ACCA

Paper P7 (INT)

Advanced Audit & Assurance
June 2012

Revision Mock – Answers

To gain maximum benefit, do not refer to these answers until you have completed the revision mock questions and submitted them for marking.

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1 THE HAVEN CONSTRUCTION COMPANY

(a) **Briefing notes for use at audit planning meeting;**

Client: Haven Construction

Year-end: 30 April 2012

Introduction

At a recent planning meeting held between the engagement partner and the directors of Haven, several issues were discussed which could lead to risks. All of these issues relate to matters which are potentially material to the financial statements.

(i) **Risks of Material Misstatement**

Alleged collusion and price fixing

Five construction companies are under investigation for apparent breach of regulations regarding tendering for contracts from the government. The allegation is that collusion took place to inflate the bid price over and above that required by the government.

The situation needs to be assessed using IAS37 *Provisions, Contingent Liabilities and Contingent Assets.* The risk is that the financial statements do not accurately reflect any provision or contingency in respect of the fine that could be imposed by the government. If it is considered that Haven faces a probable cash outflow, then a provision and any expenses associated with this should be recognised. If the outflow is possible then a note must be included in the financial statements explaining the situation and providing an estimate of the possible financial effect.

The risk is either that profits are overstated and liabilities understated or that there is inadequate disclosure if the outflow is simply possible.

Land purchase

Some land purchased three years ago was included in Haven's non-current assets at purchase price. The purchase price of the land reflected the likelihood that houses would be built on this land. However, coastal erosion on the site now indicates that the land is unsuitable for building houses and that it may be difficult to sell the land due to the inherent uncertainty of it continuing to exist.

IAS 36 *Impairment of Assets* is relevant to this situation. The IAS states that an impairment review must be carried out if there are indicators that an asset is impaired. It is almost certain that the land will be over-stated in the financial statements of Haven because it can no longer be used for the intended purpose on purchase. An impairment review is required and any loss in value must be separately disclosed.

The risk is that the land value is overstated on the statement of financial position and any loss in value is understated on the income statement. There is also a risk of inadequate disclosure as IAS 1 *(Revised) Presentation of Financial Statements)* indicates that this loss should be disclosed separately.

Forward exchange contracts

To mitigate possible exchange rates losses on building contracts in the United States, Haven has entered into some forward exchange contracts. These contracts should be classified as derivative financial instruments. The contracts must be recognised as a financial asset or liability depending on the whether the terms of the contract are favourable or unfavourable at the statement of financial position date.

The risk is that the contracts have not been included in the statement of financial position at all as they were acquired at no cost. This means that there is no accounting entry to flag the need for appropriate valuation and disclosure.

There is also the risk of the contracts being valued incorrectly. Valuation is a specialist exercise; as Haven has not used these contracts before, there is a high risk that the valuation will be too high or too low, with a consequent impact on profit, unless a specialist valuation expert is employed.

Finally there is the risk that disclosure of the contracts is insufficient. IAS 7 *Financial Instruments: Disclosures* includes many disclosure requirements; there is a risk that these requirements are not met.

Sub-contractor work below standard

A sub-contractor has used a banned substance in an office block that Haven has the responsibility to construct. While Haven could keep quiet about the situation, it appears that the banned substance needs to be replaced, resulting in extra cost, and that Haven may also incur penalties for completing the office block after the scheduled completion date.

IAS37 *Provisions, Contingent Liabilities and Contingent Assets* is again relevant. The financial statements must reflect the additional costs that Haven will incur in completing the contract and any additional provision for late completion. The matter is made more complex because it is unclear whether any of those costs can be reclaimed from the sub-contractor who carried out the below-standard work.

The risk is that any provision for rectification costs and penalties is understated and that profits are overstated by the same amount. If any reclaim from the sub-contractor is uncertain then full provision for all costs must be made.

If the sub-contractor is liable for the cost of rectification work, then a separate contingent asset should be disclosed or provided for, depending on the likelihood of monies being received from the sub-contractor. The amounts must not be off-set so the full amount payable by Haven is clearly shown.

Structural integrity testing

Haven has been developing a new technique to test the structural integrity of bridges. It appears that all expenditure on this project has been capitalised.

IAS38 *Intangible Assets* requires that expenditure on new techniques, such as this one, is only capitalised when various conditions are met. The main point here is that development costs can only be capitalised when the technical and commercial feasibility of the new technique have been confirmed. All research costs must be written-off to the income statement.

The risk is that intangible assets are overstated and costs on the income statement are understated because either research costs have been capitalised, and/or development costs have been capitalised prior to the technical and commercial feasibility of the testing system being confirmed. Total costs on this project require splitting between those which can be capitalised and those which need to be taken to the income statement immediately.

Project managers' bonuses

Project managers are paid a bonus based on the costs of their projects being below that expected at specific times on the contract.

There is a risk that costs are not included in contract costings by project managers in order to obtain an enhanced level of bonus. This could occur by delaying adding costs to projects (for example delaying recognition and payment of sub-contractor invoices).

The risk is that the bonus payable to managers is overstated, decreasing profit by a similar amount and that the liability for bonus payment is also overstated.

Disclosure of operating segments

Haven has three operating divisions, each providing about the same turnover and profit to Haven as a whole.

IFRS 8 Operating Segments requires listed companies to disclose in a note to the financial statements information about the performance of the various different operating segments of the business. Haven must therefore provide information separately about each of its three divisions as these provide material amounts of turnover and profit.

The risk is the non-disclosure of information relating to each division of Haven.

Capitalisation of brand names

"Bridge It", "Home It" and "Construct It" all appear to be internally generated brand names.

IAS 38 *Intangible Assets* prohibits the recognition of internally generated brands.

The risk arises from significant expenditure on the launch of the brand in Chessland. If any of the associated expense has been capitalised as a brand name, this would mean that non-current assets are overstated, and profit for the year would be overstated.

(ii) **Audit procedures**

Potential fine from Fair Trading Office

- Obtain and review correspondence from the Fair Trading Office (FTO) regarding notice of fine being imposed.
- Obtain bid for work provided by Haven and confirm details agree to the FTO notice.
- If possible, obtain bids from the other four companies and ensure again that they agree to the notice issued by the FTO.
- Discuss the matter with the directors, obtaining their opinion on whether or not the fine will be imposed.
- Discuss and obtain documentary evidence from Haven's legal advisors on whether or not any fine will be imposed.
- Review FTO judgements in the past to determine whether there are any similar cases which may indicate the possible outcome of this case.
- Review the disclosure made in the financial statements by the directors, ensuring this is adequate.
- Obtain a letter of representation point from the directors confirming adequacy of disclosure and/or provision made in the financial statements.

Land undergoing erosion

- Agree cost of the land to non-current assets register, through the General Ledger to the statement of financial position.
- Discuss with the directors the extent of erosion to date and the extent to which this impacts on Haven's ability to build houses on the land.
- Obtain specialist advice on the rate of erosion (e.g. from professors or universities specialising in this area) to confirm that erosion will continue and that the land cannot be built on.
- Consider the realisable value of the land; obtain advice from an estate agent on the amount the land could be sold for.
- Identify other land around that owned by Haven which is also being eroded. Where possible, obtain information such as listing in estate agents to confirm the valuation of this land.
- Consider the impact of any provision on the financial statements, and the need for separate disclosure of this provision and impact on profit.
- Obtain financial statements and ensure that the directors have adequately disclosed and/or provided for any fall in value.
- Obtain letter of representation point from the directors confirming their valuation of the land and that disclosure made and provisions in the financial statements are in their opinion adequate.

(b) **Environmental reporting**

Matters to consider when deciding on the extent and type of information to include in Haven's annual report regarding environmental reporting:

Initially, disclosure may be determined by legislative requirements; many countries have specific disclosure requirements enforced by statute or by listing rules for quoted companies. These rules must be reviewed and appropriate disclosure made.

As Haven is a construction company, disclosure of key points such as environmental damage or recycling of waste is advisable. Haven needs to develop specific targets such as percentage of waste products recycled or sent to landfill and then report on whether or not those targets have been achieved.

Disclosure of similar companies can be obtained by reviewing their annual reports. It is likely that similar companies will have similar disclosure targets hence this should provide Haven with useful ideas.

Consider whether or not the environmental information requires an assurance report. If an assurance report is required then the environmental report must contain verifiable information. For example, percentage of waste recycled must be verifiable by an independent firm.

Consider the use of a standard reporting system such as the Global Reporting Index. This provides various areas where environmental reporting can be undertaken and therefore a good framework for including an environmental report in the annual report. Companies such as Marks & Spencer use this approach.

The expectations of major stakeholders can be considered. Depending on those stakeholders, environmental information may focus on maintaining a good company image through to impact of environmental activities on profit or impact on the share price.

Marking guide

	Marks
(a) (i) **Risks**	
Generally 1 mark per point up to 3 marks per risk	
• Alleged Collusion	
– fine could be imposed	
– probable outflow, provision; outflow possible, note	
– risk: profits overstated, liabilities understated, disclosure inadequate	
• Eroded Land	
– land unsuitable for sale or build	
– impairment review if indicators of loss in value	
– risk: land overstated, loss in value understated (income statement)	
• Forward Exchange Contracts	
– derivative financial instruments: recognise as financial asset/liability if favourable/ unfavourable at reporting date	
– risk: not included as acquired at nil cost	
– risk: incorrect value, inadequate disclosures – no experience	
• Subcontractor Work	
– banned substance; penalties, cost of replacement	
– uncertainty reclaiming costs – full provision	
– risk: profits overstated, liabilities understated, disclosure inadequate	
– contingent asset – disclosure, no offsetting	
• Structural Integrity	
– expenditure capitalised, only if technically/ commercially feasible	
– all research costs to be written off (split expenditure)	
– risk: intangible assets overstated, costs understated	
• Bonuses	
– risk costs not included to obtain bonus	
– e.g. delay recognising/paying subcontractor invoices	
– risk: bonus and liability overstated, costs understated	
• Operating Segments	
– Three divisions, material turnover and profit	
– Disclosure note: performance each segment	
– Risk: non-disclosure	
• Brand names	
– Internally generated brand names, significant expenditure	
– Recognition prohibited	
– Risk: non-current assets overstated, profit overstated	
	Max 16
(ii) **Procedures regarding fine and land being eroded**	
• 1 mark for each relevant procedure	
• Max 5 for each area being audited	**Max 10**
(b) **Environmental reporting**	
Up to 1 mark for each valid suggestion	
– legislative requirements	
– specific targets	
– similar companies	
– assurance	
– standard reporting system	
– stakeholder expectations	**Max 6**
Professional marks	**2**
Total	**34**

2 JM BARRIE

(a) **Report**

To: **Mr James Hook**

From: **P. Pan**

Subject: **Risk Audit Engagements**

Date: **9 March 2010**

Introduction

The report has been requested in order to outline and explain the operation of a risk audit engagement. The report will outline the steps taken in such an engagement and provide an explanation of the expected output of the work performed.

Objectives of Risk Audit

Risk audit is a systematic way of understanding the risks that an organisation faces. It is vital that businesses understand the risks that they face in order that they can manage them and, ultimately, survive the rigours of the modern commercial environment.

In order to manage risk businesses must have appropriate internal control systems. This is a major part of corporate governance and, as such, it is the directors' responsibility for ensuring the internal controls are sufficient to enable the business to operate effectively. It is therefore the directors' responsibility to ensure that the internal control mechanisms are sophisticated enough to deal with current business risks, not just the ones that existed when the system was implemented.

This is where risk audit comes in. It involves a review of both the internal and external environment to identify risks that currently threaten the business' position or that could develop into serious areas of concern in the future.

Once management are aware of the risks they face then they have a choice of options to manage those risks:

1. Transfer it, e.g. to an insurer;
2. Avoid it, e.g. terminate an area of operations;
3. Establish more effective internal controls; or
4. Accept it, if it is of little concern.

By using the most up-to-date information management give themselves the best possible opportunity of evolving with the business environment and surviving in the face of ever more sophisticated competition, changing buying habits and economic/regulatory pressures.

Steps Involved in a Risk Audit

The steps involved depend largely on the requirements of the client. The guidance for performing risk audit is not nearly as strict as an audit of financial statements and there is therefore a lot of flexibility in the variety of services offered.

The directors should consider what areas they would like to review. A general business risk audit would consider the full range of possible internal and external risks, which would be a significant undertaking. Alternatively, a more focused review could be performed. For example; Wendybird appears to have been affected by changing social and environmental concerns and IT systems are perhaps outdated. A risk assessment could focus on these factors.

Next, the directors need to consider whether they require a limited assurance report, which would include some form of opinion. This might be required, for example, if the directors wished to publish some form of report, such as a social and environmental report.

Alternatively, if the directors simply wish to review risks to assess the strength of their internal controls then an ‘agreed upon procedures’ engagement may be more suitable, where the reporting accountant would report factual findings without offering any form of assurance.

Identification

Once the terms of the engagement are agreed (and confirmed in a letter of engagement) the auditor would need to go through a process of identifying risk areas. Essentially risks, from the business’ perspective, can come from a wide range of sources. However, they all have one thing in common: the potential to damage company wealth.

Typically risk assignments focus on the external business environment and/or the internal business environment. The external environment can be analysed in many ways but a common method is to sub-divide it using ‘PESTLE:’ political, economic, social, technological, legal and environmental risk areas.

There are a number of ways these external risks can be identified but common methods include:

- Simple interviews, with key staff to identify what they consider to be the main drivers of company performance and the key competitive pressures the company faces;
- Analytical reviews of historical financial data to identify key performance trends; and
- Analysis of existing market data and original research.

Of particular interest to Wendybird would be price sensitivity during recession, the impact of newer product technologies (such as plastics), legislation with regard to sustainable resources, foreign exchange risk and social/environmental perceptions.

Internal risks are commonly subdivided into operational, financial and compliance risk areas. For Wendybird the key risk appears to be unsophisticated IT/accounting systems, which increase the risk of fraud and accounting error. However an assessment could extend to the remoteness of production operations and the consequences for control systems and compliance with overseas regulations.

Internal risk assessment centres on enquiry of key staff members to identify how the company's main systems operate. Once documented the key controls can be tested either by observation of the controls in operation, by reviewing documentary evidence of authorisation procedures or through the use of audit software.

Assessment

Once identified, the next task is to assess the risks. These need to be measured in terms of their likelihood of occurrence and the potential impact they would have on the business. Obviously not all risks will be considered as serious as some. A simple ranking system of high, medium and low risk areas (or red, amber, green) can be used to assess the risks that need the most immediate action.

It should be noted that the assessment process relies heavily on the judgement of the reporting accountant. However, through a process of analysis of the findings of identification and from enquiries with key management an appropriate assessment of the likelihood and the potential impact should be possible. As with any judgement though, an absolute guarantee of the level of risk cannot be offered.

Review

Once the risks have been assessed the auditor will then analyse the existing controls that the organisation has in place to manage the risks identified. This involves enquiring of key staff how the various internal management systems operate. Once the systems are documented the key controls identified within the system will be tested to ensure they operate in line with company policy and procedure.

For example: a review may identify the possibility of damage and/or theft of company owned vehicles as high risk. The system would incorporate all fleet car management from purchase, to maintenance all the way through to disposal. The key controls would most likely be security systems and insurance. The auditor would test the insurance by reviewing the level of cover maintained in comparison to the value of the fleet currently owned.

Report

The final stage of the process would be to report the findings back to the client, which in your case would be the board of directors. The report would list the key risk areas, i.e. those assessed as high (high probability and/or high impact). For each of the risks the report would discuss the effectiveness of the existing controls in place and, for any ineffective areas that expose the business to potential losses, the auditor (depending on the initial terms agreed with the client) will most likely recommend courses of action that may be taken to improve risk management.

Hopefully this gives you some insight into the possible nature of a risk audit. I would like to take the opportunity to reinforce my opening statement that an engagement of this nature is wide in scope and most investigations are tailored to the specific needs of the client. If you would like to discuss the possibilities more specifically I would be more than pleased to come and meet with you again with the aim of designing a more bespoke package.

In the mean time if you have any more queries please do not hesitate to contact either myself or a member of my team.

P. Pan

Audit Manager

(b) **Internal vs. External**

Firstly it should be noted that risk management is complicated and time consuming due to the wide variety of risks businesses are exposed to. Risks also evolve constantly so risk management cannot be seen as a one off exercise. In fact the various corporate governance initiatives in place around the world place responsibility on managements' shoulders to constantly monitor risks to ensure their internal controls are adequate. Certain industries also demand ongoing risk assessment as part of their codes of conduct, such as banking.

The Case for Internal Audit

The actual management of risk is a responsibility of management and is therefore and internal function. Thus many companies prefer to keep their assessment 'in-house.'

Internal audit teams have the advantage of familiarity with the organisation's culture, systems, procedures and policies. Given their familiarity with the nature of the business and how things are supposed to work, internal audit should be able to perform a highly specific and focused risk assessment. It can be argued that an external team would take a long time to develop the same understanding and could never, in practice, maintain the same knowledge of a company's nuances as it evolves.

Internal teams are flexible in terms of the way they are deployed. As they are controlled by management they can be directed to perform a variety of engagements that can be changed at a moment's notice. All engagements with external teams are subject to the restrictions of engagement letters, availability of resources and the fees they charge.

Internal audit should produce work that is written and structured according to the expectations and norms of the organisation, which is therefore relevant for the intended use. External teams could be criticised for pitching their reports at too high a technical level for the intended audience or perhaps in an area the audience was not specifically concerned with.

The Case for External Audit

External teams should comply with IFAC's (and ACCA's) Code of Ethics. They should therefore be more objective than an internal team, who will suffer from over familiarity with the company.

The external auditor's requirement to conduct engagements in line with these professional standards should boost the confidence of the end user. This is particularly important where the user may be a regulating body external to the company.

An external team also provides a fresh pair of eyes. Internal teams can be criticised for being blinkered in their investigations. They are so familiar with the company failings that they almost ignore the possibility of new risks. External teams have to conduct thorough reviews to identify all the key risks a business faces. Failure to do so would lead to poor quality work, loss of reputation and perhaps even financial repercussions.

It is also important to consider the professional skills an external team brings to an engagement. Through continuing professional development external teams have to keep up to date with current developments and best practice. In theory this should then benefit the client, who should receive the most up to date service. The same cannot always be said of internal teams.

Finally, external teams are available on a more flexible basis, meaning they are not employed fifty two weeks a year. Whilst internal audit can be deployed to a variety of engagements they require fixed, salaried staff. External teams can be engaged to perform reviews as necessary. In theory this should make the external resources more competitive.

Conclusions

On balance there is no definitive answer as to which is superior; internal or external. Each case must be decided on its own merits. However, it appears as though the cost of the engagement may be the deciding factor. For small and medium sized companies there appears little need for a full time staff. Risk assessments would be few and relatively far between. In such cases the flexibility afforded by an external supplier would appear to be the superior option.

However, as a business increases in size there would appear to be a greater need for more risk assessment services. Hence, a full time internal department could be a more cost effective solution and one that can be fully controlled by management.

As stated, though, a proper evaluation can really only be achieved on a case by case basis.

(c) **Social and Environmental Audit**

Current Trend

There are two key explanations for the growth in social and environmental audit. The first is simply due to pressure to improve corporate social responsibility. This has come mainly from investor and consumer groups but has also been reflected in changing regulations. Businesses, particularly in certain industries under public scrutiny, such as petrochemicals and clothing manufacture, are therefore keen to reverse the trend of negative publicity.

This does not mean that a social and environmental audit is merely a PR exercise; it is an opportunity for a company to review its operations to reduce the risk of infringing ethical principles and legal requirements and to communicate this process with the public.

The second key reason is that many companies perceive a valid financial impact on their business from performing in a socially responsible manner. Arguments to support this include:

- The reduction/avoidance of financial penalties for breaching regulations;
- The reduction of pollution, which is in fact wastage and therefore costly to the company;
- The adoption of newer, more environmentally friendly plant and machinery, which should also be more efficient; and
- The improvement in social relations with employees, which should improve worker morale and therefore output.

Limitations

Many companies produce social and environmental reports and to improve their credibility they seek some form of external assurance report. This poses a number of problems for a reporting accountant:

(i) There are no mandatory standards for this complex and far reaching area of reporting;

(ii) The reports can often be extremely subjective, i.e. what is the definition of ‘green’ or ‘socially responsible;’ and

(iii) Traditional accountants may not be capable of verifying complex key performance indicators, such as carbon emissions.

The question must be asked whether an accountancy firm is the correct agent to perform such an audit. Some commentators have argued that environmental engineering firms would be better suited to these forms of engagement.

Audit Services

Faced with these limitations it may appear that the traditional accountancy firm is out of its depth. However, accountants do possess many skills that are transferable to a social or environmental audit.

Firstly; auditors have to identify relevant external laws and regulations as part of a normal audit of historical financial information. ISA 250 provides guidance in this area for a traditional audit. These skills are transferrable to a social or environmental audit.

Auditors are required to assess the external legal/regulatory environment and discuss how management ensures internal controls are adequate to prevent and detect breaches. Auditors also have to test those controls to identify the risk that unidentified breaches occur that may require provisions or disclosure in the financial statements.

Therefore an auditor can provide assurance on the internal systems a company has to identify relevant regulation and to prevent and detect possible breaches.

In terms of KPIs it is unlikely an auditor will ever be able to provide assurance on whether ‘the number of serious accidents’ or ‘kg of carbon emissions’ are appropriately calculated. However, once again the auditor can provide assurance on the operation of the systems that a company has to capture and report this data.

Whilst there are some inherent limitations to an auditor providing assurance services in the field of corporate social responsibility there is no need for auditors to turn their backs on it completely. As long as auditors are aware of their limitations and their reports adequately word the purpose of the report and the scope of the work performed then traditional auditing should be able to contribute to this fast growing area of corporate reporting.

<table>
<tr><th colspan="2">Marking guide</th></tr>
<tr><td></td><td>Marks</td></tr>
<tr><td>(a) Risk Audit
Generally 1 mark for each thoroughly explained objective and procedure.
Ideas
• Survival in modern commercial environment;
• Maintain effective internal systems;
• Management of risk;
• Wide scope of risk audit;
• Limited assurance vs. agreed upon procedures;
• Identification;
– External environment;
– Interviews, analytical reviews, research;
– Internal environment;
– Enquiry re. systems, documentation and testing
• Assessment;
– Probability vs. impact;
– High, medium, low risk;
– Judgment.
• Review;
– Analysis of control effectiveness
• Report;
– Key risks;
– Recommendations for improvement
1 mark for using appropriate report format, ½ mark for an appropriate introduction and up to 1½ for professional language, clarity and flow of report (all at marker's discretion)</td><td>15 marks</td></tr>
<tr><td>(b) Internal vs. External
Generally 1 mark per discussed point. However, note that the question requires evaluation: if candidate fails to discuss both sides or to come to a conclusion cap marks at 3.
Ideas
Internal
• Familiarity
• Flexible deployment;
• Focussed in accordance with organisational norms.
External
• Objectivity;
• Professional standards;
• Fresh perspective;
• Professional skills and training;
• Employed as and when required.</td><td>6 marks</td></tr>
<tr><td>(c) Social/Environmental Audit
Generally 1 mark per explained point.
Ideas
Trend
• Investor/consumer pressure;
• Economic benefit (up to 2 if examples provided).
Limitations
• No mandatory standards;
• Subjectivity;
• Difficulty verifying environmental measures.</td><td>5 marks</td></tr>
<tr><td>Total for question</td><td>26</td></tr>
</table>

3 BLACK GULL

(a) (i) **Matters to consider**

Materiality

There are two issues with materiality.

Firstly, the estimate of $15m for rectification work on aircraft is material to profit (being between 43% and 60% of annual profit). In addition, as a one-off cost there is justification for disclosing this amount separately, and not including it within operating costs.

Secondly, the effect of the impact on the emissions legislation on Black Gull. There is no specific quantifiable impact; the materiality issue is whether Black Gull is a going concern given the significance of this legislation. As aircraft are 95% of tangible non-current assets, it would appear that if these assets are impaired and not replaced, then Black Gull cannot continue trading.

Accounting treatment

Under IAS 37, Provisions, Contingent Liabilities and Contingent Assets, a provision should be recognised where there is a present obligation as a result of a past event, a probable outflow of economic benefit, and a reliable estimate can be made of the amount. There is a past event (the legislation) and there will be an outflow of economic benefits (the rectification cost); the issue is whether there is in fact any obligation as the legislation does not come into force for another twelve months, and the aircraft could be sold.

It is also unclear whether the actual accounting basis of the financial statements is correct. As the legislation will come into effect in one year, Black Gull's aircraft would appear to be significantly impaired; they can only continue to fly for one more year unless the rectification work is successful. Under IAS 36 Impairment of Assets, the value of the aircraft will need decreasing to their recoverable amount. If rectification is unsuccessful, this may effectively be scrap value only.

Furthermore, if there are no plans to replace the aircraft, then Black Gull cannot continue as a going concern and the financial statements may need to be prepared on a break-up basis.

Overall, management's estimates need to be approached with scepticism due to the fact that Black Gull may not be a going concern and therefore their jobs will be lost if this event occurs.

Audit report

Finally, the effect on the audit report needs to be considered. If the rectification provision is not removed, then a qualification of the audit opinion, using the "except for" wording, will be required, on the basis of a material misstatement.

The going concern situation is more complicated. If the accounting policy used to prepare the financial statement is appropriate (going concern or break up) then the auditor will normally agree with this policy. An emphasis of matter paragraph may be necessary to draw attention to the break-up basis if this is used.

However, if the auditor's opinion is that the going concern assumption is inappropriate for Black Gull and the financial statements are still produced on this basis, then an adverse opinion will be necessary. This opinion is required, even if the matter is fully disclosed in the financial statements.

(ii) **Further audit procedures**

Rectification estimate:

- Discuss with the directors why they believe this amount to be sufficient to ensure aircraft meet the new emission standards.
- Enquire with aircraft manufacturers whether rectification is possible and if this is the case, how much rectification will cost.
- If possible, discuss the matter with those charged with governance as not being able to rectify the aircraft will have a significant effect on the company.
- Obtain a representation letter point from the directors confirming their estimate of the rectification cost.

Going concern assumption:

- Discuss the future of Black Gull with the directors.
- Enquire whether the directors have any other plans if rectification is not possible. For example, purchase of aircraft that do meet the emission standards so that Black Gull can continue trading.
- Discuss the impairment of aircraft with the directors and obtain their estimate of scrap value.
- Carry out an independent impairment test on the aircraft, using an expert if necessary, and compare the results to the directors' valuation.
- Where possible, obtain information on other aviation companies from the Internet or other sources and evaluate the impact of the new legislation on those companies.
- Obtain a representation letter point from the directors regarding the future viability of Black Gull.

(b) **Should auditors be blamed when a company fails?**

The recent economic crisis has led to a number of high profile company collapses. This usually results in an examination of the role of the company's auditors, and a discussion of whether the audit firm should have spotted the going concern problems, and warned stakeholders of the issues.

Looking at the first part of the statement, this asks whether auditors should accept some of the blame when their client firm fails. This suggests that the auditor is in some way at fault, and has helped to contribute in some way to the failure of a business. It is the responsibility of management to ensure proper risk assessment and risk management is conducted in a business. Although in some jurisdictions the auditor performs an assessment of risk management procedures, this is not the fault of the auditor if such procedures are inadequate and contribute to the collapse of a company.

However, it is fair to say that auditors have a responsibility to gain an in-depth understanding of their client's business, including the environment in which it is operating. This means that the auditor should at the very least be aware of going concern problems, and are in a position to alert management to problems that they may have overlooked. But it remains the responsibility of management to deal with such problems.

One of the features of the recent economic crisis, which has resulted in the failure of many companies, is the speed at which the crisis deepened. The auditor, when assessing going concern status, does not have a crystal ball, and cannot be expected to foresee situations in the future which may impact the survival of their client's business. Especially in a speedy economic downturn it is unfair to criticise the auditor's view of going concern status at a year end.

The issue may be one of misunderstanding – the so-called expectation gap. The general public perceives the role of the auditor to be much wider than just providing an opinion on the financial statements. The expectation is that auditors provide advice on business strategy, and so should take some of the responsibility when the business fails. This indicates that the public do not understand the importance of the independent status of the auditor, and that the auditor must not take on the role of management.

There may of course be situations in which an audit firm has not acted appropriately, for example, in not challenging the management on matters having a significant impact on the financial statements, or failing to detect frauds which have a material impact on the financial statements. In such cases the auditor may indeed be partly to blame if the company subsequently collapses.

The second part of the statement asks whether the auditor should do more to warn stakeholders about going concern issues. It could be argued that it is the responsibility of management to make such warnings, and in fact, financial reporting standards require a lot of disclosure about concentrations of risk. In particular IFRS 7 Financial Instruments: Disclosures requires detailed notes to the accounts describing and providing details on concentrations of certain risks. So, a lack of disclosure may not be the critical issue. The problem is more likely to be that readers of financial statements do not have the financial awareness to understand these disclosures. The auditors cannot be blamed if users of financial statements are not sufficiently financially literate to be able to understand such disclosures.

Auditors highlight significant going concern problems using an emphasis of matter paragraph within the audit report. This means that problems should be clearly highlighted for users of the accounts. Perhaps more could be done to make any such disclosures as transparent as possible, which would aid users' understanding of going concern problems. In addition, shareholders' meetings could be used more often as a vehicle for the auditor to raise concerns with shareholders. Auditors, however, may be reluctant to voice concerns in such a forum, and may be put under pressure from management not to speak out.

To conclude, it would seem unfair to make auditors take some of the blame for the failure of a company, when it is explicitly the role of management to safeguard the company and manage its risk exposure. However, auditors could be more proactive in highlighting going concern problems through the various channels available to them, i.e. through highlighting matters within the audit report, and through contact with shareholders at general meetings of the company.

Marking guide	
	Marks
(a)	
• **Matters to consider:** Up to 1 mark per point	**6**
– Materiality	
– Going concern	
– Past event, probable outflow, measured reliably	
– No obligation	
– Impairment	
– Break-up basis	
– Estimates – scepticism	
– Inadequate disclosure – qualified opinion	
– Going concern basis – emphasis of matter	
– Inappropriate – adverse opinion	
• Further audit procedures Up to 1 mark per relevant procedure	**5**
	Max 12
(b) **Auditor blame**	
Up to 2 marks for each point discussed:	
– Management responsibility for risk assessment	
– Auditor should be aware of going concern issues	
– Auditor must not take on management role	
– Misunderstanding of roles of management and auditor	
– Auditor may be to blame if overlooked a fraud/other matter	
– Financial statements contain disclosure on risk assessment	
– Users may not be financially literate	
– Auditors could make problems more visible and understandable	**Max 6**
Total	**20**

4 PARKER & CO

(a) Wournos

It is not inappropriate for an audit firm to employ staff under short term contracts or necessarily to provide work experience. However, the firm must be careful to ensure that any people employed do benefit the audit firm and normally only work at clients with express permission of the client.

The main issue is that temporary members of staff, especially those not under training contracts or qualified accountants, will not be subject to the ethical guidance of an Institute and so could be seen as higher risk of breach of ethical guidelines. This may be particularly true in areas such as confidentiality where non-accountants may not be aware of the requirement not to discuss any client information with persons outside of the assurance firm.

The request for Lucy to work on the audit of Maine is wrong for three reasons.

- Firstly, it is up to the audit firm, not the client, to decide which members of staff should be part of the audit team. The firm needs to select staff with appropriate skills and knowledge to provide the best service to the client. While work experience staff could be part of this team, care will still be taken selecting clients to ensure at least some benefit is provided.

- Secondly, Maine Co is an audit client and Lucy is the daughter of the finance director. The fact that the finance director wants Lucy to gain experience in the company is irrelevant. Lucy will not be independent of the client and there is both a familiarity and a self-interest threat. Lucy will not perform work with professional scepticism, and she will be unwilling to challenge the decisions made by her father (although this is relatively unlikely considering the junior work that Lucy could perform).
- Finally, there is the risk that Lucy will report back to her father on confidential information on Parker's audit processes or practices.

The most appropriate course of action will be initially to interview Lucy to determine whether she actually wants work experience in an assurance firm. However, the outcome of the interview may be that Lucy will not be employed if either Lucy or Parker believes this is inappropriate or Lucy is found not to have the necessary basic skills required. If she does want work experience and does how the skills Parker may accept her as a suitable temporary employee. However, the assurance firm must then to ensure that she does not work on the audit of Maine Co. These conditions must be made clear to the finance director before any interview takes place.

(b) **Teagues**

Assistance with accounts preparation for public limited companies prior to conducting and audit is banned by ACCA code of ethics apart from emergency situations.

The situation here appears to be an emergency situation so it is not necessarily inappropriate for Parker to assist their client.

The potential for any independence conflicts is also limited to some extent as draft accounts have been produced and the audit is complete apart from reviewing the statutory financial statements. However, this is an emergency situation. Parker will still need to audit the statutory financial statements although the statement of financial position and income statement information at least should have been simply transferred from the draft accounts.

Specific threats that Parker must be aware of are:

- Self-review threat. Parker will still be preparing the notes to the financial statements and then auditing these. This threat will be mitigated by having the two sets of work carried out by two different teams within Parker.
- Management threat. Parker must be careful not to make any management decisions regarding disclosure of information in the financial statements; in other words responsibility for the financial statements must remain with the management of Teagues. A management representation letter point to this effect must be drafted and Parker not sign the audit report until this letter has been received from Teagues management.
- Professional indemnity. As Parker would not normally take on this work, contact should be made with the firm's insurers to disclose the work to be carried out and ensure that insurance is valid should mistakes occur.
- Parker should also produce a separate engagement letter and fee note for the work. The engagement letter will again explain that the responsibility for the financial statements must remain with the management of Teagues.

(c) **Crocker**

Obtaining payments on account for services provided by assurance firms is not illegal. However, those payments will be invoiced by the firm and the firm will normally ensure that services have been provided to at least the value of the payment on account.

Where payments on account are in excess of services provided, then the audit firm is holding client money; this situation is not mentioned in the ethical guidance of the ACCA. The audit firm must therefore be seen to be acting with integrity regarding this amount and only accept payment where services have actually been provided.

The comment by the Chairman that any over-payment of fee can be refunded appears to be a money laundering issue. The payment made is significantly more than the assurance fee for last year, so a repayment is likely. Obtaining money from an assurance firm would appear to make those funds "clean" as they have come from a reputable source; Crocker may be attempting to disguise the source of funds by using Parker in this way.

The situation must be reported to the Money Laundering Reporting Officer in Parker immediately. That person must decide whether or not to make a Suspicious Activity Report to the appropriate authorities (SOCA in the United Kingdom). As a refund of the payment is likely, an SAR will have to be raised if only to protect Parker. The Chairman of Crocker cannot be informed of this action until clearance is received from the authorities.

This also means that Parker cannot repay the money to Crocker until that clearance is obtained. As Parker will be holding money which it has not earned the money should be transferred into a "client account" to protect title of the funds for Crocker in the short term.

If clearance is received, then Parker must suggest the amount is repaid now, to the same bank account it was paid from. If money-laundering is proven, then Parker must follow the instruction of the relevant authority.

As always, if the situation is unclear, Parker's MLRO may take advice from the ethics department of the ACCA.

Marking guide	
	Marks
(a) **Wournus**	
• Up to 1 mark for each point explained	
– Short-term contracts not inappropriate	
– Must benefit firm and have client permission	
– Risk of breach of ethics e.g. confidentiality	
– audit firm chose staff with appropriate knowledge, skills, experience	
– familiarity and self-interest threat, no professional scepticism	
– may disclose confidential info to father	
– interview	
– must not work on Maine audit	**7**
(b) **Teagues**	
• Up to 1 mark for each point explained	
– accounts preparation for listed banned	
– emergency	
– audit nearly complete and draft a/cs prepared	
– self-review threat	
– different teams	
– management threat	
– representation letter	
– professional indemnity	
– separate engagement letter and fee note	**7**
(c) **Crocker**	
• Up to 1 mark for each point explained	
– not illegal	
– holding client money, act with integrity	
– money laundering, disguise source of funds	
– report to MLRO	
– no tipping off	
– cannot repay money until clearance received	
– if clearance received refund immediately	
– contact ACCA ethics department	
	6
Total	**20**

5 HAVEN CO

(a) (i) Purpose of "findings from the audit" points

ISA 260 Communication of Audit Matters With Those Charged With Governance requires the auditor to communicate many matters, including independence and other ethical issues, the audit approach and scope, the details of management representations, and the findings of the audit. The findings of the audit will be communicated as a management letter where deficiencies in control, the effect or consequence of those deficiencies and recommendations for improvement will be given.

The reason for communicating these matters is to show that the auditor has formally notified those at the highest level of management of those matters. It also means that management are fully aware of the audit services that have been provided to the company and that the auditor will provide recommendations and guidance to help management fulfill their responsibilities within the company. For example, systems and controls are maintained to the highest possible standard.

(ii) **Matters to include**

Significant difficulties encountered during the audit

A computer systems change for payables was carried out during the year. The auditor will normally perform audit procedures to confirm the completeness and accuracy of the transfer of payables balances onto the new system in order to place reliance on that system. The loss of information during this transfer meant additional audit procedures had to be performed to confirm the opening balances.

Management need to be made aware of additional audit work that had to be carried out as this can cause inefficiencies in the audit process (the audit of payables could be delayed) and an increase in the audit fee is likely to cover the additional cost. Management need to be aware of these difficulties partly so the auditor can defend a fee increase and partly as this may show poor controls within the company.

Independence threat

The directors kindly offered to take the audit team out to a motor racing event as part of Haven's expense. The engagement partner politely had to refuse this offer.

While this may appear ungrateful, there remains the issue of independence of the auditor to the client. Acceptance of what appears to be excessive hospitality could be construed as an attempt to influence the opinion of the auditor. Management need to be aware of this type of situation so they can monitor auditor independence and ensure this is being maintained.

Internal control deficiency

There is a potential control deficiency in the cash receipts systems at Haven Co. While this is immaterial it is important that the auditor brings it to managements' attention with an indication of the implication of the deficiency and recommendations on how to alleviate the deficiency.

The auditor is attempting to help those charged with governance improve the control systems within the company. This is especially important where fraud may be involved, or where the deficiency could be indicative of similar deficiencies in other shops.

Accounting treatment – book inventory

Books are overvalued. IAS2 states that inventory should be valued at the lower of cost or net realisable value. In Haven Co, directors are attempting to value books at a value above cost and €526,000 is material to the financial statements being more than 10% of the loss for the year. Over-valuation will also have helped to minimise the total loss.

The auditor needs to inform those charged with governance of the situation, stating clearly the accounting policy expected and the effect on the financial statements of non-compliance. In the report, the auditors will request that the financial statements are amended; failing this, a qualified opinion using the "except for" wording, on the grounds of a material misstatement will be issued. Those charge with governance then have the chance of avoiding a modified audit opinion if the financial statements are amended.

(b) (i) **Advantages of directors issuing a "balanced and reasonable" opinion which auditors will then report on.**

Users of the annual report should find it more trustworthy as the directors show some responsibility for the report. There is a danger that annual reports simply provide a vehicle for directors to make general comments about the company. Providing an opinion would hopefully imply that directors had considered the content of the report in more detail.

Similarly, the directors will be more aware of their responsibility towards the annual report. Hopefully they will try and ensure the accuracy of information within the whole annual report as they know that their opinion and the report will be relied on by shareholders and investors.

Auditors will provide some assurance on this report. Again this will enhance the credibility of the report and remove any doubt from the users of the annual report as to whether the auditor does in fact review the whole report.

(ii) **Problems for the auditor in forming an opinion**

The auditor will be reporting on significant amounts of information that is not audited. There is a significant risk that the auditor's opinion will be incorrect, or that auditors cannot form an opinion, due to lack of evidence.

Auditors will have to decide how to word this additional assurance report so as not to cause confusion with the main audit report. There is a risk that the opinion on "balanced and reasonable" has the same assurance as a "true and fair" opinion, which is unlikely to be the case due to limited audit evidence.

Provision of another report without clear criteria or which may be mis-understood leaves the auditor open to additional legal claims for producing inappropriate or misleading reports. Auditors' indemnity insurance is likely to increase as a result of this.

Auditors could still report material inconsistencies under ISA702/706. However, this would not alleviate the problem of members not understanding the audit report or not finding this additional information the report.

Finally, the lack of clear format for an annual report will mean that review procedures will be difficult to apply. At a minimum, audit fees will rise as auditors attempt to review annual reports in more detail placing further pressure on maintaining audit quality and the perception that audits are expensive.

Marking guide			
			Marks
(a)	(i)	**Report to those charged with governance**	
		• 1 mark for formal communication	
		• 1 mark for recommendations to management	**2**
	(ii)	**Identification and explanation of matters**	
		• 1 mark for identifying each matter including linking this to scenario and a further 1 mark for explanation, up to 2 marks each matter	
		– computer systems change, additional procedures	
		– increase audit fee, inefficiencies, poor controls	
		– excessive hospitality, bribe	
		– management aware, monitor auditor independence	
		– internal control deficiency & recommendation	
		– help those charged with governance	
		– accounting treatment inventory (lower cost, nrv)	
		– request amendment, or qualified opinion	**10**
(b)	(i)	**Advantages of balanced and reasonable opinion**	
		• Up to 2 marks per relevant explained point	
		– trustworthy	
		– responsibility	
		– assurance	**4**
	(ii)	**Problems of auditor reporting on this opinion**	
		• Up to 2 marks per relevant explained point	
		– information not audited, increased risk	
		– wording of opinion	
		– material inconsistencies	
		– review procedures difficult	**4**
	Total		**20**