

## Suggested solution

### Section A

#### Question 1

##### Briefing Notes

To: Ruby Swift, Audit engagement partner

From: Audit manager

Subject: Audit planning in relation to Python Co

#### Introduction

These briefing notes have been prepared to assist in planning the audit of Python Co for the year ending 30 September 20X5. The notes begin with an evaluation of the significant audit risks which should be considered in planning the audit of Python Co, together with an assessment of the impact of Python Co using a service organisation. This is followed by an evaluation of the audit work proposed on the purchase of the new head office building during the year. Finally, the notes discuss the ethical and professional issues arising from the request by Python Co.

#### (a) Evaluation of significant audit risks

##### Assessment of materiality as percentage of revenue

Based on projected revenue for the year, materiality will be within the range 0.5% - 1% or \$263,500 - \$527,000.

As the company is not listed, it does not have any external providers of finance, however there are questions over some of the internal controls in place and the use of accounting estimates in respect of significant balances in the financial statements. This would be classed as a high-risk client and the lower threshold of \$263,500 will be used as the materiality threshold.

##### New client

This is the first year that Kotlin Associates is auditing the company which increases detection risk. As our firm does not have experience with the client, detecting material misstatements will be more difficult. This risk can be mitigated through rigorous audit planning, including obtaining a thorough understanding of the company.

##### Opening balances and comparatives

There is a risk that opening balances and comparative information may not be correct or accounting policies inconsistently applied as the prior year figures were not audited by Kotlin Associates. This may provide management with the opportunity to manipulate the financial statements. 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 free from material misstatement. Kotlin Associates will also need to verify that the accounting policies adopted by Python Co have been applied consistently and in accordance with IFRS® Accounting Standards.

## **Corporate governance and deficiencies in internal controls**

There are indicators which suggest that Python Co has a weak governance structure due to the lack of business experience on the board. There are no non-executive directors to provide oversight and expertise to the board. The directors also lack expertise in accounting, with no finance director so there is a potential lack of proper scrutiny and control over the finance function and its financial statements.

There is evidence of regulatory controls not being adhered to, with the recent penalty for failing to complete appropriate money laundering checks on the project owners. This could lead to bad publicity, and a failure to attract future backers to the projects promoted by Python Co. There is also the possibility of additional breaches and fines which will affect the profitability of the company.

The management controls over the development and enhancement of the new software have resulted in implementation problems. As the accounting software is integrated with the accounting system, there may be further unidentified errors as a result of the lack of controls. These could render the underlying information unreliable for the purpose of, and as a basis for, the audit. This is a major concern and control risk is likely to be the most significant risk to address in the audit. As there were a significant number of journals, it is also likely that these will need to be examined carefully and agreed to supporting documentation. It is unlikely that a controls-based strategy will be appropriate and more time will need to be assigned to the audit to enable higher levels of substantive testing than usual.

### **Intangible assets (software costs)**

During the year, \$6.2 million was spent on the enhancement of the IT platform used to manage crowdfunding platforms. This is significantly above the materiality threshold.

IAS 38 *Intangible Assets* requires an entity to recognise an intangible asset, whether purchased or self-created (at cost), if it is probable that the future economic benefits which are attributable to the asset will flow to the entity; and the cost of the asset can be measured reliably. Until the technical feasibility of the enhancements is established, then costs must be expensed to the statement of profit or loss. There is a high risk that costs which do not meet the recognition criteria were recognised.

It is noted that there are costs of \$600,000 which have been included in the carrying amount of software costs which should be recognised as research costs and expensed as they were not used in the final software design. Therefore, there is an overstatement of intangible assets of \$600,000, and an understatement of expenses.

### **Intangible asset valuation**

Where an intangible asset has a definite useful life, the asset must be amortised over that life. In this case the company assumes a five-year life for intangible assets. While this is in line with IAS 38, it must be considered whether a five-year life is appropriate for the upgrades made to the system. It may be that some elements of the system have a life of five years and that others may have shorter lives as changes in technology and user trends may require some elements of the design to be replaced in a shorter timeframe. Management should also review the appropriateness of the life of the assets annually. Given the lack of expertise of the board of directors with respect to financial reporting, it

is possible that an inappropriate life has been determined and should in fact be shorter than five years. Should this be the case, intangible assets would be overstated and expenses would be understated.

As the carrying amount of software has been overstated with the inclusion of the \$600,000 research costs, the amortisation for the year will also be overstated by \$120,000. The net impact on profit before income taxes is \$480,000 overstatement of profit, which is material.

IAS 36 *Impairment of Assets* requires non-current assets are tested for impairment where there is an indicator of impairment. An asset is impaired where the recoverable amount of the asset is lower than the carrying amount, where the recoverable amount is the higher of an asset's fair value less costs of disposal and its value in use. The existing internally developed software may have been rendered obsolete by the upgrade and should therefore be tested for impairment.

There is a risk the asset is overstated and expenses understated if the asset is impaired and an impairment review is not performed or the impairment loss recorded is insufficient. There is a high level of audit risk associated with this area given the significant judgement and estimation involved and the lack of financial expertise in the company.

### **Purchase of head office**

The company has bought a property during the year for \$4 million which exceeds the materiality threshold set for the audit. Additional costs of \$1.145 million were incurred relating to the building purchase. These additional costs also exceed the materiality threshold for the audit.

IAS 16 *Property, Plant and Equipment* requires that any costs directly attributable to bringing the asset to the location and condition so it may be used, should be included within the carrying amount of the asset. The professional fees of \$500,000 should be included within the cost price of the asset. Python Co has inappropriately expensed these costs and as such property, plant and equipment is understated and expenses are overstated by \$500,000.

The costs of \$645,000 relating to the relocation of staff from the previous property are correctly expensed and should not be included within the carrying amount as these are specifically excluded by IAS 16. However, there is a risk that these costs may be misstated or include costs which should be included within the carrying amount of the building.

As the property is depreciated over 20 years, and the cost of the property has been incorrectly recognised in the financial statements, there is a misstatement in the depreciation charge for the year. The understatement of depreciation is \$25,000 (\$500,000/20 years), which, although not material in its own right, may be material when aggregated with other immaterial misstatements.

### **Accrued revenue**

The year-end revenue accrual is made up of two elements:

- projects which have reached their funding target and where Python Co is waiting on the receipt of the revenue; and

- projects where management believe the funding targets will be met.

IFRS 15 *Revenue from Contracts with Customers* requires a company to recognise revenue only when a performance obligation has been satisfied. In this case, the performance obligation is the successful funding of a project, i.e. one that has achieved its financial target. Therefore, management are correct to accrue for the projects which have achieved their target, but the money has not yet been paid across by E S Crow Co. However, the \$1.2 million accrual in respect of projects which are expected to reach their target should not be recognised in the year to 30 September 20X5. These projects are still in progress, and the performance obligation of the successful funding has not been satisfied; it is therefore incorrect to accrue for this revenue. Therefore, there is an overstatement of revenue and an overstatement of accrued revenue of \$1.2 million.

### **Provision relating to the data breach**

According to IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*, a provision should be recognised if there is a present obligation as a result of a past event, which can be reliably estimated.

It may be necessary for Python Co to recognise a provision or disclose a contingent liability for fines and associated legal costs resulting from the data breach. This will depend on the likelihood of a cash payment being made, and the materiality of any such payment, in accordance with IAS 37.

The fine for the data breach is due to be decided by November 20X5, which is after the end of the financial year. The potential fine could be 2% to 4% of revenue, which is \$1.05 million to \$2.1 million; so even with the lowest possible fine, this is a material amount.

The amount of the fine is based on the severity of the breach and the actions which have been taken by the client since the breach. As Python Co has subsequently improved the security of the website, it is possible that the fine may be at the lower end of the range.

Even if the amount is not material, the information related to the breach and the fine could be qualitatively material to the decision-making of users of the financial statements.

The auditor will need to discuss the possible fine in more detail but based on the information in the scenario a reasonable estimate of the possible fine is \$1.05 million. There is therefore a potential understatement of provisions, and an understatement of expenses.

### **Sustainability report**

While management are correct in stating that audit work does not need to be performed on the sustainability report, ISA 720 (Revised) *The Auditor's Responsibilities Relating to Other Information* requires Kotlin Associates to read and consider the information in the sustainability report and ensure that it is not materially inconsistent with the financial statements.

This is the first time that the company has prepared a sustainability report and there is an elevated risk of misstatement due to the subjective nature of the sustainability information which may be included by management, and because legislation is not prescriptive as to what should be published.

The audit team should not allow the client to restrict the work which should be performed on the sustainability report as this may be an indicator of management bias. The audit team should increase professional scepticism when reviewing the report or any additional information to be published with the financial statements.

### **Conclusion**

Control risk will be assessed as high on this audit and a more substantive audit approach adopted due to the impact of the software implementation issues. The lack of monitoring by senior management presents an overriding risk and impacts all areas of the audit.

In addition, the valuation of intangible assets is high risk, and should be prioritised due to the use of management judgement in determining the useful life of the assets and potential impairment of the values. The materiality of the balance, as well as the strict recognition criteria, further increases the risk.

### **(b) Use of a service organisation**

ISA 402 *Audit Considerations Relating to an Entity Using a Service Organisation* is the source of guidance for auditors when an audited entity outsources one or more business activities. ISA 402, which is relevant to the planning stage of the audit, requires the auditor to obtain an understanding of the nature and significance of the services provided by the service organisation and their effect on the user entity's internal control relevant to the audit, sufficient to identify and assess the risks of material misstatement. The impact on the audit strategy is as follows:

The scope of the audit will increase since Kotlin Associates would need to understand the nature of the service which is performed by E S Crow Co. A key consideration is whether E S Crow Co's services are limited to recording and processing transactions, or whether they execute transactions, therefore taking on accountability for those transactions.

E S Crow Co is providing a revenue collection service for Python Co. The daily statement provided by the service organisation details which projects are completed, and this is then transferred to Python Co. It is evident that this is a transactional arrangement, but Kotlin Associates should still make sure that the controls are in place both at the service organisation, and also at Python Co. A Type 2 report has been provided by the auditor of E S Crow Co. This will be reviewed by Kotlin Associates to understand the systems and controls which are in place, and, importantly, details of the tests of controls performed by the auditor.

Although this report is useful, Kotlin Associates should still satisfy themselves of the competence and independence of the E S Crow Co auditor and review the standards under which this report has been issued, which further increases the scope of the audit.

The adjustments made by Python Co will require additional focus during the audit as it is evident that there are few controls in respect of the revenue transferred to Python Co from E S Crow Co, aside from checking the money received agrees to the statements.

Kotlin Associates needs to obtain assurance as to the operating effectiveness of the controls over the revenue collection by E S Crow Co during the financial reporting period of Python Co, which is 1 October 20X4 up until 30 September 20X5. The Type 2 report provided by E S Crow Co's auditors is for the period ending 31 May 20X5. Kotlin Associates will need to perform procedures on the operating effectiveness of the controls for the period 1 June - 30 September 20X5. It may be possible to request an interim Type 2 report for this period and then perform procedures on both reports when they are received.

There is a risk that the listing of projects in the statement from E S Crow Co may not agree to the information on Python Co's website and platform as no checks are performed by Python Co to verify completeness of the information. Revenue may be misstated as a result.

In conclusion, Kotlin Associates must ensure that they use appropriately skilled and experienced staff to adequately assess the service organisation. Additionally, Kotlin Associates should plan for additional time to ensure that the service organisation is contacted with sufficient time so that the required information and any visits to E S Crow Co or validation of the work by their auditor in respect of the Type 2 are conducted in advance of the final audit work.

### **(c) Evaluation of the audit work proposed for the purchase of the head office building**

The audit assistant has only proposed procedures which will verify the actual cost of the new building and confirm the date it was purchased; it will not take into account any additional costs, such as those incurred as legal fees. As IAS 16 requires such legal and professional fees to be included within the carrying amount of the building, it is essential that these are also verified back to the original invoices. The procedures also do not verify the ownership of the property.

The following additional procedures should be performed:

- Obtain the contract for the purchase of the building to verify the ownership and any rights and obligations associated with the ownership of the property.
- Obtain a breakdown of the legal and professional costs and agree the amounts to respective invoices and bank statements.
- Review other costs expensed (including those within the \$645,000) in respect of the purchase to assess whether any other costs should be included within the carrying amount of the building and to ensure completeness of the expensed items.
- Discuss with the financial controller the requirement to include all the costs directly associated with the purchase of the property within the carrying amount and request an adjustment is made with respect to the legal and professional costs of \$500,000.
- Obtain and review a copy of the title deed of the property (and insurance contract) to confirm that the property is in Python Co's name.

Tutorial note: Other relevant audit procedures not stated here will be given credit

**(d) Request from the financial controller**

The request from the financial controller of Python Co to assist with a future acquisition is an example of providing a non-assurance service.

The IESBA International Code of Ethics for Professional Accountants (the Code) specifies that assisting an audit client in developing corporate strategies and identifying target companies for potential acquisition are examples of corporate finance activities. Providing these services can create self-review and advocacy threats to objectivity.

The self-review threat arises because any future acquisition will impact on the company structure and will therefore directly affect balances and transactions which Kotlin Associates will audit. The audit team are likely to be less sceptical of transactions and balances which members of the corporate finance team have reviewed or been involved in.

The advocacy threat arises because Kotlin Associates will be promoting their client's interests as a result of the request to attend meetings with the company's providers of finance. Attendance at these meetings is likely to suggest to the lender that the firm support the company's position or application for finance.

The Code requires Kotlin Associates to evaluate the significance of the threats to objectivity and to consider if safeguards are available to reduce the threats to an acceptable level.

The significance of the threats depends on matters such as:

- The degree of subjectivity involved in determining the appropriate treatment for the balances and transactions in the financial statements.
- The extent to which the outcome of the corporate finance service will directly affect amounts recorded in the financial statements.
- The extent to which the outcome of the corporate finance service will have a material effect on the financial statements.

Safeguards may be available to reduce the threats to an acceptable level, including:

- Using staff not involved with the audit to provide the corporate finance service to Python Co to address the self-review and advocacy threats.
- Have an appropriate reviewer who was not involved in providing the corporate finance service advise the audit team or the corporate finance service and review the appropriateness of relevant accounting treatments, to address the self-review threat.
- Kotlin Associates should decline the request to attend any meeting with the bank to discuss the potential funding, as this may be seen as a potential advocacy threat.

The matter should be discussed with those charged with governance of Python Co to ensure that all parties are aware of the limitations of what may be performed by Kotlin Associates.

## **Internal controls**

The CEO's request for Kotlin Associates to work with Python Co's finance team to design and evaluate internal controls over the accounting system creates a self-review threat to objectivity. This is because in subsequent audits the audit team may over-rely on the internal controls designed and evaluated by the audit firm. This could result in the auditor failing to apply an appropriate level of scepticism when assessing the work, resulting in a failure to identify deficiencies.

The Code allows internal audit services to be provided to an audit client that is not a public interest entity provided safeguards are in place such as using professionals who are not audit team members to perform the service.

Designing, implementing, monitoring and maintaining internal control is likely to result in the firm assuming management responsibility. Assuming a management responsibility is prohibited by the Code.

Therefore, Kotlin Associates should politely decline the request made in the financial controller's email and ensure that the board is fully aware of the ethical issues raised by their requests.

## Section B

### Question 2

#### (a) Babbage Co

##### Controls work

ISA 315 (Revised 2019) requires the auditor to obtain an understanding of the control environment relevant to the preparation of the financial statements through performing risk assessment procedures. This includes understanding the entity's information system and control activities. Having assessed these risks, the auditor is required to perform procedures to determine whether the controls are designed and implemented effectively, and functioning as designed.

As this is the first year of the engagement, it would be expected that a significant amount of work would be performed on systems and controls, making it particularly inappropriate to rely wholly on data analytics. Data analytics cannot be used as a substitute for gathering evidence.

Not performing any additional procedures to assess the operating effectiveness assumes that there are no significant audit risks pertaining to trade receivables. There is a risk that misstatements may not be detected due to an overreliance on the data analytics software, and an assumption that the controls are operating effectively.

##### Audit documentation and risk assessment

It appears that the audit file lacks appropriate documentation and that the audit team has not gained sufficient understanding of the client's systems.

A sample of 36 items was identified by the data analytics software. However, the information provided in the audit file extract does not detail the specifics of these items or any details of the parameters set within the software. It is essential that the basis for the sample is understood, as it may be inappropriate for the risk assessment on the audit. Even with the use of data analytics software, the sample size should be justified.

Without the information of the customer's name, the amount of the outstanding debt and the date, it would be impossible to retest the item and confirm the conclusions. This contravenes the internal quality procedures as well as ISA 230 *Audit Documentation*, which requires the auditor to prepare audit documentation that is sufficient to enable an experienced auditor, having no previous connection with the audit, to understand:

- The nature, timing and extent of the audit procedures performed to comply with the ISAs and applicable legal and regulatory requirements;
- The results of the audit procedures performed, and the audit evidence obtained; and
- Significant matters arising during the audit, the conclusions reached thereon, and significant professional judgements made in reaching those conclusions.

The exceptions should have been discussed with the audit manager and the client, however, there is no audit evidence to confirm that this has taken place. It is insufficient to state that because the individual amounts do not exceed materiality, no further testing is required. The aggregate of these exceptions may exceed materiality, and there is a risk

that trade receivables is overstated, and the allowance for irrecoverable debts is understated.

Procedures performed by the team only confirm the existence of the receivable not the recoverability of the amount. After-date cash testing has been performed, however, there is no documented evidence to explain how the audit team has confirmed the recoverability of the amounts which were unpaid as of the date of testing (10 June 20X5). There are no details of any discussion or evidence of further manual, substantive testing.

There is no evidence of review of the audit file extract, and the reviewer section is blank which is a further breach of ISA 230 and contravenes the firm's internal quality procedures. This increases the risk that trade receivables may be misstated in the financial statements.

There is a possibility that this issue is not restricted to just this one engagement of Babbage Co, and that it may be affecting other engagements as well.

### **Professional competence and due care**

The lack of understanding of the data analytics software by the audit team and the fact that this has not been rectified by the manager or partner prior to the issuance of the auditor's report highlights a competence deficiency within the firm. It is essential that the audit team is trained to use the new technology, and their work and any judgements made, reviewed to ensure correct application.

The audit team appears to have placed excessive reliance on the data analytics software without properly evaluating the evidence obtained and whether it is sufficient and appropriate. There also appears to be a lack of appropriate supervision and review of the audit team's work.

There is a risk that the lack of understanding and documented evidence may be present in other audits performed by teams inexperienced in the use of the data analytics software and this should be investigated further.

### **Actions to be taken**

- The audits of other clients by the manager and partner responsible for the audit of Babbage Co should be reviewed to ensure that these issues are not present in any other audits.
- The firm should ensure that the staff training on the use of the data analytics software is being completed and is appropriate to the needs of the audit team.
- A technical specialist should review the use of data analytics.

### **(b) Ada Group**

When assessing whether it is appropriate to accept the audit of Ada Group, Turing & Co must assess threats arising to independence and the availability of safeguards to ensure these are mitigated sufficiently to allow the audit to be performed in an unbiased manner.

## Fees

### Self-interest – audit fees

The fees proposed for the audit are high, representing 22.8% ( $\$358/(\$1,210+\$358)$ ) of the firm's total forecast fee income for the year ending 31 December 20X5 including the fee for the audit. Such a level of fees may be considered to give rise to the threat of fee dependency. The Code identifies high fees as giving rise to self-interest and intimidation threats as the firm will be less willing to challenge the client for fear of losing them and the associated income.

While the code does not set a cap on the size of the audit fee for an unlisted client relative to the firm's total income, the threat becomes more significant the higher the fee level.

This threat is both firm wide and can exist at the level of the local office or partner where an individual partner's remuneration or career is impacted by the loss of a significant client. ISQM 1 *Quality Management for Firms that Perform Audits or Reviews of Financial Statements, or Other Assurance or Related Services Engagements* requires firms to have in place a culture and a system of quality management (SoQM) which prioritises audit quality over revenues and profits to reduce this threat.

The internal SoQM for the firm is likely to have a fee threshold at which a fee dependency threat exists and will have suitable safeguards to mitigate this threat. Generally, this would include involving a reviewer to perform an engagement quality review (EQR) and to assess the reasonableness of the fees charged.

The firm should inform those charged with governance (TCWG) of the threat and the safeguards in place to mitigate this to an acceptable level.

### Self-interest – other fees

The fee dependency risk is exacerbated in this instance by the fees for the provision of other services. With respect to the Ada Group, adding the proposed audit fee to the fees already billed in this financial period gives a total fee income of \$596,000, representing 38% of forecast annual fee income for the current year. Of this, \$157,000 is non-recurring in relation to the forensic work, giving a recurring fee of \$439,000 or 28% of the firm's income.

For an unlisted audit client, where the total fee income from that client exceeds 30% of firm fees for more than five years, the Code requires the audit firm to obtain an external review of the fifth year's audit work before a sixth year's audit opinion is issued.

As such, this level of fee dependency should be reviewed against the firm's internal policy on fees. If the firm are also appointed as auditor to the Group, Turing & Co may determine it is appropriate to have an EQR on each of the firm's engagements with the Group. It would also be advisable to decline any additional services, such as forensic and consulting work, as this would safeguard against the threat of fee dependency.

### Basis of calculating fees

The proposed audit fee for the audit of Ada Group includes a discount in recognising Ada Group as a valuable client. The Code prohibits audit fees from being influenced by the provision of other services unless this arises because of cost savings from experience of the client. From the way the discount is described, it appears to be influenced by value

of the client to Turing & Co which implies that the discount is a recognition of the other services provided. Therefore, this is inappropriate as it contravenes the Code and must be refused.

### Question 3

#### (a) Fraud

If the full extent of the fraud is \$40,000, the audit team is correct to determine that the fraud is quantitatively immaterial, it is, however, material by nature to the financial statements. However, without performing further procedures it is not possible to reach this conclusion. There is no auditor-generated evidence to support the assertion that \$40,000 is the total amount of stolen funds. Relying solely on a conversation between the Group finance director and Clive Apricot who carried out the fraud, and a list of invoices provided by the Group finance director is not sufficiently reliable.

The Group finance director could be involved with the fraud and is attempting to deceive the auditor and minimise the suspected scale of the fraud to deter further investigation being carried out. The auditor should approach the comments made by the Group finance director with an attitude of professional scepticism, especially given that he has asked the audit team not to investigate further, which raises suspicion that he may be covering up the fact that the fraud was on a larger scale than has been made known to the auditor.

There are two courses of action for the auditor. First, independent investigations should be carried out by the auditor to obtain sufficient, appropriate evidence relating to the amount of the fraud. This is particularly important given that the Group finance director seems unwilling to make any adjustment to the financial statements. If the fraud is financially significant, the financial statements may be materially misstated.

Second, the auditor should consider their reporting responsibilities. ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* requires that when fraud has taken place, auditors shall communicate these matters on a timely basis to the appropriate level of management in order to inform those with primary responsibility for the prevention and detection of fraud of matters relevant to their responsibilities. Given that the Group finance director alerted the auditor to the fraud, it seems likely that management and those charged with governance are already aware of the fraud. However, the auditor should consider whether a formal, written communication is needed.

In addition to reporting to management and those charged with governance; ISA 240 requires that the auditor shall determine whether there is a responsibility to report the occurrence or suspicion to a party outside the entity. The auditor's duty to maintain the confidentiality of client information makes such reporting potentially difficult, and the auditor may wish to take legal advice before reporting externally.

#### (b) Audit evidence

##### **New security system**

Given that the costs included in the carrying amount of the new security system are material to the Group financial statements, more audit work should have been carried out to determine whether it is acceptable that all, or some, of the \$1,200,000 should have been recognised as an intangible asset.

There is a risk that research costs, which must be expensed, have not been distinguished from the costs which have been included within the carrying amount of the asset. Currently, the audit evidence is not sufficient and appropriate to conclude that the accounting treatment is appropriate, and therefore intangible assets could be materially misstated.

Agreement of amounts to invoices provides evidence of the value of expenditure, but does not provide sufficient, appropriate evidence as to whether the expenditure is capital or revenue in nature which is necessary to determine the appropriate accounting treatment.

A significant element of the asset is the \$450,000 of employee costs which does not appear to have been verified against supporting documentation (timesheets) or the nature of the work. Only employee costs which have arisen from the generation of the intangible asset may be included within the carrying amount of the asset, so further investigation should be carried out to verify this material balance.

The internally generated brand of \$250,000 should not be included in the carrying amount of the security system. Such costs are specifically prohibited under IAS 38 *Intangible Assets* and should be expensed to the statement of profit or loss. Therefore, there is a material misstatement in respect of intangible assets. There will also be a corresponding adjustment required in respect of the amortisation of the security system of \$50,000.

Performing an arithmetic check on a spreadsheet does provide some evidence over the accuracy of the calculations but does not provide sufficient, appropriate evidence on the validity of the projections, and in particular, there is no evidence that the assumptions are sound. Given that the Group finance director has not allowed the audit team access to information supporting the spreadsheet and has refused to answer questions, he may have something to hide, and the audit of the projection should be approached with a high degree of professional scepticism. The assumptions may not be sound and may contradict other audit evidence.

The attitude and actions of the Group finance director indicate a lack of integrity which should be discussed with the audit committee, as the committee should be in a position to discuss the situation with him, with the objective of making all necessary information available to the audit team.

### **Written representation**

Finally, there appears to be over-reliance on a written representation from management. ISA 580 *Written Representations* states that written representations should be used to support other audit evidence and are not sufficient evidence on their own. In this situation, it appears that the representation is the only evidence which has been sought regarding the likely success of the new product development.

Further evidence should be obtained to distinguish between research costs and development costs, and to support whether the development costs meet the recognition criteria of IAS 38 *Intangible Assets*. This includes:

- A discussion with the project manager to obtain their view on the likely launch date for the new product, anticipated level of demand, any problems foreseen with completion of the project.
- A review of timesheets and discussion with management to ascertain the work and roles of the staff members whose time has been included within the \$450,000 to ensure only directly attributable costs are included.
- For the sample of costs included in the \$1,200,000, a review of purchase invoices to ensure they are in the name of the company and whether the costs are capital or revenue in nature.
- Results of any market research to support the assertion that the new product will generate future economic benefits.
- A discussion with management to identify how they have incurred development costs without carrying out any research first.
- Assuming that the Group finance director makes the supporting documentation, including assumptions, available to the audit team, a review of the assumptions for reasonableness and consideration of whether they are in line with business understanding and other audit evidence obtained.

### **(c) Evaluation of auditor's report**

#### **Headings and structure**

The report should not have the opinion and basis for opinion combined in one paragraph. The report should start with the opinion paragraph, which is then followed by the basis for opinion.

In addition to separating out the paragraphs, they should be given appropriate headings. According to ISA 705 *Modifications to the Opinion in the Independent Auditor's Report*, when the opinion is modified, the heading should be used to denote the type of modification which is being made to the opinion – in this case the title 'Qualified opinion' seems most appropriate. The basis for opinion paragraph should be headed 'Basis for qualified opinion'.

#### **Qualified opinion**

The use of the phrase '...do not present fairly...' is wording used in an adverse opinion when a misstatement is material and pervasive. The misstatement of \$250,000 is material but unlikely to be pervasive, therefore a qualified opinion should be issued.

According to ISA 705, when the opinion is qualified the following wording should be used 'except for the effects of the matter(s) described in the Basis for Qualified Opinion section, the accompanying financial statements present fairly, in all material respects (or give a true and fair view of)...'.

The draft opinion paragraph uses different wording – in particular, using the phrase 'the financial statements are likely to be materially misstated' does not indicate that a definitive conclusion has been reached, and could give users of the report some doubt as to the credibility of the auditor's opinion.

### **Basis for qualified opinion**

This paragraph should contain further information on the reasons for the modification including a description and quantification of the financial effects of the material misstatement. In this case, the paragraph should refer to the overstatement of intangible assets of \$250,000, and the overstatement of profit by the same amount.

### **Emphasis of matter paragraph**

According to ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*, an emphasis of matter (EOM) paragraph is used when the auditor considers it necessary to draw users' attention to a matter which is of such importance that it is fundamental to users' understanding of the financial statements. The matter discussed in the EOM paragraph must be properly presented and disclosed in the financial statements.

The draft auditor's report includes an EOM which is being used to discuss two matters, neither of which are appropriate for inclusion in an EOM. First, the EOM describes the fraud which has taken place during the year. This matter is immaterial in monetary terms and therefore is not likely to be considered to be fundamental to users' understanding of the financial statements.

It is not professional to highlight illegal activity in this way, and it could increase the risk of litigation from the Group, as this amounts to a breach of confidentiality.

Second, the EOM refers to the difficulties encountered in the audit of intangible assets due to the Group finance director refusing to allow full access to necessary sources of evidence. This matter should not be reported to shareholders in the auditor's report. The appropriate method of reporting is to those charged with governance of the Group, as required by ISA 260 *Communication with Those Charged with Governance*. ISA 260 requires the auditor to communicate to those charged with governance regarding a range of matters, including significant difficulties, if any, encountered during the audit.

Related to this, stating that it is the Group finance director personally who is responsible for the material misstatement and hence the modification of the auditor's opinion is not professional and could raise further legal problems, for example, the Group finance director could accuse the audit firm of making false statements or defamation of character.

In addition, referring to the potential resignation of the audit firm anywhere in the auditor's report is not appropriate. This matter should be discussed with those charged with governance who will then take the matter up with the Group's shareholders.

## Mark scheme

### Question 1

#### (a)

Assessment and justification of materiality – up to 2 marks

Relevant trends or calculations which form part of the evaluation of audit risk – up to 3 marks

Audit risks – up to 2 marks each

- New client
- Corporate governance and internal controls
- Intangible assets – treatment of R&D costs
- Intangible assets – valuation
- Non-current assets – head office
- Accrued revenue
- Provision for possible fine (up to 4 marks)
- Sustainability report
- Conclusion – prioritisation of the risks

**Maximum 21 marks**

#### (b)

1 mark per relevant point, including:

- Need to understand nature and significance of the services provided by service organisation
- Impact on the planning of the audit (up to 2 marks)
- Type 2 report – usefulness, consideration of period covered, reliability (up to 2 marks)
- Revenue may be misstated due to lack of controls exercised by Python Co
- Impact on the audit – staffing, additional time required

**Maximum 6 marks**

#### (c)

Assessment of the procedures – 1 mark per relevant point, up to 3 marks

Recommendations – 1 mark per relevant point, up to 3 marks

**Maximum 6 marks**

#### (d)

1 mark per relevant point, including:

- Self-review threat explained
- Advocacy threat explained
- Significance of the threats
- Safeguards explained and relevant to the threats identified
- Actions (discuss with those charged with governance)
- Internal controls work – self-review threat explained

- Internal controls work – assuming management responsibility explained
- No safeguards are appropriate – explained

**Maximum 7 marks****Professional skills marks:****Communication**

General briefing notes format and structure (use of headings, sub-headings and an introduction)

Style, language and clarity (tone of report response, presentation of calculations, appropriate use of the tools, easy to follow and substantive amount of content)

**Analysis and evaluation**

Appropriate evaluation of the issues using calculations to support the challenges and identification of trends to identify significance of the risks

**Professional scepticism and judgement**

Effective challenge of information, evidence and assumptions supplied as part of the risk evaluation, including where areas of bias may require additional professional scepticism to be applied

Critical assessment of the evidence in relation to the property and the service organisation is provided

**Commercial acumen**

Valid ethical and professional matters for the firm are considered and take into account the implications on the audit firm, the engagement and the client

**Maximum 10 marks****Total 50 marks**

**Question 2****(a)**

Each quality management, professional or ethical issue – 1 mark per relevant point

- Controls work for new client (up to 2 marks)
- Audit documentation and risk assessment (up to 4 marks)
- Professional competence and due care (up to 2 marks if evaluated in the context of the team performing the audit and/or at the firm level) e.g. excessive reliance and not being monitored
- Similar issue potentially leading to incorrect opinion in other audits, so further checks will need to be completed

Each action or procedure recommended – 1 mark each

- Audits of other clients by the manager and partner responsible should be reviewed for the same issues
- Training on the data analytics and documentation for staff
- Review by technical specialist on the correct use/best practice of/in data analytics in the audit process (firm wide application)

**Maximum 12 marks**

**(b)**

1 mark per relevant point, including:

- Threat of fee dependence as a result of high fees
- Fee dependence creates specific ethical threats – self-interest and intimidation
- No cap on fees set by the Code, however best practice/relevance to the ethical aspect/firm may have SoQM limiting fee threshold
- Mitigation of threat
- Increased risk due to fees from other services
- Possible actions to safeguard
- Discount could impact audit quality
- Refuse discount as it contravenes the Code

Relevant calculations which are explained in the context of the scenario – up to 2 marks

**Maximum 8 marks**

**Professional skills marks:**

**Analysis and evaluation**

Effective evaluation of the quality of the audit is supplied including an assessment of the issues raised, with appropriate recommendations made for further actions

**Professional scepticism and judgement**

Ethical and professional issues arising in relation to fees are examined and raise valid questions for Turing & Co

**Maximum 5 marks**

**Total 25 marks**

**Question 3****(a)**

1 mark per relevant point, including:

- Assessment of materiality
- Reliability of verbal evidence
- Possible collusion between Clive Apricot and the Group finance director
- Audit team need to use additional professional scepticism
- Independent investigations required as financial statements may be misstated
- Auditor's requirement to report to those charged with governance
- Reporting requirements of the auditor
- Duty to maintain client confidentiality – seek legal advice before reporting externally

**Maximum 6 marks**

**(b)**

1 mark per relevant point, including:

- Assessment of materiality
- IAS 38 intangible assets misstated
- Audit work insufficient – explained (up to 2 marks)
- Inclusion of brand incorrect – explained with reference to IAS 38 (up to 2 marks)
- Reliance on written representation limitations
- Further evidence (up to 2 marks)

**Maximum 7 marks**

**(c)**

1 mark per relevant point, including:

- Combination of 'basis of opinion' and 'opinion' incorrect
- Incorrect headings
- Qualified opinion paragraph wording is incorrect/ambiguous/needs clarification
- Further details required under basis of opinion
- Fraud is immaterial, not fundamental to user's understanding
- Unprofessional language used (up to 2 marks for stating examples and reasoning)
- Issues during audit should be discussed with those charged with governance
- Inappropriate to state resignation in auditor's report

**Maximum 7 marks**

**Professional skills marks:****Analysis and evaluation**

Systematic and structured approach taken to evaluate the extract of the proposed auditor's report

### **Professional scepticism and judgement**

Assessment of the implications of the fraud on audit completion addresses a range of matters and is connected to further actions to be taken

Sufficiency and appropriateness of audit evidence is challenged and linked correctly to additional work required

**Maximum 5 marks**

**Total 25 marks**