Answers

1 Briefing notes

To: Harvey Rebus, Audit engagement partner

From: Audit manager

Subject: Audit planning in relation to Pale Co

Date: 1 July 20X5

Introduction

These briefing notes have been prepared to assist in planning the audit of Pale Co. The notes begin with an evaluation of the business risks facing the company and continue by evaluating the audit risks which should be considered in planning the audit. The notes also include the recommended principal audit procedures which have been designed in respect of a change in fair value to the company's timber plantation following a recent storm. Finally, the notes discuss some ethical and other professional issues arising from a recent phone call with the company's chief finance officer (CFO) which impact on our audit planning.

(a) Business risks

International expansion

The expansion into Farland introduces a business risk in that the company will be managing operations in a foreign country for the first time. Farland is remote, so it may be difficult for Pale Co's management team to plan regular visits to the new operations, so establishing robust management oversight and controls could be difficult. In addition, Farland may have different laws and regulations compared to the company's home jurisdiction, so there is a heightened risk of non-compliance. Even the type of trees growing in the rainforest will be different, and management may not have experience in their harvesting, processing and the sale of timber products. All of these issues create a risk that the international expansion may not be successful, and at the same time will represent a drain on management's time and resources. Operations in the home country of Pale Co may suffer as a result.

Gold Standard accreditation

There is a risk that the Gold Standard accreditation may not be renewed, with implications for reputation, and more specifically for the new contract with Royal Co, which largely accounts for an increase of 5·5% in the company's revenue this year. Several of the key performance indicators (KPIs) which need to be met to retain the Gold Standard seem to be in jeopardy, for example, there has been a decline in the percentage of timber which is harvested in line with Gold Standard requirements, and the projected metric of 82% is only just above the required level of 80%. In addition, the Gold Standard is linked to ethical business practice, and there are some indications that the company's business ethics are questionable – for example, the legal case being brought by employees and the incentive payment made to a government official. If the Gold Standard accreditation is lost, Royal Co and other customers may cancel contracts, resulting in a loss of revenue and cash flow.

Legal case

The legal action against the company by its own employees is a significant risk. If the issue becomes public knowledge, there will be reputational problems, and the amount which is being claimed, $19 million, exceeds the company's cash balance. If the legal claim were to go against the company, it would struggle to find the funds to pay the damages given that it is already at the limit of its borrowing arrangements. The situation could also indicate poor governance of the company, if decisions are being made which put the lives of employees at risk and result in days lost due to accidents at work, and the matter seems to be dismissed as unimportant by the management team and legal advisers.

Damage to assets caused by storms

The recent storms have caused significant damage to the company's timber plantation asset. Unpredictable weather patterns could cause further harm or even totally destroy the company's timber plantations. Assuming that trees will be replanted to replace the damage caused by the storm, it can take many years for trees to grow to a harvestable size, so the company faces a significant depletion of its future cash inflows for years to come. This risk is very difficult to mitigate, perhaps the diversification into tropical rainforest is a way to reduce the risk exposure of the company's operations being concentrated in one geographical area.

Liquidity

The financial information provided indicates that the company's liquidity position has deteriorated over the year. The company has only $4·5 million of cash – a reduction of 33·8% compared to the end of the last financial year. While this has been explained as due to inflationary pressures, management should be doing more to maintain a reasonable level of cash in order to properly manage its working capital. Inventory levels have increased significantly by 67·4% and while again the reason for the increase has been explained by management, if the inventory of processed timber cannot be shipped to customers in the near future, working capital will continue to deteriorate. The company may become unable to meet obligations as they fall due, especially if the industrial action continues to restrict the possibility of export sales which account for 30% of the company's revenue.

Industrial action

The industrial action at the country's ports has already meant lost sales, and, as explained above, there is a risk that revenue and cash inflows will continue to be negatively impacted. Export sales account for 30% of total revenue, approximately $12·75 million, making this a potentially very significant issue should the industrial action continue. Customers may begin to look elsewhere for their supply of timber, leading to cancelled future orders and contracts.

There is also an issue that the increased storage of timber which is awaiting export to foreign customers will incur additional storage costs.

Incentive payment

The fact that the payment is being reported in the media indicates that there is something unusual about the payment and, in fact, the incentive payment could be a bribe. The reputational risk to the company is high, especially given that it should be adhering to a high standard of business ethics in accordance with its Gold Standard accreditation. Customers may not wish to associate themselves with a supplier which engages with unethical and possibly illegal payments. The company could face legal action if, indeed, the payment is a bribe, and aside from this exacerbating the reputational risk, it has very little cash available to pay any fine or penalty imposed.

If the incentive payment is proven to be a bribe, there could be implications for the government grant, which contains stipulations regarding ethical business practices. In the worst case, the grant may need to be repaid if the terms and conditions are found not to have been complied with.

This issue is discussed further in part (d) to these briefing notes in terms of how it impacts on our role as auditor.

Tutorial note: *Credit will be awarded for discussion of other relevant business risks, for example, the solvency issue raised by the company being at the limit of its borrowing agreement, the lack of cash other than relating to the government grant available for establishing operations in Farland, the lack of an audit committee and independent internal audit team, the reputational damage which may be caused by the legal case and incentive payment, and the inflationary pressures which will make costs hard to control.*

(b) Evaluation of audit risks

New client

This is the first year in which Chief & Co has audited the company, which increases detection risk, as our firm does not have experience with the client, making it more difficult to detect material misstatements.

In addition, there is a risk that opening balances and comparative information may not be correct. The prior year figures were not audited by Chief & Co, therefore we should plan to audit the opening balances carefully, in accordance with ISA 510 *Initial Audit Engagements – Opening Balances*, to ensure that opening balances and comparative information are both free from material misstatement.

Tutorial note: *Credit will also be awarded for discussion of Pale Co operating in a specialised industry, which could create a detection risk given the audit firm's lack of experience in auditing clients in this industry.*

Corporate governance

The company does not have to comply with corporate governance requirements as it is not a listed entity. However, it is good practice to have an established audit committee, especially for a large company like Pale Co which is seeking a stock market flotation in the relatively near future. The internal audit team is small and lacking in independence as they report directly to the CFO. This means that the scope of their work is likely to be quite limited due to insufficient resources, and any recommendations made could potentially be ignored by Mark York. This has implications for controls over financial reporting, which could be deficient, and increases control risk. There is a high scope for errors in financial reporting processes and for deliberate manipulation of balances and transactions, as the internal audit team does not have sufficient resources for thorough monitoring and reporting.

Pressure on results

The company is not a listed entity, but the existing and new shareholders will be looking for a return on their investment in the form of a dividend payment. In addition, in the run up to a potential stock market flotation, there will be pressure for the company to show good financial performance. The company also has ambitious international expansion plans. Pressure to return a better performance creates an incentive for management bias which 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.

The fact that the projected profit before tax is 30% higher than the previous year's figure could indicate that operating expenses are understated. Management bias could also have led to some of the accounting treatments suggested by Mark York, which work to improve the company's profit for the year.

Government grant

A government grant of $20 million has been awarded to Pale Co, this amounts to 3·6% of total assets and is material to the projected statement of financial position. Mark York has suggested that he will recognise $10 million of the amount received in profit for the year – projected profit before tax is only $6·5 million, so increasing the profit by this amount would be highly material to the statement of profit or loss.

The audit risk relates to whether this should be recognised as income in the current accounting period. IAS® 20 *Accounting for Government Grants and Disclosure of Government Assistance* requires that government grants are recognised in profit or loss on a systematic basis over the periods in which the entity recognises expenses for the related costs for which the grants are intended to compensate. Mark York is planning to recognise half of the grant as income this year, however, this is not appropriately justified. The grant has not been awarded to compensate for management time in planning the international expansion, so the appropriate accounting treatment would seem to be that the entire amount of the grant should be recognised as deferred income in this financial year, as the expenditure for which the grant is specifically provided has not yet been incurred. Therefore, there is a risk that the company will recognise the income too early, leading to overstated profit and understated liabilities.

Tutorial note: *Credit will also be awarded for discussion relating to the company's use of the grant for building accommodation for employees, and relevant audit risks, e.g. the recognition of the accommodation as property, plant and equipment and treatment of the part of the grant relating to the construction of assets.*

There could be a further issue in that the terms of the grant may require complete or partial repayment if the conditions of the grant are not satisfied, for example, if Pale Co does not retain its Gold Standard accreditation or if the circumstances of the employees' legal case are considered to be indicative of unethical business practice by the company. The company should evaluate whether the terms are likely to be met, and if not, should consider whether it would be appropriate to recognise a provision or disclose a contingent liability in the notes to the financial statements. According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised where a present obligation exists as a result of a past event which can be reliably measured and is probable to result in an outflow of economic benefit.

The risk is therefore that this has not been considered by management, leading possibly to understated liabilities or inadequate disclosure as required by IAS 37.

Legal case

The legal case could also give rise to a risk of understated liabilities or inadequate disclosure if the company fails to provide for the $19 million claimed by employees or to disclose the matter as a contingent liability. It will be a matter of significant judgement to decide whether the legal claim is likely to go against Pale Co or not at this early stage, however, the matter is material at 3·5% of total assets and being close to three times projected profit for the year therefore warrants careful consideration. Due to its sensitive nature, the auditor may also consider the issue to be material by nature.

Reduction in fair value of timber plantation

The company's timber plantation asset, prior to recognising any change in fair value, is projected to amount to 90·9% of the company's total assets and is therefore highly material.

The company has correctly obtained an expert's opinion on the change in fair value of the destroyed and damaged trees caused by the storm. The expert's valuation has helped management to determine that a reduction in fair value of $70·5 million should be recognised in the financial statements within profit. This amount is material in its own right at 14·1% of the timber plantation asset and being more than ten times projected profit. When the loss in value is recognised, it will turn the projected profit into a significant loss. There is a risk that management will not recognise the loss in full due to the impact it will have on profit. This is therefore a very significant issue for the audit planning.

There is a risk that the expert's valuation is not appropriate, for example, if the expert does not have appropriate expertise to perform this specialist valuation, which would lead to issues in whether the valuation can be relied upon. In addition, the expert has considered only the value of the destroyed and damaged trees and not considered any other impact of the storm, for example, if other assets such as roads and buildings have been affected by the storm and should be tested for impairment.

Therefore, based on the issues discussed above, there is a risk that the loss is not fully recognised in profit for the year, and the carrying amount of non-current assets is overstated.

Inventory

The level of inventory has increased significantly, by 67·4%, and the value of inventory at 30 June 20X5 represents 2·8% of projected total assets. The inventory is therefore material to the financial statements. There is a risk that if the industrial action continues, and the company cannot fulfil its export sale contracts, the customers will cancel their orders. The inventory then may not be saleable to other customers, perhaps if the timber has been cut to customer specification or requires modification to secure a sale to a different customer. According to IAS 2 *Inventories*, inventory should be recognised at the lower of cost and net realisable value, and there is an audit risk that inventory is overstated if any necessary write down to net realisable value is not recognised. This would result in overstated current assets and overstated profit.

Going concern

There are several indicators that despite its projected increase in revenue and profit, the company faces going concern problems. These indicators include, but are not limited to, operational problems including the destroyed timber plantation and industrial action, reputational damage caused by the legal claim and possible illegal payment, financial problems caused by lack of cash and the fact that its results are likely to be much worse than that projected by management when the decrease in fair value of the destroyed timber plantation is taken into account.

IAS 1 *Presentation of Financial Statements* requires that management provides a note to the financial statements which discusses any material uncertainty over the company's ability to continue as a going concern. If management fails to disclose this note, or provides the note but with inadequate detail, then the requirements of IAS 1 may not have been followed, creating a significant audit risk.

(c) Change in fair value of the timber plantation asset

- Obtain the expert's report on the value of the destroyed and damaged timber plantation to:
  - Gain understanding and allow evaluation of the methodology and assumptions used, e.g. the basis of determining the amount of any income which may be generated from the timber to be salvaged from damaged trees.
  - Confirm the geographical extent of damage by the storm.
  - Confirm the basis of determining whether trees have been completely destroyed or damaged.
- Discuss the expert's methodology and assumptions with management to confirm their rationale and compliance with the measurement requirements of IAS 41 *Agriculture*.
- Obtain confirmation of the expert's qualifications and experience in assessing storm damage to timber plantation assets and quantifying financial losses.
- Obtain confirmation that the expert is independent from Pale Co and its management team.
- If possible, visit the site of the storm damage to form a view on the scale of the destruction and to evaluate whether any assets other than the trees have been destroyed or damaged.
- Discuss with management the actions which have been taken in response to the storm, e.g. the extent of progress made to clear the destroyed trees and harvest the damaged trees.
- Obtain any documentation relating to any potential sale of damaged trees, e.g. customer orders, to confirm any realisable value of damaged trees.
- From the non-current asset register, confirm the carrying amount of the standing trees prior to any change in fair value being recognised.
- Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures.
- Develop an auditor's estimate of the fair value of the timber plantation, in accordance with the IAS 41 requirements, and compare to management's estimate of the change in fair value.
- Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the storm damage is covered by insurance.

(d) Ethical issues

Assurance on key performance indicators (KPIs)

There are several issues to consider with regard to providing this service. A significant issue relates to auditor objectivity. The KPIs include financial and non-financial metrics. The financial metrics, including revenue, operating profit and profit before tax, will be extracted from, or reconciled to, the figures as shown in the audited financial statements.

While the KPIs will not form part of the audited financial statements, they will be published in the annual report and therefore form part of the 'other information' in relation to which the auditor has responsibilities under ISA 720 *The Auditor's Responsibilities Relating to Other Information*. ISA 720 requires that auditors read the other information in order to identify any material inconsistencies between the financial statements and the other information.

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 would be read by the audit team as part of their review of other information. The team performing the assurance work would be reluctant to raise queries or highlight errors which may have been made during the external audit when reading the other information.

Tutorial note: *Credit will be awarded for discussion of other relevant threats to objectivity created by providing an assurance service on the KPIs, including the advocacy threat and self-interest threats.*

The IESBA *International Code of Ethics for Professional Accountants* (the *Code*) provides guidance when auditors provide additional services to an audit client. Chief & Co needs to evaluate the significance of the threat and consider whether any safeguards can reduce the threat to an acceptable level. For example, a partner who is independent should be involved in reviewing the audit work performed.

There is also an ethical issue in respect to the fee proposed by Pale Co for the assurance engagement. If the firm decides to take on the engagement, it should be treated as an engagement separate from the audit and with a separate fee charged for the work and confirmed in a separate engagement letter. The suggestion to simply amend and increase the audit fee and to determine it on a contingent basis, as in the fee is only payable if the assurance is favourable, is not appropriate. Contingent fees can give rise to a self-interest threat, as it is in the financial interest of the audit firm to give a favourable assurance opinion in order to secure the income. The *Code* prohibits the use of contingent fees for audit services, but they are allowed for other types of work, depending on factors such as the nature of the engagement and the range of possible fee outcomes. The most prudent course of action, should Chief & Co take on the engagement, would be to charge the fee on a non-contingent basis, separate from the audit fee, to remove any ethical issues relating to the fee.

Aside from ethical issues, Chief & Co must also consider whether they have the competence to perform the work. Providing assurance on non-financial KPIs 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. In particular, the firm would need to ensure that it fully

understands the Gold Standard accreditation. Given that this is a specialised industry, and this is the first client which Chief & Co has in the industry, it is questionable whether the firm has the competence to carry out the work.

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.

Incentive payment

Mark York has suggested that incentive payments are 'routine', but it could be against the law. The incentive payment raises concerns that the company may not be complying with relevant law and regulations. The incentive payment could be a bribe and an illegal payment. If so, this indicates a lack of integrity of management, as clearly Mark York is aware of the payment and seems to be justifying it.

The auditor also needs to consider the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. ISA 250 states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulation, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where non-compliance has an impact on the financial statements.

Therefore, the auditor should ensure they have a full knowledge and understanding of the relevant laws and regulations, and the implications of non-compliance. ISA 250 requires that when non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore, procedures should be performed to obtain evidence about the suspected non-compliance, for example, to obtain any documentation which may exist to support Mark York's claim that the payment is in the normal course of business. The planned audit procedures should be sufficient for the audit team to conclude on the accounting treatment and on whether the auditor has any reporting responsibilities outside the company, for example, to communicate a breach of anti-corruption legislation to the appropriate authorities.

ISA 250 also requires the matter to be discussed with management and, where appropriate, with those charged with governance. Given the potential impact of the news story for the company's reputation, the matter should be discussed as soon as possible.

Finally, there appears to be an intimidation threat. Mark York has urged the audit team not to investigate the incentive payment, attempting to restrict the audit team's ability to obtain audit evidence in relation to the payment. According to ISA 210 *Agreeing the Terms of Audit Engagements*, the management of a client should acknowledge their responsibility to provide the auditor with access to all information which is relevant to the preparation of the financial statements which includes unrestricted access to persons within the entity from whom the auditor determines it necessary to obtain audit evidence. The comment by Mark York would appear to be an imposed limitation on the scope of the audit, and the audit engagement partner should raise this issue with the company's management team.

The CFO would appear to lack integrity as he is trying to keep the issue a secret. The audit engagement partner should consider whether other representations made by Mark York should be treated with an added emphasis on professional scepticism, and the risk of management bias leading to a risk of material misstatement could be high. This should be discussed during the audit team briefing meeting.

Conclusion

These briefing notes highlight that the company faces significant business risk, in particular, in relation to its financial position and the recent storm damage. There are a number of significant audit risks which will need to be carefully considered during the planning of the audit, to ensure that an appropriate audit strategy is devised. Going concern should be a key focus of the audit. We need to perform detailed work on the highly material change in fair value of the timber plantation due to the recent storm, as detailed in the notes. Finally, there are several ethical matters to be discussed with management and incorporated into our audit planning. The assurance engagement on the company's KPIs should only go ahead once all ethical implications have been carefully evaluated and appropriate safeguards put in place.

2 (a) Cameron Co

There are problems indicated by the review in relation to both the audit of Cameron Co's individual financial statements by Carrey Associates, and in the way the Group auditor has dealt with the issue of there being a new component auditor involved in the Group.

Internal audit

First, it is not appropriate that Carrey Associates has relied on the work performed by the internal audit team. A significant self-review threat to the objectivity of Carrey Associates arises from the firm providing both internal and external audit services to Cameron Co. The IESBA *International Code of Ethics for Professional Accountants* (the *Code*) suggests that providing an audit client with an internal audit service creates a significant self-review threat because in subsequent audits the audit team will use the internal audit work performed, leading to potential over-reliance. There is therefore a risk that the audit has not been performed with sufficient objectivity and professional scepticism. In addition, it is not clear whether appropriate safeguards are in place to reduce the threats to an acceptable level, for example, by ensuring that the two services were provided by separate teams.

There is a risk that insufficient audit evidence has been obtained over internal controls. This is a breach of ISA 315 *Identifying and Assessing the Risk of Material Misstatement Through Obtaining an Understanding of the Entity and its Environment*,

which requires the auditor to obtain an understanding of the internal controls relevant to the audit, including an evaluation of the design and implementation of the internal controls. It appears that this audit work has not been performed at all, due to over-reliance.

There is a further issue with the timing of when the internal controls had been tested, which took place in May 20X4. The financial year ended on 31 January 20X5, so it appears that the controls had not been evaluated for the last eight months of the financial year. ISA 330 *The Auditor's Responses to Assessed Risks* states that if the auditor intends to rely on controls over a period of time, the tests performed must be able to provide audit evidence that the control operated effectively over that period. This exacerbates the risk of over-reliance discussed above, as there could have been significant changes in internal controls during that period, which had not been identified by the external audit team.

This raises concerns over the quality of the audit which has been performed by Carrey Associates. Given that Cameron Co is a significant component of the Group, any material misstatements which have not been detected by the component auditor could have implications for the Group financial statements, which could also be materially misstated.

In addition to the self-review threat to objectivity, a threat of management responsibility arises, whereby the audit firm, by performing internal audit services, is making decisions and using judgement which is properly the responsibility of management. An audit firm should not assume management responsibility. This raises concern over Carrey Associates' general approach to ethical issues, and whether the ethical threats raised have been properly evaluated by the firm.

Group auditor evaluation of Carrey Associates

The comment made in the Group audit working papers indicates that there has been no understanding obtained by the Group auditor in relation to the scope and extent of the audit evidence obtained by the component auditors. This is a significant quality control problem and a breach of ISA 600 *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* which requires that the Group audit team obtains an understanding of the component auditor, and be involved with the component auditor's risk assessment to identify risks of material misstatement. This is especially the case, given that Cameron Co is a new component of the Group, and this is James & Co's first experience of working with Carrey Associates.

The fact that an audit partner has left James & Co to work as an audit partner at Carrey Associates has no bearing on whether James & Co should have obtained an appropriate understanding of Carrey Associates. An understanding of whether Carrey Associates follows the same ethical framework as the rest of the Group and an understanding of their competence is required. It appears that the Group audit has been conducted without this necessary understanding being obtained, which is a breach of ISA 600.

In addition, a familiarity threat to objectivity arises because of the connection which the Group audit team will have with the audit partner who is now working for Carrey Associates and who previously worked on the external audit of Cameron Co. The familiarity threat means that the Group audit team may have over-relied on the work of the component auditor, due to this close working connection, and failed to apply appropriate professional scepticism.

Use of local accounting rules

Cameron Co uses local accounting rules in its individual financial statements, which is acceptable. However, for the purpose of consolidation, the same accounting policies must be applied across all Group companies, as required by IFRS® 3 *Business Combinations*. The fact that the Group audit partner has concluded that no work is needed in relation to the accounting policies indicates poor quality audit work and insufficient audit evidence has been obtained. Adjustments may have been necessary to Cameron Co's balances and transactions prior to consolidation; with no audit work being performed to assess whether this is the case, there is a risk of material misstatement in the Group financial statements.

The fact that it is the Group audit partner who reached this conclusion indicates a lack of competence and raises concerns over the quality of the audit as a whole.

(b) Marsden Co

This subsidiary has been audited by a local office of James & Co, however, the fact that James & Co is auditing the Group and the subsidiary does not mean that communications between the audit teams should be lacking in terms of their formality or level of documentation. ISA 600 requires documentation of a range of matters, including:

– The nature, timing and extent of the Group audit team's involvement in the work performed by the component auditors on significant components,

– The Group audit team's review of relevant parts of the component auditors' audit documentation and conclusions, and

– Written communications between the Group audit team and the component auditors about the Group audit team's requirements.

For all companies within the Group, regardless of materiality, the Group auditor should evaluate and review the work done by the component auditor. The component auditor may be asked to prepare a report summarising the work done and this could be in the form of an executive summary, or a memorandum of audit issues arising from the audit of the company. Alternatively, the Group auditor may issue a questionnaire, to be completed by the component auditor, which would highlight key issues arising from the audit of the component. In the absence of written documentation, it is difficult to understand the matters on which the Group audit team and component audit team communicated, whether matters have been resolved and the impact which these matters might have on the Group financial statements.

Specifically in relation to the subsequent events review, the Group audit team should have requested the subsidiary audit team to provide relevant information, or performed a subsequent events review themselves. ISA 600 requires the Group audit team or the component auditors to perform procedures designed to identify events at those components which occur between the dates of the financial information of the components and the date of the auditor's report on the Group financial statements, and which may require adjustment to or disclosure in the Group financial statements. If neither audit team has performed a subsequent events review, there may be matters which have not been identified which could be adjusting or non-adjusting events which impact on the subsidiary and Group financial statements.

ISA 600 requires that the Group audit team communicates its requirements to the component auditor on a timely basis. This communication shall set out the work to be performed, the use to be made of that work, and the form and content of the component auditor's communication with the Group audit team. Specifically, ISA 600 requires the Group audit team to communicate a list of related parties prepared by Group management, and any other related parties of which the Group audit team is aware. Without this communication, the auditor of Marsden Co will not be aware of the work which needs to be performed in respect of related parties, so the audit evidence obtained is likely to be insufficient and/or inappropriate. ISA 600 also requires component auditors to communicate any related parties which had not previously been identified by Group management or the Group engagement team. If the component auditor has not made this communication, there is a risk that related parties have not been identified and reported appropriately, and that disclosures may be incomplete.

(c) Dean Co

Insufficient audit evidence has been obtained in relation to the financial asset. The audit team should not just have accepted management's valuation of $68,000, which could be based on inappropriate assumptions. An offer of $68,000 may have been received, but this has also not been verified by the audit team. As there is no active market for the shares, fair value should be based on an exit price at the measurement date and should reflect assumptions which market participants would use including risk. Even if the offer was genuinely received, this is not an appropriate basis for the valuation of shares, especially given that the offer was made nine months before the year end. An appropriate level of professional scepticism has not been used in the audit of the financial asset.

Fair values should be determined close to the financial year end, and the $68,000 might reflect out-of-date perceptions of the value of Corden Co. From the information provided, it seems that the financial asset could be impaired and is likely to be overstated in value. Dean Co's 2% shareholding is recognised at $68,000; however, 2% of the net assets of Corden Co at 31 January 20X5 amounts to only $11,000. If the financial asset is overvalued, then any necessary adjustment would have a profit implication and this is not mentioned in the audit working papers.

Using Group materiality in the audit of a subsidiary is not appropriate. The value of the financial asset is less than Group materiality, but it might be material to Dean Co's individual financial statements. It is not clear that the individual audit team determined an appropriate level of materiality as part of their planning of the individual company audit. The Group audit team should determine component materiality to be used by component auditors in their audit of subsidiary balances and transactions, and component materiality should be lower than materiality for the Group financial statements as a whole. Therefore, it seems likely that the Group audit team has not communicated an appropriate level of component materiality to the team auditing Dean Co.

While the possible adjustments in relation to the financial asset are not material to the Group, they could be material to Dean Co's individual financial statements, and there is a risk that an inappropriate audit opinion has been issued in relation to this subsidiary's individual financial statements.

(d) Horner Co

There has been a breach of relevant law and regulations. The audit team should have considered the requirements of ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. ISA 250 states that while it is management's responsibility to ensure that the entity's operations are conducted in accordance with the provisions of laws and regulations, the auditor does have some responsibility in relation to compliance with laws and regulations, especially where a non-compliance has an impact on the financial statements.

The auditor is required by ISA 315 to gain an understanding of the legal and regulatory framework in which the audited entity operates. This will help the auditor to identify non-compliance and to assess the implications of non-compliance. Therefore, the auditor should ensure that a full knowledge and understanding of the relevant data protection laws and regulations is obtained in order to evaluate the implications of non-compliance.

ISA 250 requires that when non-compliance is identified or suspected, the auditor shall obtain an understanding of the nature of the act and the circumstances in which it has occurred, and further information to evaluate the possible effect on the financial statements. Therefore, procedures should have been performed to obtain evidence about the suspected non-compliance, for example, to discuss the breach with management to understand how it happened, whether it was due to deliberate action or an unintentional mistake, and who was responsible. In addition, the audit team should have performed further procedures, for example, discussion with the company's legal advisers to understand the legal consequences of the breach. From the information provided, it seems that the audit team failed to obtain more information or evidence due to their belief that the situation had little to do with the audit. The audit has therefore not been performed appropriately, as the requirements of ISA 250 have not been followed. The matter could be immaterial in monetary terms, but without further investigation, it is not possible for the audit team to reach this conclusion. However, in many jurisdictions fines and penalties associated with data protection breaches are often significant. Also, the matter could be material by nature, so regardless of the monetary amounts involved, further work should have been performed.

ISA 250 requires the matter to be discussed with management and, where appropriate, with those charged with governance. It appears that some discussion was held, as the audit manager is aware that the employee has been dismissed. However, the discussions should have been fully documented and raised to the level of Group management, as the matter could impact on the Group and not just on Horner Co.

The audit team should have considered the potential implications for the financial statements. The non-compliance could lead to regulatory authorities imposing fines or penalties on the Group, which may need to be provided for in both the individual and Group financial statements. Audit procedures should have been performed to determine the amount, materiality and probability of payment of any such fine or penalty imposed. The individual and Group financial statements could be materially misstated and given that an unmodified audit opinion has already been issued, this is a significant issue for James & Co to now consider.

In terms of reporting non-compliance to the relevant regulatory authorities, ISA 250 requires the auditor to determine whether they have a responsibility to report the identified or suspected non-compliance to parties outside the entity. In the event that management or those charged with governance of the company or the Group fail to make the necessary disclosures to the regulatory authorities, James & Co should consider whether they should make the disclosure. This will depend on matters including whether there is a legal duty to disclose or whether it is considered to be in the public interest to do so. It seems that this has not been considered so far, but the audit firm can still make any necessary disclosures.

The *Code* requires auditors to comply with the principle of confidentiality, and if disclosure were to be made by the auditor, it would be advisable to seek legal advice on the matter. Further advice on disclosure in the public interest is given in the *Code*, which gives examples of situations where disclosure might be appropriate. These examples include references to an entity being involved in bribery and breaches of regulation which might impact adversely on public health and safety. The *Code* also clarifies that in exceptional circumstances where the auditor believes there may be an imminent breach of a law or regulation, they may need to disclose the matter immediately to an appropriate authority. The decision to disclose will always be a matter for the auditor's judgement and where the disclosure is made in good faith, it will not constitute a breach of the duty of confidentiality.

Tutorial note: *Credit will also be awarded for discussion of relevant ethical threats to objectivity which may arise in relation to the non-compliance, including intimidation and self-interest threats.*

3 (a) Matters and evidence

(i) Railway operating licence

Matters

Uncertainties in relation to going concern

IAS 1 *Presentation of Financial Statements* requires management to disclose material uncertainties in relation to going concern and ISA 570 (Revised) *Going Concern* requires the auditor to assess the adequacy of this disclosure. Therefore the principal matter raised by the unresolved status of the licence tender is the potential impact on Matty Co's financial performance and financial position if the company is unsuccessful in the tender process. This in turn creates uncertainties in relation to the going concern status of the company. The licence is due for renewal on 28 February 20X6 which is 11 months from the reporting date and therefore within the foreseeable future for the purpose of the going concern review. Although the company has been informed that it is the preferred bidder, there are still significant doubts as to whether the licence will be renewed given the government's requirement that the company addresses the recent criticisms and the pending review in one month's time.

The revenue generated from the national railway licence represents 66·9% of Matty Co's revenue for year and is highly material to the company's statement of profit or loss for the year and critical to its operations. It is also significant that the national railway licence contributed profit before tax of $11·2 million which is 106·7% of this year's profit; without this contribution to the company's profit this year, the company would be loss-making. In addition to these considerations, even with the inclusion of the national railway licence in this year's results, Matty Co's performance is deteriorating as evidenced by its declining revenue (down by 36·3%) and profit before tax (down by 52·5%). The company's assets are also down by 8·7% on the prior year which may be indicative of a business which is struggling to renew its capital expenditure and maintains its liquidity.

Evidence

- A review of the press reports in relation to the late running of Matty Co's trains and the quality of its service to assess the seriousness and significance of the issue.
- A review of any correspondence files between Matty Co and the government transport department in order to identify any developments in the licence renewal process and consider their impact on the likely renewal of the licence.
- Notes of discussions held between the auditor and the management of Matty Co in relation to any contingency plans if the company fails to secure the national railway licence; for example, any other licences or opportunities which may exist in the market and any emergency sources of finance which might be available to the company.
- A review of the company's board minutes for evidence of management discussion of the status of the tender process and of any contingency plans.
- A review and analysis of budgets and cash flow forecasts by the auditor in order to assess the ability of the company to survive as a going concern for the foreseeable future.

- Copies of the company's bank facilities reviewed to assess the feasibility of the company's ability to operate within them should they be unsuccessful in winning the contract.
- Written representations from management in relation to the status of the tender process and management's expectations of its expected outcome.

(ii) Purchased customer list

Matters

Assessment of useful life

The carrying amount of the customer list purchased from Jess Coaches is highly material to Matty Co's draft statement of financial position at 24·3% of total assets. According to IAS 38 *Intangible Assets*, a reporting entity should recognise intangible assets initially at cost and should assess whether an intangible asset's useful life is finite or indefinite. An assessment of a useful life as indefinite is only appropriate if on an analysis of all of the relevant factors, there is no foreseeable limit to the period over which the intangible is expected to generate net cash inflows for the entity. This assessment requires a significant level of judgement to be exercised and the subjectivity of the carrying amount creates a high level of risk for the auditor. In this case, the trading history of Jess Coaches prior to its acquisition by Matty Co may provide some evidence that there is no foreseeable limit to the period over which the purchased customer list can be expected to generate cash flows. However, this assumption needs to be assessed carefully by the auditor. Intangible assets with an indefinite life should not be amortised according to IAS 38.

Impairment review

IAS 38 also requires a reporting entity to test intangible assets with an indefinite useful life annually for impairment. This impairment review would involve a comparison of the carrying amount of the customer list to its recoverable amount which, given the difficulty in identifying a sales value for the customer list, is likely to be based on an assessment of its value in use. The assessment of value in use is a highly subjective exercise which involves an estimate of the future cash flows the entity expects to derive from the customer list, expectations about possible variations in the amount or timing of these future cash flows and the time value of money represented by the current market risk-free rate of interest. Management's assessment of value in use as $7·2 million appears to be very close to the asset's carrying amount of $6·9 million and it is possible that management may have manipulated its assumption to avoid the recognition of an impairment loss. The auditor will therefore need to carefully review and consider management's assessment of value in use and the assumptions implicit in its calculation.

In addition to these considerations, the emergence of a new competitor which is capable of taking major customers away from Jess Coaches and the loss of two key customers already are indicators that the intangible asset may indeed be impaired. If the recoverable amounts of the intangible assets are therefore less than their total carrying amount of $6·9 million at the reporting date, an impairment loss should be recognised in the statement of profit or loss for the year and the intangible assets should be written down accordingly.

Evidence

- A copy of the purchase agreement to identify the details of the acquisition including the purchase consideration, the assets acquired and the date of the acquisition agreed to the detail included in the accounting records.
- Agreement of the purchase consideration of $6·9 million to the company's cash book and bank statement to confirm purchase price.
- A review of Jess Coaches' trading history and any market research which has been performed on the ability of the purchased customer list for evidence of how it will generate future revenue for Matty Co.
- A copy of the client's schedule calculating the value in use of the purchased customer list as $7·2 million and a confirmation of the schedule's mathematical accuracy.
- A review and assessment of the company's cash flow forecast which has been used to support the value in use of $7·2 million agreed to the value in use calculation.
- A discussion with management in relation to the basis of the calculation of value in use and an assessment by the auditor of the reasonableness of management's key assumptions.
- A sensitivity analysis performed by the auditor varying these key assumptions and an assessment of the materiality of the potential impact of varying the assumptions on the calculation of the value in use of the customer list.
- A review of Matty Co's management accounts for the reporting period and for the post reporting date period to date in order to identify and quantify the cash flows generated by Jess Coaches' customer list and any significant variances investigated.
- A comparison of the discount rate used in the value in use calculation to published market rates and notes of discussions with management in relation to the basis of any adjustments made by management, in order to ensure that an appropriate rate has been used.
- Written representations from management confirming that to the best of its knowledge, the assumptions used in the calculation of value in use are reasonable and appropriate and that in its opinion, the purchased customer list is not impaired and its carrying amount is fairly stated.

(iii) Chairman's statement

Matters

Duty to review other information

According to ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information*, the auditor has a duty to review other information which has been included in the annual report and determine whether the other information contains any material inconsistencies with the financial statements. In this case, the performance review included in the chairman's statement does appear to contain some significant inconsistencies.

First, the chairman's description of Matty Co as a 'stable and high-performing' company seems inconsistent with the going concern uncertainties which exist around the national railway licence. Furthermore, the statement that Matty Co's 'business has always grown each year and has produced an ever-improving return for our investors' seems inconsistent with a 36·3% fall in revenue.

Second, the finance director's comment that 'everyone understands that it is the chairman's role to promote the company with a positive and upbeat narrative' is inappropriate. The chairman's statement should be accurate and objective and the finance director's attitude that it is the chairman's role to promote the company regardless of the accuracy of the narrative in his statement creates doubts in relation to management integrity.

Evidence

- Notes of discussions with management explaining the apparent inconsistencies between the chairman's statement and the financial statements, requesting amendments to the chairman's performance review and documenting the client's response.
- A detailed review of all the other information contained in the annual report to identify any other possible inconsistencies and investigation of such issues.

(b) Appropriateness of the draft auditor's report

The finance director has agreed to include a short note to the financial statements to disclose information relating to the material uncertainty relating to going concern. The note must be reviewed for completeness and if the auditor assesses that the client's disclosure is not adequate, a modified audit opinion would be appropriate in relation to a material misstatement as a result of the inadequate disclosure.

The form of the opinion would be qualified 'except for' or adverse depending on the auditor's judgement of the matter's pervasiveness to the financial statements. In this case, adverse may be the appropriate form of audit opinion given that the disclosure note is described as 'short' and that management may appear to negate the significance of the uncertainties by stating that they are 'very confident' that they will be successful in the tender process. A full description of the status of the tender negotiations as at the date of the auditor's report and their potential impact on the financial statements should then be detailed in the 'Basis for qualified or adverse opinion' paragraph.

However, if on the other hand, the outcome of the auditor's assessment is that the client's financial statement disclosures are considered by the auditor to be appropriate, the material uncertainty in relation to going concern should be disclosed in a separate section entitled 'Material uncertainties related to going concern' which should appear immediately below the 'Basis for opinion' paragraph and not in the key audit matters (KAM) section of the auditor's report. According to ISA 570, the material uncertainty related to going concern section should:

- Draw attention to the note in the financial statements which discloses the going concern issue; and
- State that these events or conditions indicate that a material uncertainty exists which may cast significant doubt on the entity's ability to continue as a going concern and that the auditor's opinion is not modified in respect of the matter.

Matty Co is a listed entity and according to ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*, KAM disclosures are required in the auditor's report for high risk areas, significant judgements and the effect of significant events or transactions which occurred during period. The assessment of the useful life of the customer list as indefinite and management's conclusion that the intangible assets are not impaired are areas of both significant judgement and high risk given their materiality. The auditor should consider disclosing these matters in the KAM section of the auditor's report.

In addition to these considerations, if the inconsistencies between the chairman's performance review and the financial statements are not resolved through discussions with the client, they should be disclosed in the 'Other information' section of the auditor's report.

Marks

1 (a) Business risks

Up to 2 marks for each business risk evaluated. In addition, ½ mark for each relevant trend or calculation which form part of a relevant explanation of the risk (max 2 marks).

– International expansion
– Gold Standard accreditation
– Legal case
– Damage to assets caused by storm
– Liquidity
– Industrial action
– Incentive payment

Maximum marks 10

(b) Audit risks

Up to 3 marks for each audit risk evaluated unless otherwise indicated. Marks may be awarded for other, relevant risks not included in the marking guide.

Materiality calculations should be awarded 1 mark each (max 3 marks).

In addition, ½ mark for each relevant trend or calculation which form part of a relevant explanation of the risk (max 2 marks).

– New client (up to 2 marks)
– Corporate governance (up to 2 marks)
– Pressure on results
– Government grant (up to 4 marks)
– Legal case
– Change in fair value of standing trees
– Inventory (up to 2 marks)
– Going concern

Maximum marks 20

(c) Audit procedures

1 mark for each well explained audit procedure, examples of which include:

– Obtain the expert's report on the value of the storm-damaged timber plantation to understand methodology and overall results
– Discuss the expert's methodology and assumptions with management to confirm their rationale and compliance with accounting requirements
– Obtain confirmation of the expert's qualifications and experience
– Obtain confirmation that the expert is independent
– Visit the site of the storm damage to form a view on the scale of the destruction
– Discuss with management the actions which have been taken in response to the storm
– Obtain any documentation relating to the potential sale of damaged trees
– From the non-current asset register, confirm the carrying amount of the standing trees prior to any change in fair value being recognised
– Consider whether the use of an auditor's expert is necessary to provide sufficient and appropriate evidence given the materiality of the figures
– Develop an auditor's estimate of the change in fair value and compare to management's estimate
– Obtain a copy of the company's insurance policy and review the terms and conditions to confirm whether the storm damage is covered by insurance

Maximum marks 6

Marks

(d) Ethical and audit planning implications

1 mark for each point discussed:

- KPIs are 'other information' which the auditor must review for material inconsistencies
- Self-review threat to objectivity (additional credit to be awarded for other relevant threats to objectivity explained)
- Assurance can be provided on the KPIs if safeguards can reduce threat to an acceptable level
- Example of safeguard, e.g. separate team to perform the work, separate partner review
- Fee for the assurance work must be separate from the audit fee
- Fee for audit cannot be on a contingent basis
- Fee for assurance work can be on a contingent basis but more prudent if not on that basis
- Competence issues due to specialist nature of the work
- Resource issues, i.e. staff availability to perform the work
- Incentive payment could be a bribe and illegal
- Auditor to obtain understanding of relevant law and regulations, e.g. anti-bribery legislation
- Audit procedures to be planned to obtain evidence relating to the payment
- Discuss with management team of the company and consider external reporting obligations
- Intimidation from CFO/limitation on the scope of the audit
- Lack of integrity – should assess other representations/apply professional scepticism

Maximum marks 10

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	Generally, up to 2 marks for each well explained point.	

(a) Cameron Co

- Internal audit – self-review threat and lack of professional scepticism (1 mark)
- Internal audit – insufficient audit work on internal controls including no understanding or evaluation of year-end controls obtained
- Internal audit – threat of assuming management responsibility and general risk that ethical code has not been followed by Carrey Associates
- Timing and reliance on controls testing
- Group audit firm has not evaluated Carrey Associates or obtained understanding of the firm
- No audit work performed by Group audit team on Cameron Co's different accounting policies – Group consolidation could be misstated
- Implications of former partner joining the component audit firm – familiarity and over reliance (1 mark)
- Possible lack of competence of the Group audit partner (1 mark)

Maximum marks	8

(b) Marsden Co

- Lack of documentation – Group instructions to component audit team not clear or missing
- Subsequent events review not performed – adjusting or non-adjusting events may not have been appropriately accounted for or disclosed
- Group related parties not communicated – likely to be inadequate audit evidence on related parties

Maximum marks	5

(c) Dean Co

- Lack of application of professional scepticism regarding valuation of financial asset
- Asset likely to be overvalued – could have material impact on Dean Co's financial statements
- Inappropriate application of Group materiality at component level

Maximum marks	5

(d) Horner Co

- Auditor is incorrect and laws and regulations do impact the audit and financial statements
- Auditor needs to gain understanding of applicable laws and regulations
- Further evidence should be obtained and the matter discussed with Group management
- Provisions for fines and penalties have not been considered
- Auditor may have a legal duty to disclose, or consider disclosing in the public interest
- The audit firm may wish to seek legal advice regarding the situation (1 mark)

Maximum marks	7
Maximum	**25**

Marks

3 (a) Generally up to 1 mark for each matter explained and each piece of evidence recommended.

(i) Railway licence

Matters

- Management should disclose material uncertainties and auditor should assess adequacy of this disclosure
- Significant uncertainty exists over renewal of licence
- Materiality of national railway contribution to revenue/profit
- Without national railway licence, company would be loss-making
- Company has deteriorating performance, declining revenue, profit and assets
- Company may be unable to renew capex and maintain liquidity

Evidence

- A review of the press reports in relation to the late running of Matty Co's trains and the quality of its service to assess the seriousness and significance of the issue
- A review of any correspondence files between Matty Co and the government transport department in order to identify any developments in the licence renewal process and consider their impact on the likely renewal of the licence
- Notes of discussions held between the auditor and the management of Matty Co in relation to any contingency plans if the company fails to secure the national railway licence; for example, any other licences or opportunities which may exist in the market and any emergency sources of finance which might be available to the company
- A review of the company's board minutes for evidence of management discussion of the status of the tender process and of any contingency plans
- A review and analysis of budgets and cash flow forecasts by the auditor in order to assess the ability of the company to survive as a going concern for the foreseeable future
- Copies of the company's bank facilities reviewed to assess the feasibility of the company's ability to operate within them should they be unsuccessful in winning the contract
- Written representations from management in relation to the status of the tender process and management's expectations of its expected outcome

Maximum marks 7

(ii) Purchase of customer list

Matters

- Materiality of customer list
- Accounting rules for intangible assets with indefinite life
- Assessment is matter of significant judgement and high audit risk
- Indefinite useful life must be substantiated
- Must test intangible assets with indefinite useful lives annually for impairment
- Accounting rules for impairment review
- Possible manipulation by management to avoid impairment loss
- Loss of two major customers/new competitor – possible impairment indicators
- If recoverable amount is less than carrying amount, impairment loss should be recognised in P/L for year

Marks

Evidence

- A copy of the purchase agreement to identify the details of the acquisition including the purchase consideration, the assets acquired and the date of the acquisition agreed to the detail included in the accounting records
- Agreement of the purchase consideration of $6·9 million to the company's cash book and bank statement to confirm purchase price
- A review of Jess Coaches' trading history and any market research which has been performed on the ability of the purchased customer list for evidence of how it will generate future revenue for Matty Co
- A copy of the client's schedule calculating the value in use of the purchased customer list as $7·2 million and a confirmation of the schedule's mathematical accuracy
- A review and assessment of the company's cash flow forecast which has been used to support the value in use of $7·2 million agreed to the value in use calculation
- A discussion with management in relation to the basis of the calculation of value in use and an assessment by the auditor of the reasonableness of management's key assumptions
- A sensitivity analysis performed by the auditor varying these key assumptions and an assessment of the materiality of the potential impact of varying the assumptions on the calculation of the value in use of the customer list
- A review of Matty Co's management accounts for the reporting period and for the post reporting date period to date in order to identify and quantify the cash flows generated by Jess Coaches' customer list and any significant variances investigated
- A comparison of the discount rate used in the value in use calculation to published market rates and notes of discussions with management in relation to the basis of any adjustments made by management, in order to ensure that an appropriate rate has been used
- Written representations from management confirming that to the best of its knowledge, the assumptions used in the calculation of value in use are reasonable and appropriate and that in its opinion, the purchased customer list is not impaired and its carrying amount is fairly stated

Maximum marks 8

(iii) Chairman's statement

Matters

- Auditor has duty to review other information for material inconsistencies
- Chairman's performance review contains apparent inconsistencies
- Discussion of inconsistencies (max 2 marks)
- Finance director's comment is inappropriate – chairman's statement should be objective
- Creates doubts over management integrity

Evidence

- Notes of discussions with management explaining the apparent inconsistencies between the chairman's statement and the financial statements, requesting amendments to the chairman's performance review and documenting the client's response
- A detailed review of all the other information contained in the annual report to identify any other possible inconsistencies and investigation of such issues

Maximum marks 5

(b) Appropriateness of draft auditor's report

Generally 1 mark for each reporting implication explained.

- Inappropriate disclosure – modified opinion due to material misstatement
- Opinion would be qualified or adverse based on auditor's judgement of pervasiveness
- Discussion of pervasiveness – disclosure paragraph may lack detail/be contradictory
- If disclosures not adequate, matter should be detailed in 'Basis for qualified/adverse opinion' paragraph
- Disclosure adequate, uncertainties should be disclosed in separate section/'Material uncertainties related to going concern'/not KAM
- KAM disclosures required for high risk areas, significant judgements and the effect of significant events or transactions which occurred during period
- Inclusion as KAM carrying amount of customer list/management's conclusion that intangibles not impaired
- Inconsistencies in chairman's statement disclosed in 'Other information' section

Maximum marks 5

Maximum **25**