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# Answers

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Section B

Peach Co

(a) Audit risks and auditor's response

**Audit risk**

A new accounting system was introduced in March 20X5 and post implementation testing has not been conducted.

There is a risk of opening balances on the new system being misstated and loss of ongoing data if they have not been transferred from the old system correctly. If the new system is not operating effectively there is a risk of misstatement of the accounting records.

Peach Co has been developing a new production process and \$0.8m was capitalised in the year as development expenditure.

IAS® 38 *Intangible Assets* requires research expenditure to be recognised as an expense as incurred and development expenditure capitalised only if strict criteria are satisfied.

There is a risk that research expenditure has been incorrectly classified as development expenditure resulting in overstated intangible assets and understated research expenses.

The capitalised expenditure should be amortised over the life of the process, commencing when the new process is first brought into use in May 20X5. There is a risk that amortisation has not been correctly calculated for the period resulting in misstated amortisation.

Peach Co holds inventory of \$227,000 that it can no longer sell in its home market. It believes it can be sold to an international customer, but there are significant additional costs that Peach Co will incur.

There is a risk that the net realisable value (NRV) of the inventory is less than cost and therefore that the inventory is overstated and cost of sales understated.

Peach Co has included in wages and salaries, significant staff costs involved in the preparation of the site for the new machinery and in testing the new machinery.

IAS 16 *Property, Plant and Equipment* states that costs, directly attributable to bringing the asset to the condition necessary for its intended use, are capitalised as part of the cost of the asset. These directly attributable costs include costs of site preparation and costs of testing.

It appears that an incorrect accounting treatment has been applied in respect of the staff costs resulting in understated property, plant and equipment (PPE) and overstated wages and salaries expense.

**Auditor's response**

The audit team should undertake detailed testing to confirm that all balances have been completely and accurately transferred to the new accounting system.

They should perform walkthroughs to document the new system and test the controls in place.

They should discuss with management any issues which have occurred since the new system was implemented.

The audit team should discuss with management the accounting policy applied, particularly in respect of identifying the research and development stages.

A detailed review of the costs capitalised and supporting documentation should be carried out to determine the nature of the expenditure. Any development expenditure should then be agreed as meeting the relevant criteria for capitalisation as set out in IAS 38.

The auditor should discuss the assessment of the useful life of the product with management and assess its reasonableness. They should also reperform amortisation calculations to confirm the amounts are accurate.

The audit team should discuss with the directors their belief that the inventory can be sold and should review any agreement with the international customer to determine the likelihood of the sale and the selling price for the inventory. They should also obtain supporting documentation in respect of the delivery and shipping costs in order to establish NRV and discuss with management if a write-down is required.

The audit team should discuss with management the accounting treatment applied and request that the relevant staff costs are included in the cost of PPE.

The audit team should undertake a review of the staff costs expensed and the process for allocating staff costs to work undertaken to confirm the amounts that should be capitalised as part of the cost of machinery. If an adjusting journal is made by management this should be reviewed for accuracy.

### Audit risk

The directors extended the useful lives of plant and machinery by an average of five years despite the fact that machinery had been disposed of at a significant loss.

Under IAS 16 asset lives should be reviewed annually, and if the asset lives have genuinely increased, then the resulting decrease in depreciation may be reasonable. However, the fact that old items of machinery were sold at a substantial loss in the period does not support the decision to increase useful life.

As such, it appears that plant and machinery is overstated and depreciation expense understated.

A member of Peach Co's finance team fraudulently purchased assets for personal use.

The reconciliation of physical assets to the non-current assets register will be ongoing at the year end, hence there is a risk that non-current assets are overstated as they may include the personal assets purchased.

Control risk is also increased if the fraud has gone undetected for a period of time.

The directors have not accounted for any costs under the new contract for bottles as no amounts are due to be paid until after the year end.

There is a risk that the costs incurred to date have not been recognised and therefore costs and liabilities are understated and profit is overstated.

A previous supplier has launched a legal claim against Peach Co. The claim has not been settled but Peach Co's lawyers believe that they are likely to have to pay an estimated \$0.3m.

As it appears probable that Peach Co will have to pay the supplier, a provision is required to comply with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. There is a risk that provisions and expenses are understated if the company has not recognised a liability in respect of this legal claim.

Peach Co obtained a new interest-bearing bank loan in the year repayable over three years.

There is a risk that the loan has not been correctly allocated between current and non-current liabilities which would give rise to a classification error and liabilities being misstated.

In addition, the finance costs are paid in arrears and may not have been correctly accrued at the year end resulting in understated accruals and finance costs.

Peach Co has strict covenants in place regarding the loan.

A breach of covenants could result in fines and penalties or mean the loan would be instantly repayable. There is an increased risk that the existence of covenants gives an incentive to manipulate key balances by overstating revenue and profit to ensure covenants are met.

### Auditor's response

The audit team should discuss with the directors the rationale for any extensions of asset lives and reduction of depreciation rates.

The revised useful life of a sample of assets should be compared to how often these assets are replaced and any gain or loss on disposal, as this provides evidence of the useful life of assets.

The audit team should discuss the fraud with management to understand how the fraud was detected and corrected. They must understand the internal controls in place to prevent other frauds occurring.

Additional procedures should be performed, particularly in respect of non-current assets additions. When testing non-current assets, they should obtain a list of all non-current assets capitalised in the year and agree the new assets to an authorised purchase order. They should select an increased sample of assets from the non-current assets register to confirm the existence of the assets and that they are used in the business.

The audit team should review the terms of the contract to understand the amounts payable and terms of payment. They should review the goods received not invoiced accrual listing to ensure that amounts payable to the supplier for bottles received have been accrued despite not being invoiced.

The audit team should review correspondence with Peach Co's lawyer to understand the likelihood of the supplier winning the case and the amount of the payments to be made to them.

The audit team should undertake a review of the loan agreement to confirm the details and reperform the company's calculations to confirm that the loan has been correctly classified between current and non-current liabilities.

The finance costs should be recalculated and agreed to the accruals schedule.

The audit team should review the loan covenants in detail to understand what Peach Co is required to comply with. They should calculate the covenants to understand whether any breaches have occurred and discuss the impact of any breaches with management.

The team should maintain their professional scepticism to remain alert to the risk over revenue recognition and judgements which affect profit.

**(b) Auditor's responsibilities in relation to the prevention and detection of fraud and error**

- Apricot & Co must conduct an audit in accordance with ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.
- Apricot & Co is required to identify and assess the risks of material misstatement of the financial statements due to fraud.
- The auditor needs to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.
- Apricot & Co must respond appropriately to fraud or suspected fraud identified during the audit, for example, the fraud regarding the purchase of assets for personal use identified by Peach Co.
- When obtaining reasonable assurance, Apricot & Co is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.
- To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISAs require that a discussion is held within the team.
- Apricot & Co must report any actual or suspected fraud to appropriate parties.

**(c) Ethical threats and appropriate safeguards**

<b>Ethical threat</b>	<b>Appropriate safeguard</b>
<p>The managing director of Peach Co has this year suggested that instead of a meal, all the audit staff and client staff go away for the weekend to a luxury hotel at Peach Co's expense.</p> <p>This represents a self-interest and familiarity threat. The acceptance of goods and services, unless trivial and inconsequential in value, is not permitted as it may make the audit staff less likely to challenge Peach Co's assumptions and explanations.</p> <p>Peach Co has suggested that the audit fee is renegotiated to be based on a percentage of Peach Co's net profit. This is a contingent fee and leads to a self-interest threat.</p> <p>If the audit fee is based on profit the audit team may feel incentivised to allow incorrect accounting treatments in order to maximise profits.</p> <p>Apricot &amp; Co has been approached by Peach Co to assist with the identification of acquisition targets.</p> <p>The provision of this type of corporate finance work creates a potential advocacy threat as Apricot &amp; Co may be seen to be promoting Peach Co as an investor. In addition, there may be a self-review threat if the potential acquisition is subsequently reflected in the financial statements and the audit team may be less likely to challenge the figures included.</p>	<p>As it is unlikely that the weekend away has an insignificant value, this offer should be politely declined. The normal meal at the start of the audit is likely to be acceptable, particularly if the audit team pay for themselves.</p> <p>Apricot &amp; Co should not agree to the proposed basis for the fees and should communicate with those charged with governance to explain that the audit fee needs to reflect the level of work and the experience of the team required to obtain reasonable assurance.</p> <p>Apricot &amp; Co may be able to accept this type of work depending on the precise nature and provided that adequate safeguards can be put in place. Care must also be taken not to make management decisions. Safeguards would include using professionals who are not involved in the audit to perform the service (e.g. corporate finance) and having an appropriate reviewer who was not involved in providing the service review the audit work or service performed.</p>

**(d) Development expenditure**

- Obtain a schedule of capitalised costs within intangible assets, cast it and agree the closing balance to the general ledger, trial balance and financial statements.
- Select a sample of capitalised costs and agree to invoices, payroll records or other source documentation in order to confirm that the amount is correct and that the cost relates to the project.
- Discuss with the directors the decision to capitalise the costs from 1 November 20X4 onwards and assess whether this is based on the project meeting all of the conditions for capitalisation in IAS 38.
- Review a breakdown of the nature of the costs capitalised to identify if any research costs have been incorrectly included. If so, request that management remove these and include within profit or loss.
- Select a sample of costs recorded as research expenses and development costs and agree to supporting documentation confirming the date of the expenditure to ensure that costs were allocated correctly.
- Review market research reports to confirm that there is a market for the new process and that the selling price is high enough to generate a profit.
- Review feasibility reports as at 1 November 20X4 and discuss with directors their view that the process was technically feasible at that date.

- Review the budgets in relation to the development project and the cash flow forecast in order to assess whether Peach Co had access to adequate cash resources to complete the project as at the date of capitalisation. Agree the budgets to supporting documentation.
- Discuss with the finance director the rationale for the useful life being applied, consider its reasonableness and agree to supporting documentation.
- Recalculate the amortisation charge and confirm that it covers the period for May to August 20X5.
- Review the disclosures for intangible assets in the draft financial statements in order to confirm that they are in accordance with IAS 38.

## Pomeranian Co

### (a) Limitations of internal control

There are limitations in any system of internal control which affects the extent to which the auditor can place reliance on it. The limitations are as follows:

#### Human error in the design of or application of an internal control

An entity may have an adequate internal control process over a particular area of the financial statements. However, human error in applying that control gives rise to an inherent limitation, for example a staff member may review a bank reconciliation but not identify an error.

There may also be a flaw in the design of internal control whereby there is an error in the design of, or change to, an internal control which means it does not operate as intended.

#### Circumvention of internal control

No system of internal control will be completely effective at preventing and detecting fraud and error. Employees may manipulate deficiencies in an entity's internal control for personal gain or to conceal fraudulent activity. This is more likely to be possible where there is collusion between employees.

#### Management override of internal control

Management is in a position of power to override an entity's internal control regardless of the strength of the system of internal control. Such management override could be to conceal information or for personal financial gain.

#### Use of judgement on the nature and extent of controls

Management is responsible for implementing controls which are designed to prevent, detect and correct material misstatements and safeguard the company's assets. Professional judgement will be needed to determine the type and extent of internal controls needed within the company and certain controls may be absent or ineffective. In particular, systems may be designed to deal with routine transactions and may therefore be inadequate in respect of non-routine transactions.

### (b) Control deficiencies and recommendations

#### Control deficiency

Credit limits set by the sales director are only changed when a customer requests an increase.

If credit limits are not reviewed regularly they could be out of date, resulting in limits being too high and therefore sales being made to poor credit risks or, alternatively, too low and therefore Pomeranian Co losing potential revenue.

Goods dispatched notes (GDNs) are sent to the finance department on a weekly basis.

If the finance department does not promptly receive GDNs, this could result in goods being dispatched but being invoiced late. This could result in revenue cut-off issues and understated receivables.

The company's credit controller is currently on maternity leave for six months and no one has taken over her duties.

Therefore, during this period no one has been responsible for monitoring and chasing ageing receivables. This could result in an increased risk of irrecoverable receivables and lead to customers not paying their outstanding balances on time, or at all, leading to reduced cash flows.

#### Control recommendation

Credit limits should continue to be set by the sales director, however these limits should be reviewed and amended as appropriate on a regular basis by a responsible official for example the finance director or sales director.

The copies of the GDNs should be sent to the finance department on a more frequent basis, such as daily.

The finance department should undertake a sequence check of the GDNs to ensure none are missing for processing.

During the period of the maternity leave an alternative member of the finance department should be trained in the credit control role (or a temporary credit controller recruited) and assigned responsibility for reviewing the aged receivables listing and following up on any overdue customers.

### Control deficiency

The monthly receivables ledger control account (RLCA) reconciliation is only reviewed by the financial controller if there are any unreconciled differences.

The RLCA reconciliation could reconcile but still contain significant errors as there could be compensating errors which cancel each other out or it may have been incorrectly prepared or manipulated and this would not be identified. If the reconciliation is not reviewed, then this significantly reduces its effectiveness.

Capital expenditure items below \$0.5m are authorised by the relevant head of department.

\$0.5m is a significant sum and although department heads undertake the authorisation process, there is still considerable scope for non-business use or surplus assets being purchased leading to reduced profits and cash flow for Pomeranian Co.

The internal audit department (IA) undertakes physical verification of assets each year. It is supposed to verify all assets over a three-year cycle, however in the current year IA will only complete the relevant procedures at one factory and one warehouse.

The company has five factories and warehouses and a head office. Therefore, on this basis it will take over five years to physically verify all 11 sites. If the non-current assets register is not physically verified on a regular basis, there is an increased risk of assets being misappropriated or obsolete assets still being included in the register, as there is no check that the assets still exist in good working order.

The warehouse manager at each of the company's five sites is responsible for supervising the monthly perpetual inventory counts and ensuring that the counting teams are following their instructions.

The warehouse managers may wish to hide inefficiencies and inventory discrepancies so that their departments are not criticised. This could result in inventory count records being inaccurate as well as an increase in inventory frauds.

The company costs its inventory using standard costs, which are not being kept up to date.

If the standard costs were last reviewed two years ago there is the risk that the costs are misstated as changes in raw materials and wages costs may not have been adjusted for. This could result in inventory and profits being misstated.

In addition, for year-end reporting, IAS 2 *Inventories* only allows standard costs to be used for valuation purposes, if they are a close approximation to actual costs, which is unlikely if the standard costs remain unchanged for a long period of time. Therefore, the inventory cost may not be in line with IAS 2.

### Control recommendation

The RLCA reconciliations should be reviewed by the financial controller on a monthly basis, even if there are no exceptions, and the review should be evidenced by way of signature on the reconciliation.

The authorisation level for department heads should be significantly reduced to a more appropriate level, such as \$25,000. Any sums in excess of this should be approved by the board. If this proves too onerous, a capital expenditure committee of senior employees should be established for authorisation of capital items. This committee should report to the board.

IA should review its programme of visits to assess if additional resources could be devoted to ensure that all 11 sites are visited in line with the policy of three years. This would ensure that physical verification of all assets could be completed more regularly. During visits any assets which cannot be located should be investigated fully to identify where they could be. If they cannot be located then they should be written off.

The inventory counts should be supervised by an independent person, such as a member of Pomeranian Co's IA department.

A review of all standard costs currently in use should be undertaken by a senior manager in the production department. Actual costs for materials, labour and overheads should be ascertained and compared to the proposed standard costs to ensure they are a close approximation.

The revised standard costs should be reviewed by the production director who should evidence this review. At least annually, a review of the standard costs should be undertaken by the production director to ensure they are up to date.

### Control deficiency

Access to the master file data for suppliers is available to all those in the purchasing department and the monthly exception report of changes to master file data is not reviewed.

All members of the purchasing department could amend data and, potentially, add new suppliers to the payables ledger system, and as the exception report is not reviewed it is unlikely that this would be identified. This leads to an increased risk of fraud as clerks could add fictitious suppliers and then place fraudulent orders without detection.

Purchase invoices are not agreed to the relevant goods received notes (GRNs) prior to authorisation and input.

This could result in invoices being paid for goods which were not received, resulting in increased costs.

### Control recommendation

The monthly exception report of changes to master file data should be reviewed by a responsible official, who should evidence this review. Any unauthorised or unexpected changes should be investigated and appropriate action taken.

The ability to make amendments to master file data should be restricted to those required and authorised to make changes to this data.

All purchase invoices should be matched to both the purchase order and the related GRN. The details should be agreed prior to the invoice being authorised and logged in the payables ledger.

## Danube Co

### (a) Land and buildings

- Obtain a schedule of all land and buildings, cast and agree to the trial balance and financial statements.
- Consider the competence and capability of the valuer, by assessing through enquiry their qualification, membership of a professional body and experience in valuing these types of assets.
- Review the assumptions and method adopted by the valuer in undertaking the revaluation to confirm the reasonableness and compliance with principles of IAS 16.
- Agree the schedule of revalued land and buildings to the valuation statement provided by the valuer and to the non-current assets register.
- Agree all land and buildings on the non-current assets register to the valuation report to ensure completeness of the land and buildings valued to ensure all assets in the same category have been revalued in line with IAS 16.
- Recalculate the total revaluation adjustment and agree correctly recorded in the revaluation surplus.
- Recalculate the depreciation charge for the year and confirm that for assets revalued at July 20X4, the depreciation was based on cost before the revaluation and based on the valuation after on a pro rata basis.
- For a sample of land and buildings from the non-current assets register, physically verify to confirm existence.
- For a sample of land and buildings trace back to the non-current assets register and general ledger to confirm completeness.
- Review the financial statements disclosures relating to land and buildings to ensure they comply with IAS 16.

### (b) Exceptions in the trade receivables circularisation

#### Nile Co

- For the non-response from Nile Co, with the client's permission, the team should arrange to send a follow-up confirmation request.
- If Nile Co does not respond to the follow up, then with the client's permission, the auditor should telephone the customer and ask whether they are able to respond in writing to the confirmation request.
- If there is still no response, then the auditor should undertake alternative procedures to confirm the balance owing from Nile Co. These would include detailed testing of the balance by a review of after date cash receipts and agreeing to sales invoices and goods dispatched notes (GDN).

#### Congo Co

- For the response from Congo Co the auditor should investigate the difference of \$14,132, and identify whether this relates to timing differences or whether there are possible errors in the records of Danube Co.
- If the difference is due to timing, such as cash in transit, details of the difference should be agreed to post year-end cash receipts in the cash book.
- If the difference relates to goods in transit, then details should be agreed to a pre year-end GDN.
- The receivables ledger should be reviewed to identify any possible mis-postings as this could be a reason for the difference with Congo Co.

**(c) Provision and receivable arising from the sale of defective goods**

- Review the correspondence with Kalama Kids Co and establish the details of the claim to assess whether a present obligation as a result of a past event has occurred.
- Review correspondence with Thames Co, the supplier of the hoverboards, to assess whether they accept liability for the defect.
- Review correspondence with Danube Co's legal advisers or, with the client's permission, contact the legal advisers to obtain their view as to the probability of either the legal claim from the customer and the request for reimbursement from the supplier being successful as well as any likely amounts to be paid or received.
- Discuss with management/enquire of the legal adviser as to whether any other customers of Danube Co have experienced problems with sales of hoverboards and therefore the likelihood of any potential future claims.
- Review board minutes to establish whether the directors believe that either claim will be successful or not.
- Review the post year-end cash book to assess whether any payments have been made to the customer or cash received from the supplier and compare with the amounts recognised in the financial statements.
- Discuss with management why they have included a receivable for the claim against the supplier as this is possibly a contingent asset and should only be recognised as an asset if the receipt of cash is virtually certain. Consider the reasonableness of the proposed treatment.
- Obtain a written representation confirming management's view that the lawsuit by Kalama Kids Co is likely to be successful and the claim against Thames Co is virtually certain and hence a provision and a receivable are required to be included.
- Review the adequacy of the disclosures of the lawsuit and supplier claim in the draft financial statements to ensure they are in accordance with IAS 37.

**(d) Key audit matters**

**(i) Factors to consider**

As Danube Co is listed, a Key Audit Matters (KAM) section will be required in the auditor's report. The audit partner would have considered whether the matter was communicated to those charged with governance as KAM are selected from matters communicated with those charged with governance. The audit partner would also have considered whether the issue relating to the claims was an area of higher assessed risk of material misstatement or a significant risk and as it is an accounting estimate the level of judgement involved. The audit partner will have also considered whether, in their professional judgement, the matters regarding the claim and counter-claim were of most significance in the audit of Danube Co's financial statements for the year ended 31 March 20X5 therefore requiring significant auditor attention.

**(ii) Contents of KAM section**

The KAM section of the auditor's report should provide a description of the issue. It should detail why this issue was considered to be an area of most significance in the audit and therefore determined to be a KAM. It would include a reference to the audit risk of completeness of the provision and recognition of the receivable and the level of judgement required in making this assessment. It should also explain how the matter was addressed in the audit and the auditor should provide a brief overview of the audit procedures adopted as well as making a reference to any related disclosures.



Section B	<i>Marks available</i>	<i>Marks awarded</i>
<b>Peach Co</b>		
<b>(a) Audit risks and auditor's responses (only 8 required)</b>		
New accounting system	2	
Development costs	2	
Inventory valuation	2	
Staff costs	2	
PPE useful lives	2	
Fraudulent purchases	2	
New supplier costs	2	
Legal claim	2	
New bank loan	2	
Loan covenants	2	
<b>Max 8 issues, 2 marks each</b>	<u>16</u>	
<b>(b) Auditor's responsibilities in relation to the prevention and detection of fraud and error</b>		
1 mark per well-explained point		
<b>Restricted to</b>		<b>4</b>
<b>(c) Ethical threats and appropriate safeguards</b>		
Luxury weekend provided by client	2	
Audit fee based on profit	2	
Corporate finance service	2	
<b>Max 2 issues, 2 marks each</b>	<u>4</u>	
<b>(d) Substantive procedures for development expenditure</b>		
1 mark per well-described procedure		
<b>Restricted to</b>		<b>6</b>
<b>Total marks</b>		<b><u>30</u></b>
<b>Pomeranian Co</b>		
<b>(a) Limitations of internal control</b>		
1 mark per well-explained point		
<b>Restricted to</b>		<b>4</b>
<b>(b) Control deficiencies and recommendations (only 8 required)</b>		
Credit limits not reviewed	2	
GDNs sent weekly to finance department	2	
No credit controller	2	
Reconciliations only reviewed if differences	2	
Capex authorisation limits too high	2	
PPE verification work not as scheduled	2	
Warehouse manager supervising inventory counts	2	
Standard costs out of date	2	
Exception report not checked	2	
Purchase invoices not agreed to GRNs	2	
<b>Max 8 issues, 2 marks each</b>	<u>16</u>	
<b>Total marks</b>		<b><u>20</u></b>

Danube Co

<p><b>(a) Substantive procedures for land and buildings</b>            1 mark per well-described procedure  <b>Restricted to</b></p>	<p><b>6</b></p>
<p><b>(b) Procedures for exceptions in the trade receivables circularisation</b>            Nile Co            Congo Co</p>	<p>2            2  <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <b>4</b></p>
<p><b>(c) Substantive procedures for provision and receivable arising from the sale of defective goods</b>            1 mark per well-described procedure  <b>Restricted to</b></p>	<p><b>5</b></p>
<p><b>(d) Factors/content for key audit matters</b>            Matter communicated to those charged with governance            Assessment of risk            Areas of judgement            Effect on audit            Description of issue            Why determined KAM            How addressed in audit  <b>Restricted to</b></p>	<p>1            1            1            1            1            1            1            1  <hr style="width: 50%; margin-left: auto; margin-right: 0;"/> <b>5</b></p>
<p><b>Total marks</b></p>	<p><hr style="width: 50%; margin-left: auto; margin-right: 0;"/><b>20</b></p>