Answers

1 (a) Goodwill in Syphon:

	$ million	$ million
Investment at cost (30 x 80% x $8·70)		208·8
Less pre acquisition dividend (8 x 9/15)		(4·8)
Adjusted cost of investment		204
Ordinary share capital	30	
Pre-acquisition reserves (40 + ((110 – 10) x 9/15)))	100	
Revaluation reserve – land (20 + 5)	25	
	155 x 80% =	(124)
Goodwill on consolidation		80

Amortisation of goodwill for the year to 30 September 2002 will be $80 million/5 years x 6/12 = $8 million

Goodwill in Andean:

Investment at cost (20 x 40% x $6)		48
Ordinary share capital	20	
Pre-acquisition reserves (14 + (36 x 6/12))	32	
Fair value – plant	18	
	70 x 40% =	(28)
Goodwill on consolidation		20

Amortisation of goodwill for the year to 30 September 2002 will be $20 million/5 years x 6/12 = $2 million

(b) Consolidated Income Statement – Hyper Year to 30 September 2002

	$ million
Sales revenue (420 + (375 x 6/15) – 20)	550·0
Cost of sales (w (i))	(378·0)
Gross profit	172·0
Operating expenses (w (ii))	(60·0)
Interest (12 + (10 x 6/15))	(16·0)
Associated company (w (iii))	6·4
Profit before tax	102·4
Income tax (20 + (35 x 6/15) + (12 x 6/12 x 40%))	(36·4)
Profit after tax	66·0
Minority interests (110 x 6/15 x 20%)	(8·8)
Net profit for the period	57·2

Note: IAS 28 'Accounting for Investments in Associates' requires income from associates to be disclosed on the face of the income statement, but does not specify its positioning or whether it should be pre or post taxation. The above answer includes the associate's income as a gross (of tax) figure before the income tax charge and the group's share of the associate's tax has been included in the income tax charge, however a range of answers would be acceptable.

(c) Investment in Associate

Cost at acquisition	48·0
Post acquisition profit before tax	6·4
Less tax (12 x 6/12 x 40%)	(2·4)
Carrying value	52·0

Alternative answer:

Net assets at 30 September 2002	70	
Fair value adjustment net of additional depreciation (18 – (18/3 x 6/12))	15	
	85 x 40%	34
Goodwill (20 – 2) (part (a))		18
		52

Workings

(i) Cost of sales

	$ million
Hyper	320
Syphon (190 x 6/15)	76
Intra group	(20)
URP in inventory (see below)	2
	378

The unrealised profit in inventory is $20 million x $^1/_2$ x 25/125 = $2 million

(ii) Operating expenses

Hyper	40
Syphon (30 x 6/15)	12
Goodwill (see (a)) – Syphon	8
	60

(iii) Associated company income:

Share of profit before tax ((48 x 6/12) x 40%)	9·6
Additional depreciation ((18/3 x 6/12) x 40%)	(1·2)
Goodwill depreciation (from (a)	(2·0)
	6·4

2 (a) (i) Vincible – Income Statement – Year to 30 September 2002

	$000
Sales revenue (473,300 + 18,000 (w (i)))	491,300
Cost of sales (w (ii))	(366,000)
Gross profit	125,300
Operating expenses	(18,400)
Impairment of non-current asset (60,000 – 40,000) (w (iv))	(20,000)
Profit on the ordinary activities before interest	86,900
Loan interest (5,000 + 5,000)	(10,000)
Profit before tax	76,900
Taxation (w (iii))	(13,900)
Net profit from ordinary activities for the period	63,000

(ii) Vincible – Statement of Changes in Equity – Year to 30 September 2002

	Ordinary Shares $000	Revaluation reserve $000	Accumulated profits $000	Total $000
Balance at 1 October 2001	100,000	nil	13,300	113,300
Surplus on revaluation of leasehold (w (iv))		126,000		126,000
Transfer to deferred tax (w (iii))		(7,200)		(7,200)
Transfer to realised profits re leasehold (126,000 – 7,200 deferred tax)/18 years)		(6,600)	6,600	
Net profit for the period (63,000 – 24,000)			39,000	39,000
Dividends paid			(15,500)	(15,500)
Amount attributable to proposed dividends (100,000 x 4 x 6c)			24,000	24,000
Balance at 30 September 2002	100,000	112,200	67,400	279,600

(iii) Vincible – Balance Sheet as at 30 September 2002

	$000	$000
Non-current assets		
Development expenditure (w (iv))		30,000
Property, plant and equipment (w (iv))		368,300
		398,300
Current Assets		
Inventory (37,700 + 2,500)	40,200	
Trade receivables (49,200 + 3,500)	52,700	
Bank	12,100	105,000
Total assets		503,300
Total equity and liabilities:		
Ordinary shares of 25 cents each		100,000
Reserves:		
Accumulated profits (see (ii))	67,400	
Revaluation reserve (see (ii))	112,200	179,600
		279,600
Non-current liabilities		
10% Convertible loan stock	100,000	
Deferred tax (70,000 x 25%)	17,500	117,500
Current liabilities (w (v))		106,200
Total equity and liabilities		503,300

(b) Earnings per share:

Basic – earnings attributable to ordinary shares	$63·0 million
Number of shares in issue (100 million x 4)	400 million
Earnings per share	15·8 cents

Diluted earnings per share

IAS 33 requires that potential ordinary shares should be treated as dilutive when their conversion would decrease the net profit per share from continuing operations. It is possible that some cases of potential ordinary shares lead to an increase in the profit per share and are therefore not dilutive. Where there exists more than one class of potential ordinary shares the Standard requires them to be ranked in the order of the most dilutive to the least dilutive.

For Vincible, there is no difference between the reported profit and the profit from continuing operations.

Directors' options:

Where an option price is less than the market price of the ordinary shares (as in this case), this will always be dilutive and is normally treated as the most dilutive. The directors and senior staff have options on 50 million shares. This will yield $120 million (i.e. $2·40 per share). This amount would be sufficient to purchase 30 million at the full market price of $4·00, thus the dilutive effect of the options is 20 million shares (50 million – 30 million). The effect of the options on the eps is to increase the number of shares by 20 million with no corresponding effect on earnings:

	shares (million)	earnings ($ million)	eps
Basic eps from above	400	63	15·8 cents
Shares after option	420	63	15·0 cents

Convertible shares.

On conversion there would be an additional 60 million ($100 million x 60/100) shares in issue.
The interest saved (after tax at 25%) would be $7·5 million ($10 million x (100% – 25%)). This would give an incremental eps of 12·5 cents ($7·5 million/60 million shares) and is thus dilutive. Therefore the maximum dilution is:

Adjusted earnings (63 million + 7·5 million)	70·5 million
Number of shares (400 million + 20 million + 60 million)	480 million
Diluted earnings per share	14·7 cents

Workings

(i) IAS 31 'Financial Reporting of Interests in Joint Ventures' requires each venturer in jointly controlled operations to account for the assets that it controls and the liabilities that it incurs in its balance sheet and the expenses that it incurs and the revenues that it receives in its income statement. As this is not a separate entity the above should be included in the appropriate 'line' items in the financial statements e.g. Vincible's share of the sales of the joint venture should be added to its own sales figure. A similar procedure should be applied to all other elements of the joint venture.

(ii) Cost of sales:

		$000
Opening inventory		27,500
Purchases		310,500
Joint venture cost of sales		8,000
Depreciation (w (iv))	– leasehold	15,000
	– plant (15,200 + 17,500)	32,700
	– development expenditure	10,000
Closing inventory		(37,700)
		366,000

(iii) Taxation:

Current tax provision for year	15,000
Deferred tax (see below)	(1,100)
	13,900

The difference between the tax base of the assets and their carrying value of $70 million would require a balance sheet provision for deferred tax of $17·5 million (at 25%). Of this $7·2 million ($28·8 million x 25%) is taken to the revaluation reserve leaving a balance of $10·3 million. The opening provision was $11·4 million, thus $1·1 million ($11·4 million – $10·3 million) is released to the income statement.

(iv) Non-current assets/depreciation/revaluation:
Development expenditure:
The capitalised development expenditure has suffered an impairment due to falling sales of the related product. Therefore it should be written down to its recoverable amount, which is the higher of its value in use ($30 million) or its realisable value ($40 million). Thus it should be written down to $40 million. This will create an impairment loss of $20 million ((75 – 15) – 40) and amortisation for the current year will be based on the revised carrying value of $40 million and its remaining life of 4 years.

Leasehold	$000
Cost	200,000
Depreciation at 1 October 2001 (7 years i.e. 56,000/8,000)	(56,000)
Net book value prior to revaluation	144,000
Revaluation surplus	126,000
Valuation 1 October 2001	270,000
Depreciation year to 30 September 2002 (270,000/18 (i.e. 25 – 7) years)	(15,000)
Net book value at 30 September 2002	255,000

Plant:		
Cost	– non joint venture	124,800
	– joint venture	70,000
		194,800
Depreciation for year	– non joint venture (124,800 – 48,800) x 20%	15,200
	– joint venture (70,000/4 years)	17,500
		32,700
Net book value (194,800 – (48,800 + 32,700))		113,300
Net book value of property, plant and equipment (255,000 + 113,300)		368,300

(v) Current liabilities:

Per trial balance	82,200
Joint venture	4,000
Accrued loan interest ((10% x 100,000) – 5,000)	5,000
Taxation	15,000
	106,200

3 (a)

Petroplant – Income Statement	**30 September 2000**	**30 September 2001**	**30 September 2002**
	$ million	**$ million**	**$ million**
Contract revenue (w (i)))	375	(w (ii)) 663	(w (iii)) 677
Cost of sales	(300)	(510)	(570)
Profit	75	153	107

Petroplant – Balance sheet (w (iv))	**30 September 2000**	**30 September 2001**	**30 September 2002**
	$ million	**$ million**	**$ million**
Current assets – amounts due from customers	95	nil	nil
Current liabilities – amounts due to customers	nil	62	nil

Workings

(i) Year to 30 September 2000

The estimated total profit on the contract is $300 million (1,500 million – 1,200 million). The costs to date of $300 million are 25% of the estimated total cost of $1,200 million, therefore the contract is deemed to be 25% complete. Petroplant would record revenue to date of $375 million (25% x $1,500 million) and a profit for the period of $75 million (25% of $300 million) would be reported.

(ii) Year to 30 September 2001	**$ million**	**$ million**
Contract value plus incentive (1,500 x 102%)		1,530
Add variation		200
Total contract revenue		1,730
Estimated cost of – original contract	1,230	
– variation	120	(1,350)
Estimated total profit		380
Actual cost to date (740 + 70)		810
Percentage complete (810/1,350)		60%
Cost of sales for 2001 (810 – 300)		510
Contract revenue to date (1,730 x 60%)		1,038
Less revenue in 2001		(375)
Contract revenue for 2001		663

(iii) Year to 30 September 2002		
Original contract revenue (1,500 + 3% labour – 2% penalty)		1,515
Add variation		200
Total contract revenue		1,715
Actual costs – original contract	1,265	
– variation	115	(1,380)
Actual total profit		335
Contract revenue for year (1,715 – 663 – 375)		677
Cost of sales for year (1,380 – 510 – 300)		570

(iv)	**30 September 2000**	**30 September 2001**	**30 September 2002**
	$ million	**$ million**	**$ million**
Contract cost to date	300	810	1,380
Recognised profit	75	(75 + 153) 228	(228 + 107) 335
	375	1,038	1,715
Progress billings	(280)	(1,100)	(1,715)
Amounts due from customers	95	nil	nil
Amounts due to customers	nil	62	nil

(b) IAS 11 says that the construction of an additional asset at the option of the customer or by agreement should be treated as a separate contract where the asset differs in design, technology or function from the original asset or if its price is negotiated without regard to the original asset. IAS 11 also says that a variation in a contract is an instruction by the customer for a change in the scope of the work to be performed. The Standard cites a change in the design of an asset as a contract variation. Although the variation in the question appears to have several features of an additional contract, it is in fact a variation of the original contract. The critical point is that an additional contract must represent an additional asset; in this case there was only ever one asset albeit with a changed specification, thus the variation must be treated as part of the original contract and not as a separate contract.

4 (a) Sundown Cash Flow Statement for the year to 30 September 2002:

Reconciliation of operating profit to net cash inflow from operating activities

Note: figures in brackets are in $ million	$ million	$ million
Profit from operations		142
Adjustments for:		
depreciation – property, plant and equipment (w (i))		45
loss on disposal of plant (60 – 48)		12
insurance claim		(15)
Operating profit before working capital changes		184
increase in inventories (86 – 72)		(14)
increase in accounts receivable (74 – 41)		(33)
increase in accounts payable (74 – 65)		9
Cash generated from operations		146
interest paid		(6)
income tax paid (w (ii))		(51)
dividends paid (w (iii))		(54)
Net cash inflow from operating activities		35
Cash flows from investing activities		
Purchase of property, plant and equipment (w (i))	(116)	
Proceeds of sale of plant	48	
Net cash used in investing activities		(68)
Cash flows from financing activities		
Issue of share ordinary shares (w (iv))	30	
Redemption of preference shares ((50 – 30) x 110%)	(22)	8
Net decrease in cash and cash equivalents		(25)
Cash and cash equivalents b/f		12
Cash and cash equivalents at the end of the period		(13)

Workings		$000
(i)	Property, plant and equipment	
	Carrying value b/f	455
	Revaluation (w (v))	29
	Disposals at carrying value	(60)
	Depreciation for year	(45)
	Carrying value c/f	(495)
	Difference cash purchase	(116)
(ii)	Income tax	
	Tax provision b/f	(32)
	Deferred tax b/f	(32)
	Income statement tax charge	(48)
	Tax provision c/f	40
	Deferred tax c/f	21
	Difference cash paid	(51)
(iii)	Movement on accumulated profit	
	Balance b/f	256
	Transfer from revaluation reserve	4
	Profit for year	88
	Balance c/f	(294)
	Difference – dividend paid	54
(iv)	Issue of ordinary shares	
	Increase in ordinary share capital (120 – 100)	20
	Increase in share premium (38 – 30)	8
	Premium on preference shares charged to share premium ((50 – 30) x 10%)	2
	Proceeds of issue	30

(v) Movement on revaluation reserve

Balance b/f	15
Transfer to accumulated profits	(4)
Balance c/f	(40)
Difference – revaluation of head office	29

(b) IAS 7 encourages management to disclose and comment on several aspects of cash flow reporting. This information is intended to help users to gain a better understanding of the financial position and liquidity of the company. The Standard encourages the amount spent on operating capacity (as part of investing activities) to be separated between cash flows that maintain operating capacity and cash flows spent on increasing capacity (if any). This information allows users to assess whether the company is investing adequately in maintaining its operating capacity. If not, the future performance of the company may be impaired. Also information regarding cash flows spent on increasing operating capacity will give a valuable indication of the growth prospects of the company.

The Standard also encourages the separate disclosure of segment cash flow information. This disclosure is consistent with the provision of segment information within the income statement and balance sheet. A company is a composite of its separate elements (segments). To achieve a better understanding of the cash flows as a whole, it is useful to analyse the cash flows of its individual parts. It is important to know which parts of the business are producing cash inflows and which parts are consuming them. Management's attention can then be directed to those areas that are consuming cash inefficiently.

5 (a) (i) Rules and Code

1. ACCA's *Rules* and IFAC's *Code of Ethics* require that auditors must be, and be seen to be, independent in order to achieve the degree of perceived objectivity required of an external auditor.
2. The *Rules* and *Code* do not yet deal specifically with the provision of internal audit services, however, both emphasise the fact that it is essential that auditors do not make management decisions and that the client should accept responsibility for the financial statements and internal controls. The *Rules* state that there is no objection, in principle, to auditors providing other services to audit clients. There is clearly a greater risk in relation to clients listed on stock exchanges, and 'public interest' clients, than to other clients.
3. The *Rules* recognise that it is a long-established practice in many jurisdictions, for external auditors to provide accountancy and bookkeeping services to smaller clients (those that are not 'public interest' or listed on stock exchanges). It is essential that management takes responsibility for the financial statements and that the audit firm conduct appropriate audit tests. It is also preferable that staff other than those providing the additional services perform the audit. The *Rules* state that assistance of a mechanical nature (such as the finalisation of the statutory accounts) and assistance provided in an emergency may also be acceptable for 'public interest' clients and clients listed on stock exchanges. The *Code* requirements are similar to those of the *Rules*.
4. The *Rules* and *Code* do not currently deal with legal services or systems advisory or implementations services separately.
5. In many jurisdictions, the level of fee income from the provision of non-audit services to audit clients is disclosed in the financial statements and this may have a bearing on the decision by a firm as to whether to provide such services, and to what extent.

(ii) Total ban or greater limitations

Internal audit

1. Some large firms provide out-sourced internal audit services to their audit clients, although many have abandoned this practice, in order to be seen to be independent and objective. In certain jurisdictions, the level of income generated by the provision of internal audit services to a particular client is restricted.
2. It has been suggested that the provision of operational internal audit services unrelated to the accounting or financial systems may not present a threat to objectivity. It is also suggested that the self-review threat arising from services relating to accounting or financial systems may be reduced by means of safeguards. Safeguards might include maintaining a clear separation between the control of internal audit by management and the internal audit activities themselves, requiring internal audit to report to an independent audit committee, and controlling internal audit through competent and senior individuals within the client.
3. It is clearly preferable for staff other than those employed as internal auditors to perform the external audit.
4. However, there are those who suggest that audit firms should be prohibited from providing such services because commercial pressures, in practice, mean that the external auditor's objectivity will always be compromised where non-audit services are provided, because the provision of internal audit services will often represent a substantial level of fees, and because internal audit is part of the overall management function.

Accountancy and bookkeeping services

5. There have been few calls for an outright ban on the provision of these services, probably because the fee income is not significant. However, there are some jurisdictions that prohibit such services. It is generally recognised that technical assistance on the preparation of complex financial statements for large companies may be desirable. It has been suggested that it is sometimes necessary for the auditors of subsidiaries of large companies to help with the preparation of financial information provided that the information is immaterial to the group financial statements and the related fees are insignificant to the total.

6. Some of the jurisdictions in which such services are banned outright do not require an audit of relatively small companies and the ban therefore applies, in practice, to larger companies that should be able to prepare their own financial statements.

Legal services

7. In some jurisdictions, legal services are not provided by external auditors simply because the legal profession does not permit its members to work with auditors. In others, there are links between legal firms and audit firms and many large firms now employ lawyers, however, employed lawyers in many jurisdictions are not permitted to appear before the courts.

8. There are two threats to auditor independence, the self-review threat and the advocacy threat. The former involves the threat posed by the auditor reviewing his or her own work. The latter involves the auditor promoting the client's interests to the extent that the auditor subordinates his or her judgement to that of the client.

9. Lawyers employed by auditors and clients' in-house lawyers may provide advisory services. Independent lawyers may provide advisory and advocacy services. As with any other advisory service, it is suggested that threats to independence may be reduced by ensuring that those who provide the advice do not work on the audit and that the client make final decisions. However, advising or acting in an advocacy role for the client in relation to a dispute or litigation that may have a material effect on the financial statements is not generally considered to be acceptable (for immaterial matters, safeguards may be implemented).

Systems advisory and implementation services

10. Like internal audit, this type of work can generate significant fees for small and large firms alike. Smaller clients in particular might require this type of service from their auditors. However, there is a very real self-review threat for advisory, and to a greater extent implementation, services although in practice it can be difficult to distinguish between the two.

11. It is arguable that, particularly for larger clients, at the very least there should be safeguards put in place where either type of service is provided, and that the firm should not report on an entity where the systems involved generate financial information. This is simply because it would be very difficult for a firm to justify the issue of a modified audit report on financial statements derived from a system with which the firm had had significant involvement.

12. Furthermore, there might be pressures for the audit firm to rely excessively on systems documentation, for example, that had already been produced by staff on the design or implementation of systems, rather than performing a thorough independent review, simply in order to avoid internal disputes within the firm.

(b) Compulsory rotation

(i) The general safeguards against the loss of independence listed in the *Rules* include a suggestion that senior staff and the audit engagement partner should be rotated periodically. The *Code* states that the use of the same senior personnel on an audit engagement over a prolonged period of time may pose a threat to independence. It also notes the important point that once professional relationships are developed, they usually lead to maximum efficiency and effectiveness. It is a common complaint amongst larger clients that there is insufficient continuity of staff, and that this can lead to matters being duplicated or missed. However, the *Code* suggests that the firm should make provision for the orderly rotation of senior staff, including the audit engagement partner.

(ii) Many jurisdictions require the rotation of the audit engagement partner (a common period is seven or five years) for the auditors of companies listed on stock exchanges and 'public interest' companies, either through codes of professional ethics, as a result of legislation or because of securities regulations. However, very few, at present, require the rotation of the audit firm.

(iii) There have been calls, recently and in the past, for the rotation of audit firms. Most professional bodies oppose this and point to evidence that suggests that material errors are more likely to go undetected where there is a change in auditors, to the long learning curve associated with large companies and to the associated costs to the client. They also point to the fact that there are relatively few large firms that have the resources to audit large multi-national companies and that rotation, in practice, would be restricted to a few large firms which would not be efficient.

(iv) It is important, however, that the appearance of independence be preserved and it is sobering to consider that the auditors of some large companies have not changed for decades.

6 (a) Examples of accounting estimates – why they are important

(i) 'Simple' accounting estimates such as provisions for depreciation, bad debts and obsolete inventory are often regarded as straightforward, but they are important because, like more complex provisions, they are easy to manipulate. They often have an effect not only on the profit figures, but also affect key operating, financial and liquidity ratios to which analysts pay great attention.

(ii) More complex estimates such as those required under IAS 19 *Employee Benefits*, and the fair value adjustments required for consolidations and the valuation of financial instruments and intangible assets, are not only material to financial statements, they are often technical, and difficult to understand and apply. This renders financial statements opaque without extensive disclosure and makes comparison of financial position and performance difficult across jurisdictions where there are different rules, and even across companies in the same jurisdiction where the bases of calculation differ. The disclosure of the basis of accounting estimates is therefore increasingly important.

(b) Approach to the audit of accounting estimates

(i) ISA 540 *Audit of Accounting Estimates* requires that auditors apply a combination of the following:

1. review and test the process used by management to develop the estimate;
2. use an independent estimate for comparison with that prepared by management;
3. review subsequent events which confirm the estimate made.

(ii) The independent estimate may be a costly process and is likely to involve reliance on the work of an expert in accordance with ISA 620 *Using the Work of an Expert*.

(iii) The review of subsequent events may reduce or even eliminate the need for the review and testing of the process used by management to develop the estimate, although this is unlikely to be the case where goodwill amortisation and similar 'long-term' estimates are involved, and particularly where large companies with tight reporting deadlines are concerned.

(iv) The comparison of accounting estimates made in the past with actual results not only provides evidence in relation to the quality of the particular estimate concerned, it also provides evidence in relation to the general competence of management in making such estimates over a period of time.

(v) In practice, the requirement to review and test the process used by management is the most important. This involves the following:

1. the evaluation of data and assumptions on which the estimate is based;
2. testing the calculations;
3. consideration of management approval procedures.

(vi) The main problem in practice in relation to many of these requirements results from the fact that the auditor is not an expert in the evaluation of accounting estimates and he is required to rely on the work of experts who at a minimum, review the work of the expert employed by the client to perform the original calculations. This not only involves time and cost, but also requires the co-operation of both the client and the client's expert. The auditor is then in the position of having to 'adjudicate' between possibly conflicting findings of experts and to form an opinion as to whether the findings are so different or sensitive, as to have a material effect on the financial statements. It is not uncommon for auditors to have findings covering a very wide range of values, all of which are reasonable and consistent with the auditor's knowledge of the business and management intentions.

(c) Reliance on management representations

(i) ISA 580 *Management Representations* states that auditors should obtain written management representations on matters material to the financial statements when other sufficient appropriate evidence cannot reasonably be expected to exist.

(ii) Auditors normally seek to obtain corroborative evidence for management representations and evaluate whether they are consistent with the other audit evidence obtained, however, there may be little or no corroborative evidence in relation to significant estimates where the estimate is made on the basis of management assumptions.

(iii) Matters in the example letter in the appendix to ISA 580 include representations to the effect that management has no intention to abandon inventory lines that would require provisions, and that losses arising from sale and purchase commitments have been properly recorded and adequately disclosed.

(iv) It is arguable that auditors do not need to seek representations in relation to many estimates because corroborative evidence is available in the form of evidence provided by experts (although that evidence is often based on management assumptions).

(v) Auditors sometimes seek to transfer responsibility for the audit to their clients by seeking management representations – management is likely to resist this. It is therefore preferable, perhaps, for auditors not to seek representations on the figures and disclosures included in the financial statements, but for them to seek representations on the assumptions used in the calculations.

7 (a) Response to explanations

(i) Firstly, the level of non-application of the control procedures is high. The auditor's overall objective is to form a conclusion as to whether the control has been applied throughout the period under review or whether the application of the control procedure has broken down. This is usually achieved by establishing the reason for the failure of the control and establishing the extent of it, by enquiry and further testing if necessary (ISA 530 *Audit Sampling and other Selective Testing Procedures*).

(ii) If the auditor concludes that controls have broken down, the next stage is to decide whether there are alternative controls that can be relied upon. If not, it may be necessary to resort to wholly substantive procedures (either detailed testing, analytical procedures or a combination thereof).

(iii) For the two cases in which the invoices were issued in an interim period during which there was no credit controller, there appears to be a breakdown in controls. The auditors will need to establish how long this period represented, and the level of unauthorised credit notes issued during that time.

(iv) Where the credit controller made verbal authorisation, the control has not entirely broken down but the auditor has to establish whether, again, this went on for a sustained period and to form a view as to whether a verbal authorisation is adequate. This will in turn depend on the auditor's assessment of overall risk in this particular area, and perhaps on the integrity of the credit controller.

(v) Where authorisation had not been made at all because of the computer breakdown, the auditor should not only assess the extent of the breakdown, but also establish whether the credit notes issued during that period were valid, and the extent to which the breakdown had an effect on other areas subject to audit.

(vi) The auditor should also consider inclusion of the control weaknesses discovered (together with recommendations for improvement) in a report to management, as suggested by ISA 400 *Risk Assessments and Internal Control* and ISA 260 *Communication of Audit Matters with Those Charged with Governance*.

(vii) Where there are significant breakdowns in the application of internal control procedures, there is a potential fraud risk and the auditor should consider the implications of his findings in the light of other audit evidence obtained (ISA 240 *The Auditor's Responsibility to Consider Fraud and Error in an Audit of Financial Statements*).

(b) Limitations and alternatives – evidence on internal controls

(i) This type of test relies on sampling and is subject to sampling error. Sampling error consists of sampling risk (the risk that the sample will not be representative of the population from which it is drawn) and non-sampling risk (the risk that errors will be made for other reasons, such as errors of judgement).

(ii) Now that computerisation is effective in many companies, it is suggested that better alternatives to this type of test include a detailed review of the control structures, and analytical procedures applied to the population controlled, to give a more holistic view. It is suggested that this is a more effective use of the audit budget and staff time. This moves the focus of the audit to a 'higher' level.

(iii) There are, however, critics of this approach who regard the change of focus as an excuse, by large firms in particular, to cut audit costs and to avoid 'getting their hands dirty' by avoiding 'messy' situations such as the situation described in the question.

(iv) The response to this is that it is necessary for auditors to be as efficient as possible, that there is nothing inherently wrong with cutting audit costs and that the situation described is often, in practice, time consuming for auditors without any real benefit either to the audit as a whole, or to the client.

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)**	Syphon's goodwill		
		gross cost of investment		1
		pre acq dividend		1
		share capital		1
		pre acq reserves		1
		revaluation reserve		1
		Andean's goodwill		
		cost of investment		1
		share capital		1
		pre acq reserves		1
		fair value adjustment		1
			maximum	**9**
	(b)	Income statement:		
		sales revenue		3
		cost of sales		3
		operating expenses		3
		interest		1
		associated company income		2
		income tax		1
		minority interests		1
			available	14
			maximum	**13**
	(c)	1 mark for each item		3
			Maximum for question	**25**

				Marks
2	**(a)**	Income statement		
		sales revenue		1
		cost of sales		3
		operating costs		1
		loan interest		1
		impairment		1
		taxation		1
			available	**8**
			maximum	**7**
	(b)	Changes in equity		
		revaluation reserve		2
		movement on accumulated profits		2
		disclosure of dividends		1
			available	**5**
			maximum	**4**
	(c)	Balance sheet		
		development expenditure		2
		property, plant and equipment		4
		inventory		1
		trade receivables		1
		loan stock		1
		deferred tax		1
		current liabilities		2
			available	**12**
			maximum	**10**
	(d)	basic earnings per share		1
		reference to anti-dilution		1
		effect of director's options		1
		effect of convertible shares		1
			maximum	**4**
			Maximum for question	**25**
3	**(a)**	contract revenue in 2000		1
		cost of sales in 2000		1
		contract revenue in 2001		2
		cost of sales in 2001		2
		contract revenue in 2002		3
		cost of sales in 2002		3
		balance sheet (1 mark for each year)		3
			available	**15**
			maximum	**12**
	(b)	definition of additional asset		1
		definition of a variation		1
		conclusion that it is not a separate contract		1
			maximum	**3**
			Maximum for question	**15**

				Marks
4	**(a)**	operating profit		1
		depreciation adjustment		1
		loss on sale of plant		1
		insurance adjustment		1
		working capital items ($^1/_2$ each)		$1^1/_2$
		interest paid		$^1/_2$
		tax		1
		dividends paid		1
		purchase of property, plant and equipment		1
		sale of plant		1
		share issue		1
		redemption of preference shares		1
		movement in cash and cash equivalents		1
			available	**13**
			maximum	**11**
	(b)	1 mark per relevant point to a	**maximum**	**4**
			Maximum for question	**15**

5	**(a)**	**(i)** *Rules and Code*	
		Up to 1·5 marks per point to a maximum of	4
		(ii) Total ban or greater limitations	
		Up to 1·5 marks per point to a maximum of	12
		(NB: No more than 3 marks per category)	
	(b)	Compulsory rotation	
		Up to 1·5 marks per point to a maximum of	4
		Total	**20**

6	**(a)**	Examples of accounting estimates – why they are important	
		Up to 2 marks per point to a maximum of	4
	(b)	Approach to the audit of accounting estimates	
		Up to 1·5 marks per point to a maximum of	7
	(c)	Reliance on management representations	
		Up to 1 mark per point to a maximum of	4
		Total	**15**

7	**(a)**	Response to explanations	
		Up to 2 marks per point to a maximum of	10
	(b)	Limitations and alternatives - evidence on internal controls	
		Up to 2 marks per point to a maximum of	5
		Total	**15**