Answers

1 (a) Consolidated Balance Sheet of Humbug as at 30 September 2001:

	$000	$000
Non-current assets		
Intangible		
Property, plant and equipment (w (i))		17,271
Goodwill (1,000 – 400 (w (ii)) + (500 – 100) (w (v)))		1,000
Software (w (i))		80
		18,351
Investments (6,000 + 400 – 4,250 (Spyder) – 1,500 (Juke Box))		650
		19,001
Current assets		
Inventory (1,120 + 640 + 50% x 600)	2,060	
Accounts receivable (950 + 380 + 50% x 320))	1,490	
Bank (180 + 50% x 280)	320	3,870
Total assets		22,871
Equity and liabilities		
Capital and reserves:		
Ordinary shares of $1 each		5,000
Accumulated profits (w (iv))		13,311
		18,311
Minority interest (w (iii))		880
Non-current liabilities		
10% Loan notes (50% x 500)		250
Current liabilities		
Accounts payable (1,300 + 850 + 50% x 400)	2,350	
Taxation (560 + 350 + 50% x 100)	960	
Overdraft	120	3,430
Total equity and liabilities		22,871

Workings (Note: all figures in $000)

(i) Property, plant and equipment

Humbug per question	11,250
Spyder per question	4,800
50% of Juke Box	900
Fair value – Spyder's plant (80% x 700)	560
Less depreciation adjustment – (80% x 700 x 2/5 (2 year's depreciation))	(224)
Unrealised profit in Humbug's equipment (w (iv))	(15)
	17,271

Software:

Fair value – Spyder's software (80% x 300)	240
Less depreciation adjustment (80% x 100 (2 year's depreciation))	(160)
	80

Note: the benchmark treatment in IAS 31 requires proportional consolidation for joint ventures, and the benchmark treatment in IAS 22 requires that only the group share (80%) of the fair value adjustments are included in non-current assets.

(ii) **Cost of control in Spyder**

Investments – equity (2,000 x 80% x $2·5)	4,000	Ordinary shares (80% x 2,000)	1,600
– loan note (50% x 500)	250	Loan notes	250
		Pre acq profit (w (iv))	600
		Fair value adjustments (560 + 240 (w (i)))	800
		Goodwill	1,000
	4,250		4,250

The goodwill relating to Spyder of $1,000,000 is depreciated over a 5-year life at $200,000 per annum for two years = $400,000.

(iii) **Minority interest**

Balance c/f	880	Ordinary shares (20% x 2,000)	400
		Profit and loss reserve (w (iv))	480
	880		880

(iv) **Profit and loss reserve**

	Humbug	Spyder		Humbug	Spyder
Unrealised profit in equipment (see below)	15		B/f	12,640	2,400
Depreciation – equipment (w (i))	224				
– software (w (i))	160		Post acq profit – Spyder	1,320	
Minority interest (20% x 2,400)		480	Post acq profit – Juke Box		
Pre-acq profit (80% x 750)		600	(50% x 500)	250	
Post acq profit (80% x (2,400 – 750)		1,320			
Goodwill amortisation – Spyder (w (ii))	400				
– Juke Box (w (v))	100				
Balance c/f	13,311				
	14,210	2,400		14,210	2,400

The unrealised profit in the equipment bought from Juke Box $200,000 x 25/125 x 50% (group share) = $20,000. As the equipment is being written off over four years from the date of purchase, $5,000 of this amount is now realised. Therefore a net adjustment of $15,000 is required to be deducted from the carrying value of the equipment and from the group profits.

(v) Joint venture – calculation of goodwill

Investment at cost (1,000 x 50% x $3·00)	1,500
Net assets on acquisition (50% x 2,000 - see below)	(1,000)
Goodwill	500

This is depreciated for one year of a five-year life = $100,000

The net assets at the date of acquisition will be equal to the shareholders' funds at that date:

Share capital	1,000
Accumulated profit b/f – the date of acquisition	1,000
	2,000

(b) The most relevant feature of all forms of joint venture is the existence of a contractual agreement which establishes joint control. In particular the existence of an agreement distinguishes joint ventures from investments in associates.

Jointly controlled operations:
Under such joint ventures each venturer contributes its own assets, incurs its own expenses and raises its own finance. The contractual agreement usually contains rules for the sharing of the revenues from the operations by the venturers. The joint venture is not a separate entity legal or otherwise. A well-known example of jointly controlled operations is the European consortium of Airbus Industries whereby several European companies each manufacture different parts of aircraft and share the revenues from their sale. The accounting treatment of such joint ventures is that each separate venturer recognises the assets and liabilities they contribute (and control) and the income and expenses they earn and incur. The treatment is the same in both the entity and consolidated financial statements.

Jointly controlled assets:
This involves the joint control (and usually ownership) of an asset or a related group of assets. The assets will provide benefits to the joint venturers either in the form of a service or revenues earned. Again the joint venture is not a separate entity. A common example of this type of joint venture is an oil pipeline where several companies contribute to its construction and operation in return for the right to transport their own oil through the pipeline. Another example may be the joint ownership and operation of an investment property where each joint venturer takes a share of the rental income. The accounting treatment is for a joint venturer to recognise their share of any jointly controlled assets classified according to the nature of the asset, not as an investment in a joint venture. For example a share of an oil pipeline would be recognised in property, plant and equipment. A similar principle also applies to the recognition of liabilities, income and expenses relating to the joint venture. The treatment is again the same in the entity as well as the consolidated financial statements.

2 (a) Vitalise Income Statement year to 30 September 2001:

	$000	$000
Sales revenue (3,900 – 250 (w (i)))		3,650
Cost of sales (2,500 – 100 (w (i)))		(2,400)
Gross profit		1,250
Operating costs (250 + 300 (w (ii)))		(550)
Loss on investment property (w (v))		(40)
Foreign exchange losses (w (iv))		(250)
		410
Finance costs (65 + 25 +13 (w (i) and (vi)))		(103)
Profit before tax		307
Income tax (260 – 90 re 'extraordinary' item) (w (iii))		(170)
Profit for the period		137

Balance sheet as at 30 September 2001:	$000	$000
Tangible fixed assets		
Property, plant and equipment (3,810 – 250 (w (iv)) – 35 (w (v)))		3,525
Investment property		350
		3,875
Current assets (1,200 + 100 inventory (w (i)))		1,300
		5,175
Equity and liabilities		
Share capital and reserves:		
Ordinary shares $1 each		1,000
Option to convert (w (vi))		60
		1,060
Reserves (see Statement of Changes in Equity below):		
Revaluation reserve	75	
Accumulated profits	1,512	1,587
		2,647
Non-current liabilities		
8% Convertible Loan Note (440 + 13) (w (vi))	453	
Loan from Easyfinance (250 + 25 accrued interest) (w (i))	275	728
Current liabilities		1,800
Total equity and liabilities		5,175

Statement of Changes in Equity – Year to 30 September 2001

	Share capital	Revaluation reserve	Accumulated profits	Total
	$000	$000	$000	$000
Balance at 1 October 2000	1,000	250	1,500	2,750
Share conversion option	60			60
Revaluation of investment property transferred to realised profits (w (v))		(140)	140	nil
Revaluation loss of head office (410 – 375)		(35)		(35)
Profit for the period			137	137
Dividends			(265)	(265)
Balance at 30 September 2001	1,060	75	1,512	2,647

Note: On 30 October 2001 the company made a bonus issue of one new share for every five held.

(b) Basic EPS

Earnings – profit after tax	$137,000

Number of shares in issue:

Although the bonus issue took place after the year-end, IAS 33 'Earnings per Share' requires that it should be included in the calculation of the eps if the financial statements have not been finalised. Therefore the denominator for the calculation would be 1·2 million (1,000 x 6/5).

Earnings per share ($137,000/1,200,000)	11·4c

Diluted EPS:

Earnings:

On an assumed conversion the amount of loan interest 'saved' will be $53,000 (see (w (vi)). As only the amount paid is allowable for tax, the after tax (at 30%) effect of this will be a saving of $41,000 ($53,000 – ($40,000 x 30%)). This will give an adjusted earnings figure of $178,000 ($137,000 basic + $41,000)

Number of shares:

Basic denominator from above	1,200,000
Shares under option	500,000
	1,700,000
Diluted earnings per share ($178,000/1,700,000)	10·5c

Workings (note: all figures in $000)

(i) Sale to Easyfinance

The 'Framework for the Preparation and Presentation of Financial Statements' requires that financial statements reflect the substance of transactions. The sale to Easyfinance is clearly not a true 'sale'; it is a secured loan carrying interest at 10% compound per annum. The correct accounting treatment is to reverse the sale with the goods going back into inventory, treat the 'proceeds' as a loan and accrue interest of 10% ($25,000) for the current year.

(ii) Extraordinary item:

IAS 8 'Net Profit or Loss for the Period, Fundamental Errors and Changes in Accounting Policies' describes an extraordinary item as one that arises from events or transactions that are clearly distinct from the ordinary activities of the enterprise and not expected to recur frequently. Although it is unlikely that the take over expenses relating to Dunsters will recur, as a category of expenditure, it is quite possible for further costs of this nature to occur. Therefore the reasoning of the directors is flawed and these costs should not be classed as an extraordinary item. They should be treated as other expenditure, with the proviso that they may require separate disclosure in the notes due to their materiality.

(iii) Taxation:

As the take over costs are not an extraordinary item, its tax effects will now become part of the tax on the ordinary activities.

(iv) Foreign Currency:

Vitalise has used the closing rate of FRF4 to the $ to translate the value of the aircraft (and presumably the creditor for it). The use of the closing rate is incorrect. IAS 21 'The Effects of Changes in Foreign Exchange Rates' requires that assets are translated at the rates at the date they were acquired. In this case this would amount to FRF3 million/6 = $500,000. In effect the fall in the exchange rate, causing a loss to Vitalise of $250,000, has been added to the cost of the asset. IAS 21 (and confirmed in SIC 11) contains an allowed alternative treatment that does allow such losses to be added to the cost of an asset, but this is only when there has been a severe devaluation (arguably this is) and there is no practical means of settling or hedging the liability. The latter does not apply to Vitalise and therefore the exchange losses must be charged to the income statement.

(v) Properties:

The fair value model in IAS 40 requires the movement in the fair value of investment properties to be reported in the income statement (in this case a loss of $40,000 i.e. $390,000 – $350,000). This differs from revaluations in IAS 16 'Property, Plant and Equipment' which requires surpluses and deficits to be recorded as movements in a revaluation reserve (although there are exceptions to this requirement). IAS 40 also requires the reclassification (as an adjustment to the opening balance of retained earnings) of any investment property revaluation reserve surplus (in this case $140,000 i.e. $390,000 – $250,000).

(vi) Convertible Loan

This is a compound financial instrument that contains an element of debt and an element of equity (the option to convert). IAS 32 'Financial Instruments: Disclosure and Presentation' requires that the substance of such instrument should be applied to the reporting of them. From the information in the question, the most appropriate way to value the separate components is by measuring the value of the debt element by discounted cash flows and assigning the 'residue' to equity:

	cash flows	**factor at 12%**	**present value $000**
year 1 interest	40	0·88	35·2
year 2 interest	40	0·78	31·2
year 3 interest	40	0·70	28·0
year 4 interest, redemption premium and capital	540	0·64	345·6
total value of debt component			440·0
proceeds of the issue			500·0
equity component (residual amount)			60·0

For the year to 30 September 2001, the interest cost in the income statement should be increased from $40,000 to $53,000 (12% of 440,000) by accruing $13,000, which should be added to the carrying value of the debt.

3 (a) (i) A discontinuing operation is a relatively large component of an enterprise that pursuant to a single co-ordinated plan is:

– being disposed of substantially in its entirety;

– being sold off on a piecemeal basis;

– or terminated through abandonment.

It must also represent a separate major line of business (in terms of a product line or geographical operation) and can be distinguished operationally and for reporting purposes. Although other closures can meet the definition of 'a separate major line of business', it is frequently assumed that for large companies this usually equates to a business segment as referred to in IAS 14 'Segment Reporting'.

An important aspect of the above is that there is an intention to dispose of the entirety of the operation even if it is not in a single transaction and the 'plan' should be formal and identify:

– the part of the business concerned;

– the principal locations and number of employees affected; and

– the expenditures and timings of the closure.

The planned closure must also lead to a constructive obligation by raising a valid expectation in those affected by it that the plan will be implemented. The 'initial disclosure event' is the earlier of the point where a binding sale agreement is entered into, or the detailed plan is approved and announced. This is not necessarily the same time as the actual sale or closure, which may take several years to achieve. Hence the use of the term 'discontinuing' rather than the previously used term 'discontinued'. Where the initial disclosure event occurs after the current year-end, but before the Board approves the financial statements, then information relating to the discontinuance should be included in the current year's financial statements. Comparative information for prior periods should be restated to show continuing and discontinuing information consistent with the current year's classification such that there is comparability for the purpose of trend analysis.

The Standard says that discontinued operations that properly meet the above definition should be relatively infrequent – merely changing the location, scale, product mix or manner of production of an operation does not in itself constitute a discontinuation.

(ii) The modern approach to corporate reporting is starting to place more emphasis on the future rather than the past. The information on discontinuing operations is designed to reflect this view and to achieve the objective of improving the value and comparability of corporate reports. In attempting to assess the likely future performance of an enterprise in terms of its earnings and cash flow there can be very little other information that is more important than knowing which parts of the business will continue and those which have ceased operations (or will cease in the near future).

An important aspect of the presentation of the information on discontinued operations is that the comparative figures for continuing operations must be restated to exclude the results of operations that have been discontinued in the current year. This allows the results of the current year's continuing operations to be compared (on a more like for like basis) to those of the previous year.

The actual information to be disclosed (to the extent that it is known) for a discontinuing operation is very comprehensive and is summarised as follows:

– a description of the discontinuing operation;

– its geographically reported segment (re IAS 14);

– the date and nature of the initial disclosure event;

– period in which it is expected to be completed;

– the carrying amounts of the total assets and liabilities to be disposed of;

– the operating results down to profit after tax;

– details of the cash flows attributable to the discontinuing operation.

The above information must be given separately for each discontinuing operation.

(b) (i) Income statement – Sandown
Note: all figures in $m

	Year to 30 September 2001			Year to 30 September 2000		
	Continuing	**Discontinuing**	**Total**	**Continuing**	**Discontinuing**	**Total**
Sales revenue	920	80	1,000	850	50	900
Cost of sales	(600)	(50)	(650)	(530)	(70)	(600)
Gross profit	320	30	350	320	(20)	300
Operating expenses	(80)	(140)	(220)	(120)	(30)	(150)
Profit (loss) before tax	240	(110)	130	200	(50)	150

(ii) IAS 35 does not give guidance on how to calculate the provision for closure costs, it leaves this to a more specific standard IAS 37 'Provisions, Contingent Liabilities and Contingent Assets'. The general requirement in this standard is that only the direct expenditures arising from a closure can be provided for. The direct expenditures must be both necessary (as part of the closure) and not associated with the ongoing activities of the enterprise. Applying this would mean that staff retraining costs of $12 million and future operating losses of $28 million could not be provided for in 2001 (unless the future losses relate to an onerous contract) and instead would be charged to the period in which they are incurred.

4 **(a)** IAS 37 defines a provision as a liability of uncertain timing or amount. They can only be recognised when:

(i) there is a present obligation as a result of a past event. The obligation may be legal i.e. enforceable by law, or it may be constructive. This is a new concept in IASs. A constructive obligation arises where an entity has indicated that it will accept certain responsibilities even though it does not have a legal obligation to do so. This may be by a pattern of past practice or by some form of published statement

(ii) it is probable that an outflow of economic resources (usually cash) will be required to settle the obligation; and

(iii) the amount of the obligation can be reliably estimated.

The last item might appear to give some scope to avoid making a provision, but the Standard makes it clear that the occasions where a reliable estimate cannot be made will be extremely rare.

The Standard also says that a provision cannot be made unless all of the above conditions are present. This may seem an obvious point, being the converse of when a provision should be made, but this does lie at the heart of some previous abuses.

Previous abuses:
Profit smoothing – this is a technique whereby companies attempt to even out the trend of profits over several accounting periods, or possibly 'create' a trend of modestly rising profit when the true underlying profits may be volatile. This is achieved relatively simply; a company may make a provision in one accounting period (say when profits are high) and then release the provision in later periods (to improve poor profits). A feature of such a technique was often that the provision was made for a particular expenditure, but then released to offset different expenditures. This has been referred to a 'big bath' provisioning.

IAS 37 prevents this in two ways: firstly a provision can only be made where an actual liability exists (often the initial provision was made for an item that does not meet the current definition of a liability), and secondly a provision made for one expenditure can no longer be used to offset different expenditures.

Creating profits – in some ways this is similar to the above, except that the original provision was not charged to income. This generally occurred during an acquisition. An acquiring company may make a large provision for reorganisation costs relating to an acquired subsidiary, and possibly to other parts of the group affected by the acquisition. This provision was treated as a liability of the acquired company thus reducing the fair value of its net assets and increasing its purchased goodwill. The overall effect would be that the original provision bypassed the income statement (it was added to goodwill) and post acquisition profits were increased by the timely release of the provision. Ultimately the amortisation of the goodwill would be charged against income, but often over a very long period. IAS 37 specifically prohibits such reorganisation provisions, except where the acquired company's previous management had already announced a formal plan of restructuring.

(b) There are two groups of liability in this example and they require different treatments. The decommissioning of the plant and removal of the temporary site buildings are liabilities that must be recognised immediately the assets are put on site, as this is the obligating event. Note this is before quarrying begins. They should be measured at the present value of the best estimate of the expenditures expected to settle the obligation. The 'unwinding' of the present value is treated as a finance cost. The most controversial aspect of this type of provision is that it is not initially charged to the income statement, but instead it is added to the cost of the assets (in this case the plant and the quarry). This has the effect of immediately recognising an obligation when it occurs, but charging it to income over the periods expected to benefit. The second group of liability is for the landscaping and roadway damage. These are costs that occur and increase through the extraction of stone. These should be charged to income annually in proportion to the amount of stone extracted and damage caused.

The condition of the licence makes the above liabilities legally binding and thus cannot be avoided. If the licence had been granted without any conditions, there would be no legal obligation. However, this does not necessarily mean there is no obligation. It may be that Stonemaster has created a constructive obligation, perhaps by its past practice with similar environmental costs, or by a published policy made in its financial statements or other public announcement. If this has created a valid expectation that Stonemaster will incur these costs, then the situation is the same as in part (i). If there is no constructive obligation, there would be no liability and no provisions should be made.

5 Vostok

(a) Risk and audit reports

(i) Assessment of the risk of material misstatement

Risk can be assessed in different ways. The risk model outlined in ISA 400 is as follows:

Audit risk = Inherent risk x Control risk x Detection risk

Audit risk is the risk of issuing an inappropriate audit opinion. Inherent risk is the susceptibility of the financial statements and individual account areas to material misstatement. Control risk is the risk that internal controls will fail to prevent or detect material misstatements, and detection risk is the risk that the auditor's procedures will fail to detect material misstatements. Audit risk is set by auditors at an acceptable level and the nature and extent of audit testing depends on the auditor's assessment of the other elements of the model.

E-businesses are subject to many of the risks that apply to other businesses, but there are additional risks associated with e-businesses. Some of the following risks are common to all businesses, others relate to Vostok alone.

Inherent risk

1. At the financial statement level, inherent risk relates partly to the general sector in which the company operates. Internet-based companies are more risky than 'old economy' businesses because they operate in a more volatile market, have less experience, less tangible assets and less financial security. The markets value such businesses erratically which means that there are greater risks associated with the financing of such businesses. All of these factors are present in the case of Vostok. There is therefore pressure on directors to present financial performance and position favourably and the auditors need to be aware of the possibility of 'creative' accounting.
2. Vostok is currently engaged in re-financing negotiations. There will be pressure on the company to present future prospects (in the form of profit and cash flow projections) favourably. There will be pressure to present the current position favourably in order to justify the future projections. This is mitigated by the fact that there may be a temptation to understate the position as the company is negotiating with former directors in relation to the valuation of their holdings. Careful attention will need to be paid to the calculation of non-financial performance measures described in the question as the calculation of these figures may not be well understood. Such figures are likely to appear in information provided to the banks and venture capitalists and affect the availability of future financing. Such figures may also appear in the information that is published with the financial statements. Auditors do not report on such figures but it is important to ensure that the auditor's report is not associated in any way with misleading information.
3. Inherent risk also relates to industry cycles, and the sector of the market in which the company operates. Over the last two years, Internet-based companies have experienced a down-turn in trading and market valuations, as new competitors have entered the sector and as the availability of finance is reduced as a result of the global economic slowdown. All of these factors mean that financing may not be available and that the company therefore represents a higher than usual going concern risk.
4. Inherent risk in particular account areas within the financial statements relates mainly to accounting policies. Financial reporting standards do not always cover emerging issues, which means that companies are not directly constrained in the way that they account for matters such as barter transactions and revenue. It is not uncommon for companies such as Vostok to report the total value of transactions as revenue, instead of the commission only, and to report barter transactions as trading income. Auditors must take care to ensure that whatever policies are adopted, they are in accordance with International Financial Reporting Standards, and that they give an overall true and fair view.

Control risk

5. The loss of two directors and several key employees potentially increases both inherent risk (going concern) and control risk. The auditors will need to examine what effects these departures have had, how the company plans to deal with them and how existing employees are being persuaded not to leave.
6. The question indicates that financial and internal controls are poor. This increases control risk and means that the quality of the financial records may be poor. Collecting audit evidence may be more difficult and detection risk may therefore be increased. If the records are very poor, a qualified opinion on the basis of a limitation in the scope of the audit may be necessary.

Detection risk

7. This is the firm's first year as auditors and Internet businesses are a new area for many firms. This means that additional work will be needed to keep audit risk down to an acceptable level. The firm will need to ensure that staff with appropriate skills and training are made available. Risks are also increased because the firm is unfamiliar with the client.

(ii) Different types of audit report – going concern

The different types of audit report set out in ISA 570 'Going Concern' are as follows:

1. If the auditors conclude that a material uncertainty exists that casts doubt on the ability of the entity to continue as a going concern, they should consider whether the financial statements adequately describe the matter and clearly disclose the uncertainty and its potential effect. If the matter is properly disclosed this way, the auditor's report is modified by the addition of an 'emphasis of matter' paragraph describing the uncertainty and drawing attention to the matter in the financial statements. Such a modification does not amount to a qualified audit report.
2. It may be necessary to issue a disclaimer of opinion where there are multiple material uncertainties (i.e. uncertainties in addition to the uncertainty relating to going concern).
3. If adequate disclosure of the matter is not made, the auditors issue a qualified ('except for') opinion if the matter is material, or an adverse opinion (the financial statements do not give a true and fair view) where the matter is fundamental. Adverse opinions are very rare, but some argue that the going concern basis is so fundamental to the financial statements that an adverse opinion should always be issued, regardless of the quantitative materiality of the amounts involved (the provisions that would be required to adjust assets and liabilities to their realisable values).
4. If the going concern assumption is inappropriate and the going concern basis is used, an adverse opinion is issued. Once again, such an opinion is rarely issued in practice because auditors are rarely sufficiently certain that the company is not a going concern.
5. ISA 570 permits auditors to request management to extend its assessment of the going concern basis beyond the normal 12 month period beyond the balance sheet date. If management are unwilling to do this, the auditors may issue a qualified 'except for' opinion on the basis of a limitation in the scope of the audit.

(b) Problems facing auditors

(i) The issue of an auditor's report with a reference to a going concern uncertainty can be a 'self-fulfilling prophecy'. This means that if there is significant doubt and the auditor refers to it, lenders will take this to mean that there is definite doubt and withdraw their funding, which by definition means that the company is no longer a going concern. Directors are therefore, understandably, often opposed to such references in auditor's reports.

(ii) However, if the auditor does not make references to going concern problems, and the company subsequently goes into liquidation, the auditor may face both adverse publicity and litigation.

(iii) This problem is compounded by the fact that neither management nor auditors can predict future events, but the general public and others expect them to be able to do so.

(iv) When a company threatens to dismiss its auditor because the auditor wishes to make reference to a going concern problem, the auditor has to consider a number of factors. The overriding concern must be the appropriateness of the audit report, the risk of litigation and the requirements of professional ethics which require that auditors behave with integrity (which implies honesty, fair dealing and truthfulness) in all professional and business relationships.

(v) National legislation in many countries requires that where auditors are changed, that they make a statement to shareholders relating to whether there are any matters surrounding their removal or resignation that should be brought to the attention of shareholders. This provides auditors with the opportunity to deal with the matter, but the wording and distribution of such statements can be difficult in practice and not all countries have such legislation.

6 Quality control

(a) Quality control policies and procedures

(i) At the level of the audit firm

1. A firm with seven offices and 150 employees will probably have sufficient resources to apply all or most quality control policies and procedures in-house. However, it may be desirable from time to time to employ competent third parties to review such policies and procedures and their operation.
2. There should be policies and procedures to ensure that staff, partners and directors adhere to the requirements of professional ethics. This can be achieved by, for example:
   - assigning an individual to be responsible for these matters;
   - communicating policies and procedures by means of training and staff handbooks with regular updates;
   - monitoring compliance periodically by means of written declarations of compliance;
   - having procedures for resolving disputes and difficult issues.
3. There should be procedures to ensure that skills and competencies are maintained by adopting:
   - proper recruitment, interview and selection procedures;
   - integrated training, professional and career development programs;
   - effective performance evaluation and feedback procedures.
4. There should be procedures to ensure that work is assigned to staff with the right level of training, experience and skills by means of a work allocation program that is integrated with staff development programs.
5. There should be sufficient direction, supervision and review of work to ensure that the work meets appropriate quality standards.
6. There should be procedures for consultation (both within and outside the firm where necessary) on technical and other matters – by appointing a technical manager or partner, for example.
7. There should be procedures for the evaluation of new clients and existing clients.
8. There should be ongoing monitoring of the operation and effectiveness of the firm's quality control procedures, by means of periodic 'cold' review of completed audit files, for example.

(ii) At the level of the individual audit

1. Individual audits should be adequately directed, supervised and reviewed to ensure that the required standards are maintained. Such procedures should ensure that:
   - appropriate staff are assigned;
   - staff understand what is required of them;
   - work is carried out in accordance with the work program;
   - significant issues are raised and dealt with at an appropriate level;
   - differences of judgement can be resolved.
2. Adequate review procedures in particular are necessary to ensure that the work program and documentation is adequate, that all issues have been addressed and that audit conclusions are in accordance with the work performed. Budgeting for review time is an important element of this.
3. In practice, it is also valuable for a 'second' or 'review' partner to be assigned to engagements where audit risk is higher than normal or where the public interest is involved.
4. All quality control policies and procedures, at the level of the firm and the individual audit, should be adequately documented.

(b) Commercial pressure and the requirements of quality control

It can be very difficult to reconcile the requirements of quality control and commercial pressures. Methods of ensuring that commercial considerations do not take precedence include the following:

(i) Having reward and promotion structures that recognise quality issues as well as commercial performance;

(ii) Ensuring that the person with overall responsibility for quality control is sufficiently senior to have effect within the firm;

(iii) Encouraging a culture of quality within the firm;

(iv) Having periodic third party reviews of the performance of the firm in respect of quality issues;

(v) Investigating instances in which commercial considerations appear to have taken precedence and taking appropriate remedial action.

7 Receivables

(a) (i) Positive and negative direct confirmations

1. Positive confirmations involve a request from the client, to the debtor, for the debtor to confirm directly to the auditor the accuracy of a balance provided. This gives the opportunity for the debtor to highlight any differences with his own records.

2. There may be a temptation for debtors simply to agree to the balance without checking, or to agree to a balance that is too low.

3. Alternatively, the debtor may be requested to provide the balance. Such requests often obtain a lower response rate though, and there is no opportunity for the debtor to explain any differences.

4. Negative confirmations involve a request from the client, to the debtor, for the debtor to reply to the auditor only if the balance stated is incorrect. This is only suitable where there is a low risk of error and negative confirmations are generally only used with representative samples of smaller items within a population.

(ii) Advantages

1. ISA 505 'External Confirmations' states that the principal advantage of direct confirmation is that it provides third party, written evidence (strong evidence) in relation to existence, measurement (cut-off), and valuation.

2. Confirmation can also provide evidence in relation to certain frauds and irregularities. These include 'teeming and lading' – the theft of cash, and 'window dressing' – the issue of false invoices just before the period-end that are cancelled out by false credit notes just after the period-end, for example.

3. Direct confirmation does not provide conclusive evidence of the recoverability of a debt but it does provide indirect evidence as to the adequacy of internal controls over receivables.

(b) Work on receivables and bad debts

Work that can be performed includes the following:

(i) A review of cash received and credit notes issued after the balance sheet date;

(ii) Analytical procedures on the ageing of receivables, and on any trends in ageing, by comparison with prior periods and budgets (a review of debtor days, for example – although this may be distorted if the company factors its debts);

(iii) A review of contracts signed, deliveries made and any correspondence with customers;

(iv) A review of the calculation of the bad debt provision (specific and general) for reasonableness and consistency with prior periods;

(v) Discussions with management on the reasons for overdue balances and the nature and extent of any disputes or similar problems;

(vi) A review of individual invoices, credit notes and other entries making up significant balances, on a sample basis;

(vii) Work on the accuracy of cut-off procedures at the period-end.

(c) Substantive tests

(i) Checking a representative sample of source documentation, such as customer orders, through to delivery notes (or similar documentation), invoices, and entries in the ledgers, the schedules supporting the financial statements and the financial statements themselves (ensuring that calculations are correct) – to ensure that all amounts (completeness) are recorded accurately in the correct period. Such tests can be performed in conjunction with tests of controls.

(ii) Checking a representative sample of entries in the financial statements through to source documentation (the opposite of (i) above) – to ensure that recorded entries represent transactions that actually took place.

(iii) Performing similar tests to those noted above on documents and entries such as credit notes, debit notes, journal and contra entries.

(iv) Performing analytical procedures on the levels of sales invoices and credit notes on, say, a monthly basis throughout the period under review, by comparison with prior periods and budgets.

Diploma in International Financial Reporting and Auditing **Marking Scheme**

This marking scheme is given as a guide in the context of the suggested answers. Scope is given to markers to award marks for alternative approaches to a question, including relevant comment, and where well-reasoned conclusions are provided. This is particularly the case for written answers where there may be more than one definitive solution.

					Marks
1	**(a)**		Consolidated balance sheet:		
			property, plant and equipment		4
			goodwill (calculation 3; depreciation 1)		4
			software		2
			investments		2
			inventory		2
			trade receivables		2
			bank/overdraft (separate)		1
			accumulated profit		3
			minority interest		2
			10% loan notes		1
			trade payables		1
			tax	1	
				available	**25**
				maximum	**20**
	(b)		one mark per point to maximum of		5
				Maximum for question	**25**
2	**(a)**		sales		1
			cost of sales		1
			operating costs		1
			loss on investment property (in income statement)		1
			foreign exchange loss (in income statement)		1
			finance costs		2
			income tax		1
			property, plant and equipment		2
			investment property		1
			current assets (re inventory)		1
			conversion option in equity		1
			convertible loan note		2
			loan from Easyfinance		2
			bonus issue disclosed as post balance sheet event		1
			changes in equity 1 mark per line item up to		5
				available	**23**
				maximum	**20**
	(b)		2 marks for basic, 3 marks for diluted eps figures		5
				Maximum for question	**25**
3	**(a)**	**(i)**	2 marks for definition, 2 marks for comments		4
		(ii)	emphasis on future		1
			ceased operations will not contribute to future results		1
			reference to comparatives to aid trend analysis		1
			½ mark for each item of disclosure to maximum of		3
				available	**6**
				maximum	**5**
	(b)	**(i)**	2 marks for each of the 2001 and 2000 figures		4
		(ii)	staff retraining and future operating losses cannot be part of the provision for discontinued operations – 1 mark each		2
				Maximum for question	**15**

					Marks
4	**(a)**	1 mark for each element defining the circumstances where a provision should, and should not, be made			4
		1 mark for each example of previous abuses			2
		1 mark for how the IAS now prevents them			2
				maximum	8
	(b)	1 mark per relevant point to a		maximum	7
				Maximum for question	**15**
5	Vostok				
	(a)	Risk and audit reports			
		(i)	Assessment of the risk of material misstatement Up to 2 marks per point to a maximum of No more than 4 marks for inherent risk and 3 marks each for control and detection risk.		10
		(ii)	Different types of audit report – going concern Up to 1 mark per point to a maximum of (but only provided that all possibilities are covered)		5
	(b)	Problems facing auditors Up to 1 mark per point to a maximum of			5
				Total	**20**
6	Quality control				
	(a)	Quality control policies and procedures			
		(i)	At the level of the audit firm; Up to 1 mark per point to a maximum of		7
		(ii)	At the level of the individual audit Up to 1 mark per point to a maximum of		4
	(b)	Commercial pressure and the requirements of quality control Up to 1 mark per point to a maximum of			4
				Total	**15**
7	Receivables				
	(a)	**(i)**	Positive and negative direct confirmations Up to 2 marks per point to a maximum of		4
		(ii)	Advantages Up to 2 marks per point to a maximum to		3
	(b)	Work on receivables and bad debts Up to 1 mark per point to a maximum of			5
	(c)	Substantive tests Up to 1 mark per point to a maximum of			3
				Total	**15**