overheads
- Obtain and review documentation for existing loan agreements with bank and draft documentation for new loan and recalculate finance costs

Maximum marks 9

Marks

(b) Krupt Ltd

Generally up to 1 mark for each point explained.

Fraudulent trading:

- Definition: carrying on business of insolvent company with intent to defraud creditors
- Can apply to any person knowingly a party to fraudulent trading
- Burden of proof: beyond reasonable doubt (criminal offence)
- Penalties and liability (½ mark each):
  - Imprisonment up to 10 years
  - Personal (civil) liability for debts of company
  - Disqualification as company director for up to 15 years

Wrongful trading:

- Definition: carrying on business of insolvent company when ought to have concluded/realised that no reasonable prospect of avoiding insolvent liquidation (and that creditors would therefore suffer losses)
- Only applies to company directors (including shadow directors)
- Burden of proof: balance of probabilities (civil wrong)
- Penalties and liability (½ mark each):
  - Personal (civil) liability for debts of company
  - Disqualification as company director for up to 15 years

Implications for Krupt Ltd:

- Mr and Mrs Krupt appear to have bought substantial quantity of goods on credit in order to ensure that bank will have sufficient secured assets to cover its debt without having to call in the personal guarantee on the directors' house; transaction will effectively transfer losses on to unsecured creditors; amounts look suspicious in that there is now sufficient inventory to cover the secured loan from the bank, i.e. £750,000 + £500,000 = £1,250,000 compared to a loan of £1,200,000 (up to 2 marks for this analysis if clearly stated and developed)
- If court concludes beyond reasonable doubt that this was intentional, imprisonment/personal liability/disqualification will all be possible penalties
- If court concludes insufficient evidence of fraudulent trading, it seems likely that wrongful trading will apply: Mr and Mrs Krupt are directors of company, clear evidence based on audit supervisor's findings that ought to have realised creditors would suffer losses
- Hence liquidator will be able to seize Mr and Mrs Krupt's house (and other assets) to swell pool of assets available to distribute to all creditors of company (including unsecured)

Maximum marks	10
Maximum	**25**