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## TEST OF PROFESSIONAL SKILLS

### Assurance and Data

Total marks: 100

Date: Thursday 9 June 2022. Time: 10:00 – 14:15

Duration: 4 hours plus 15 minutes break.

### Notes to Candidates

This paper contains four exam questions and appendices. Candidates should attempt all four questions.

Please read each question carefully and follow the instructions fully with regards to response requirements. Candidates who do not provide their responses in the correct format may be penalised.

- You are permitted to submit **ONE Microsoft WORD document** at the end of your exam
- You are allowed to use Microsoft Excel during the exam **HOWEVER** you **MUST** copy and paste your Microsoft Excel output(s) into your final Word document.
- All Microsoft Excel output(s) included in Microsoft Word must be legible and viewable.

You **MUST NOT** submit this question paper as part of your answer.

In submitting this exam, you confirm that your conduct throughout the exam adheres to the [ICAS Academic Integrity Policy](#). You confirm that you did NOT act in any way that would constitute cheating, misrepresentation or unfairness including, but not limited to, using unauthorised aids and assistance, impersonating another person and committing plagiarism.

You agree that ICAS will check your work for plagiarism and you confirm that you understand that assessed work that has been shown to have been plagiarised will be penalised.

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## QUESTION 1 (40 marks)

You are the audit manager on the audit of the financial statements of Lumen Fire & Security Ltd ('LFS'), a new client, for the year ended 30 June 2022. You are currently planning the external audit team's approach to the audit of plant, property and equipment ('PPE').

LFS develops and manufactures fire alarm, security and lighting systems and distributes these to customers worldwide. The company's head office is based in Birmingham, England along with a large manufacturing site and distribution hub.

LFS also has manufacturing sites and distribution hubs in various locations throughout the UK and France. In addition to the Birmingham manufacturing site and distribution hub, there are two further English manufacturing sites in Newcastle and Oxford. There are also two further English distribution hubs in Leeds and Luton. In France, the company has two manufacturing sites and one distribution hub.

There have been several developments during the year to 30 June 2022 in respect of PPE. The lease on the Luton distribution hub property is due for renewal in October 2022 and negotiations began in October 2021. The negotiations were not favourable and the decision was made in December 2021 to close the Luton distribution hub at the end of the lease and move the activity to the Birmingham distribution hub. LFS' board of directors ('the board') decided to develop surplus unused space at the Birmingham hub to increase its capacity to enable this transition. The Oxford manufacturing site was also subject to significant maintenance during the year.

You recently met with LFS' financial controller, Janet Francis, who provided you with background on the company's PPE processes, including those around record keeping and maintenance and review (Appendix 1). The audit team is planning to place assurance on LFS' internal control processes around PPE and your audit partner, Clive Gollings, would like you to review the information provided and identify the key controls within the PPE system at LFS which are designed effectively to prevent, detect or correct misstatements in the PPE balance, and evaluate why each control would be classified as a key control for the purpose of the external audit. Furthermore, he would like you to design tests of controls to confirm the operating effectiveness of each identified key control.

Clive also mentioned that LFS carries out a quarterly count of its PPE. LFS' internal audit team also carried out an annual review of PPE (Appendix 2) alongside the March 2022 counts. This review included physical verification of a sample of PPE held by the company at individual locations. Clive has noted this as a key control and therefore this does not need to be considered as part of your review of Appendix 1.

Clive intends for the external audit team to place reliance on the work of internal audit but, as this is a new client, he has determined that some physical verification of PPE should still take place. Therefore, he would like you to review the results of the internal audit review and to recommend which of the locations the external audit team should attend to conduct a

physical verification of assets.

Finally, Clive mentioned that LFS usually carries out revaluations of their land and buildings every three years with the last full valuation carried out at 30 June 2021. Due to the development works carried out at the Birmingham distribution hub, the board has decided to undertake a revaluation of this site as a matter of urgency. The original proposal made by the board was to utilise the firm of chartered surveyors who undertake valuations of LFS' land and buildings every three years, Carter Lucas Valuations Ltd ('Carter'). However, as no valuation was scheduled for this year, the firm is unable to provide an indication of whether they can undertake this work and LFS' operations director has made an alternative suggestion for an expert to provide a valuation.

Paul Davies, who took part in the prior year valuation process, left Carter in March 2022 and formed his own firm. This followed the completion of his chartered surveyor qualification in February 2022. The operations director has stated that Paul would provide these services for a much lower fee than Carter as he works alone and therefore the valuation will not be required to go through a lengthy review process. He has also suggested that, depending upon the results of this engagement, LFS could consider using his services for the next full valuation of the land and buildings.

The majority of the work carried out by Paul Davies since forming his own firm has been domestic valuations and this assignment would be his first commercial activity. As the audit team will be seeking to place reliance on Paul's work at year end, Clive has requested you evaluate the proposal to use him as the external surveyor to determine whether it is likely that reliance can be placed by the external audit team on the revaluation of the distribution hub. Clive has noted that LFS may need to extend the revaluation exercise to all land and buildings and not just the Birmingham distribution hub and he will discuss this with the board directly.

**Required:**

1. In respect of the system notes detailed in Appendix 1, prepare information suitable for inclusion in the audit file where you:
  - (a)
    - (i) Identify the key controls within the PPE system at LFS which are designed effectively to prevent, detect or correct misstatements in the PPE balance.

**(4 marks)**
    - (ii) Evaluate why each control would be classified as a key control for the purpose of the external audit.

**(8 marks)**
  - (b) Design tests of controls to confirm the operating effectiveness of each identified key control.

**(8 marks)**
2. Prepare information, appropriate for inclusion in a memo to the audit partner, recommending, with reasons, which of the locations the external audit team should attend and carry out a physical inspection of PPE. (Note: you are not required to provide reasons for any locations that you determine should not be attended).

**(14 marks)**
3. Prepare information, suitable for inclusion in a briefing note to the audit partner, where you evaluate the proposal to use Paul Davies as the external surveyor to determine whether it is likely that reliance can be placed on his work by the external audit team.

**(6 marks)**

**(40 marks)**

## **APPENDIX 1 (QUESTION 1) – Notes from meeting with Janet Francis, LFS' financial controller**

### *Record keeping*

The company maintains a central PPE register for all sites at head office which forms the basis of the PPE figures in the financial statements. A reconciliation of the combined register to the nominal ledger is carried out monthly by a finance clerk, which is reviewed and approved by Janet, with any reconciling items investigated.

Assets are grouped by location and all assets have been assigned a sequential serial number, which is recorded in the PPE register. Only the finance department, based at head office, can make changes to the combined PPE register.

A full count of PPE at each site is carried out every quarter. LFS' internal audit team also carry out an annual review of PPE held by the company alongside the March count. Following each quarterly count, the site management will call the finance department to request any amendments needed.

A rolling five-year capital expenditure ('capex') budget, which is approved by the board, is maintained by the finance department and distributed to all department heads. All PPE expenditure requisition forms are sent to the purchasing director for authorisation who reviews the requisitions in conjunction with the approved capex budget. Upon authorisation, a purchase order ('PO') is raised and sent to an approved capital supplier. Any requisitions that are not included in the approved capex budget require secondary approval by Janet. Any requisition that is not part of the approved capex budget with a value above £10,000 requires further approval by the board.

When assets are received at a location, a multi-part goods received note ('GRN') is generated and a copy submitted to the finance department. A junior accounts payable clerk reviews each GRN and determines if the goods are of a capital nature. If the goods relate to capital expenditure she files these GRNs in a capital expenditure file. To help with time planning, she waits until there are approximately 10-15 GRNs before matching each one with the relevant PO and invoice. She then records the assets into the relevant category in the PPE register.

### *Maintenance and review*

There is a rolling maintenance and review programme for the manufacturing equipment owned by LFS. All production line PPE is subject to monthly maintenance checks and any remedial works completed as a priority. Manufacturing equipment is replaced in line with the expected life as determined by the equipment manufacturer. Manufacturing equipment is depreciated based on individual useful lives as per their replacement cycle.

The maintenance and review programme identifies pieces of surplus equipment, which are then either scrapped or sold. Material usage and wastage is also reviewed every two years by the financial controller to ensure efficiency of the equipment is in line with production targets.

## APPENDIX 1 (QUESTION 1) (continued)

### *Vehicles*

The keys for the vehicles are stored in a safe at each distribution hub with only the site manager and foreman having access. Vehicles are allocated daily to the drivers with keys for the vehicles being signed out by the user of the vehicle for that day. All vehicles are fitted with GPS trackers and are registered with a monitoring company in case of theft.

### *Site ownership*

LFS owns its three UK manufacturing sites, the Birmingham distribution hub and head office premises. The title deeds for the owned properties are secured by the LFS finance department in an electronic fire-proof safe at the Birmingham head office. The remaining UK distribution hubs and all of the French premises are leased and the original lease agreements are also secured in the safe.

Access to the safe requires a four-digit pin code. A universal four-digit code is used for all safes within the LFS company. All sites are covered by company provided fire and security systems, with a centralised monitoring station at the head office.

### *Land and building valuations*

Each year, Janet undertakes a desktop valuation of the land and buildings to ensure that the net book values are appropriate based on local market conditions. If any significant movements are anticipated, an independent third-party valuer, Carter Lucas Valuations Ltd, is engaged to corroborate the value.

**APPENDIX 2 (QUESTION 1) – Annual review of PPE provided by LFS’ internal audit team**

<b>Description of location</b>	<b>Main asset categories on site</b>	<b>Forecast PPE net book value 30 June 2022 (£'000)</b>	<b>Audited PPE net book value 30 June 2021 (£'000)</b>
Birmingham head office	Land & buildings, fixtures and fittings, computer equipment, motor vehicles	1,247	1,132
Birmingham manufacturing site	Land & buildings, fixtures and fittings, plant & machinery	377	302
Birmingham distribution hub	Land & buildings, fixtures and fittings, commercial vehicles	78	57
Newcastle manufacturing site	Land & buildings, fixtures and fittings, plant & machinery	312	305
Leeds distribution hub	Fixtures and fittings, commercial vehicles	57	59
Oxford manufacturing site	Land & buildings, fixtures and fittings, plant & machinery	354	374
Luton distribution hub	Commercial vehicles	95	189
France manufacturing sites (combined)	Fixtures and fittings, plant & machinery	210	210
France distribution hub	Fixtures and fittings, commercial vehicles	189	189
<b>Total</b>		<b>2,919</b>	<b>2,817</b>



## APPENDIX 2 (QUESTION 1) (continued)

### *Findings from internal audit review carried out in 2021-22*

- Three of the four production lines at the Oxford manufacturing site were subject to substantial maintenance during the year, with the replacement of numerous significant components on a like for like basis. When visiting this site, the fourth production line was not in use due to a reduction in demand for the products produced by that line. Due to a lack of activity on this line, the site manager reduced maintenance on this line and several components are now overdue for replacement.
- A significant amount of time was allocated to the March 2022 PPE count at the head office site due to the number of new PPE items. During the year, LFS replaced the computer equipment at the site including the purchase of new expensive laptops and tablets for the sales teams. The asset count identified that several items of the older computer equipment that were written off in the PPE register were still in use, with the new equipment not at the site and therefore unable to be verified.
- The meeting rooms at head office were subject to refurbishment to a very high standard, the expenditure which was deemed to be capital expenditure by the junior accounts payable clerk.
- The development of the surplus unused space to increase capacity at the Birmingham distribution hub involved a significant programme of works, effectively doubling the size of the warehouse. Various work was carried out to also increase the energy efficiency of the warehouse. All costs relating to this project were capitalised.
- PPE from the Luton distribution hub has started to be reallocated to the other sites within the business, mainly the Birmingham distribution hub, or scrapped/sold if determined to be surplus to requirements or damaged. This process has been managed by the operations team at LFS with minimal input from the finance department. In March 2022, the internal audit team identified assets at the Luton distribution hub that the site foreman had requested be removed from the PPE register as they had been scrapped, in particular a small forklift truck and several pieces of computer equipment.
- There were no issues noted from visits to the Birmingham and Newcastle manufacturing sites or Leeds distribution hub.
- There were no issues of any significance identified at the French sites. The internal audit team undertook test counts of the PPE counting process remotely through online meetings with the assistance of the local onsite team.

## QUESTION 2 (20 marks)

You are a business consultant engaged by Smile Software Limited ('Smile'), a large company which provides software to over 40% of private dental practices around the UK. The software allows practices to book appointments, manage patient records, record clinical notes, hold payment details, create patient statements and generate numerous informative reports. The software is accessed on a cloud-based system which is hosted on secure cloud servers.

Smile's customers have been asking for some time to get additional functionality within the software to compare their practice to other practices within their region and the wider UK. By adding a new 'data insight' module to their product, Smile's customers will be able to create targeted marketing campaigns for their patients (based on age / gender / geography), use a built in tool to benchmark pricing of individual treatments to the overall market and ensure that customers can identify trends in treatments in real time.

As the types of treatments available continually changes, the data insight module will analyse data relating to patient treatments for the last three years. However, dental practices are required by law to maintain data relating to patients for at least eleven years after the completion of treatment, for children until the age of 25 or whichever period is longer.

With this in mind, the Smile board of directors ('the board') has recently met and agreed a new business strategy to grow the business by 30% by June 2024 with a view to listing on the London Stock Exchange later that year. In order to do this, they have approved a budget for the company's IT department to develop the new data insight module and hope that this will generate revenue growth and win new customers.

In advance of developing the new data insight module, the board is keen to ensure that Smile's current data management processes are effective. Information regarding Smile's processes have been provided by IT director, Stuart Rodgers, (Appendix 1) and you have been engaged to conduct a review over Smile's current data management processes in advance of developing the new module.

### Required:

1. Prepare information, suitable for inclusion in a report to the board, in which you identify the weaknesses, evaluate the implications and recommend improvements to Smile's data management processes.

**(20 marks)**

## APPENDIX 1 (QUESTION 2) – Key information and comments relating to data management processes at Smile, provided by Stuart Rodgers, IT director

Smile has two cloud-based servers:

- Server one contains Smile's customer information (eg dental practice bank account details for payment, contact information and correspondence) and this is referred to as **customer** data.
- Server two stores the dental practice patient information (eg treatment history, patient contact information, patient medical records and any debit/credit card details used to pay for treatment since becoming a patient). This is referred to as **client** data.

When a customer (dental practice) engages with Smile, they pay an upfront fee and a rolling monthly subscription thereafter. The upfront fee covers time for an implementation manager to visit the practice, install the software and provide training to staff. The monthly subscription covers licenses to the platform, third party hosting and ongoing customer support. There have been a number of reports made by dental practices to customer support recently that other people at the practice are able to see the full profile of patient information and not just the dentist in charge of that patient.

Last year a migration exercise took place to move various old software updates and old anonymous customer data from a hard drive onto server one. It was subsequently detected that an attack on the network had taken place that resulted in some of this customer data being unlawfully accessed. Smile had not updated their cyber security and firewalls since the employee in charge of this left and did not explain to the new staff member that this required annual review. On a weekly basis, customers' details are backed up onto server one, however the back-ups have not been tested for twelve months.

In early 2012, it was decided that Smile should set up a new cloud-based server (server two) and it should start storing client data. Initially, Smile only stored client data from dental practices based in London and gradually rolled out this process across the UK.

By late 2013, client data captured by customers from 2008 onwards was successfully stored by Smile. Approximately 20% of this data is saved as PDF files and is unable to be interrogated in its current form.

The following data is held on clients:

- Name
- Age and gender
- Practice they are a client of
- High level category of treatment received (note 1)
- Average cost of treatment category
- Patient medical conditions

*Note 1- No detailed treatment information is held on clients. Currently treatments are grouped into high level categories, for example, teeth whitening is under "Cosmetic", fillings are grouped into "Tooth repair" etc.*

## **APPENDIX 1 (QUESTION 2) (continued)**

Smile plans to use all of the client data held within server two from 2008 onwards to inform the new data module as the board believes the more data the better. All of the data stored has not been manipulated in any way or reviewed since it was created.

Smile has a data retention policy but it was created many years ago and it only concerns customer data, making no reference to client data and, therefore, all data stored on server two is available to Smile for the new module.

### QUESTION 3 (22 marks)

You are the audit manager planning the group audit of Delta Oil International Group Limited ('Delta Oil') for the year ended 31 August 2022. Specifically, you are evaluating potential audit risks and calculating overall group materiality and the trivial threshold.

Delta is a mid-size independent oil producer and has been your audit client for the past five years. Prior to this financial year, the group had only one trading subsidiary, Delta Drilling Limited ('Delta Drilling') and its operations consisted of one platform operating in the UK North Sea and a corporate office based in London, England.

You recently met with Steven Milner, the chief financial officer, to get an update of business developments during 2021-22 to help with your audit planning and Steven informed you that the group had acquired two 100% owned subsidiaries during the year.

The new subsidiaries are UK company, Progressive Renewables Limited ('Renewables') and a US company, Permian Fracking Inc, trading as Frackmaster ('Frackmaster'). The companies were acquired on 30 November 2021 and 31 January 2022 and gave rise to goodwill of £30m and £15m respectively. The group, comprising Delta Oil and its subsidiaries, reports in pounds sterling and prepares consolidated financial statements based on International Financial Reporting Standards ('IFRS'). All members of the group have a year end of 31 August 2022 and there are no intercompany transactions.

As at June 2022 the management of the two new components of the group is de-centralised as the integration process is still ongoing. As a result, financial information is produced for review by management under three segments: the combined results of Delta Oil and Delta Drilling; Renewables; and Frackmaster. On a monthly basis, Delta Oil's board of directors ('the board') receives a financial performance pack consisting of a consolidated group income statement, summary information on revenue performance and liquidity ratios for the three segments and a projection of the group's cash position for the next twelve months.

Steven provided you with the financial performance pack summarising the group's financial performance for the nine-month period to 31 May 2022 (Appendix 1). He also provided you with extracts from the investment appraisal analysis carried out in advance of the two acquisitions which was presented to Delta Oil's board and investors (Appendix 2). The investment appraisal provides a high-level description of the principal activities and prospects of the acquisitions.

To aid with the audit team's understanding, Steven also provided an extract of an email from Melanie Forrest, Delta Oil's financial controller, outlining the consolidation process following the new acquisitions (Appendix 3).

Steven noted that performance for the first nine months of the year had been impressive. He was particularly pleased with the profit trajectory considering the volatility of oil markets. Profit before tax is a key metric under the group's banking facility as there are associated covenants which are tested quarterly based on several profit related metrics. Furthermore, Delta Oil's shareholders have been actively considering listing on the London Stock Exchange in the medium to long term. Consequently, profitability and dividend prospects would be a key focus for analysts considering investing in the group's shares.

**Required:**

1. Prepare information suitable for inclusion in a note to the audit partner in which you identify and evaluate the audit risks for the Delta Oil group.  
**(17 marks)**
  2. Recommend a level for overall group materiality and the trivial threshold, giving explanations justifying your value.  
**(5 marks)**
- (22 marks)**

## APPENDIX 1 (QUESTION 3) – Financial performance pack of Delta Oil International Group for nine-month period to 31 May 2022

### Consolidated group income statement For the nine-month period ended 31 May 2022

	Actual £'m	Budget £'m	Variance £'m      %	
<b>Revenue</b>	<b>323.1</b>	<b>315.6</b>	<b>7.5</b>	<b>2%</b>
Cost of sales	(226.1)	(213.0)	(13.1)	6%
<b>Gross profit</b>	<b>97.0</b>	<b>102.6</b>	<b>(5.6)</b>	<b>(5%)</b>
Gross margin	30%	33%		<b>(10%)</b>
Distribution costs	(16.1)	(17.4)	1.3	(7%)
Administrative expenses	(33.9)	(34.4)	0.5	(1%)
<b>Operating profit</b>	<b>47.0</b>	<b>50.8</b>	<b>(3.8)</b>	<b>(7%)</b>
Finance costs	(9.7)	(10.3)	0.6	(6%)
<b>Profit before tax</b>	<b>37.3</b>	<b>40.5</b>	<b>(3.2)</b>	<b>(8%)</b>
Tax	(6.4)	(6.9)	0.5	(7%)
<b>Profit after tax</b>	<b>30.9</b>	<b>33.6</b>	<b>(2.7)</b>	<b>(8%)</b>

- Revenue is ahead of budget due to a faster than anticipated oil price recovery. The acquisitions have also contributed to revenue growth with Renewables having a particularly strong quarter which was significantly ahead of budget.
- Gross margin has deteriorated against budget due to an increase in projected decommissioning costs. The group has legal decommissioning obligations under UK and US environmental regulations. The decommission obligation is estimated quarterly and the resulting changes are capitalised and amortised in cost of sales.
- Finance costs are lower than budgeted due to gains realised on forward exchange rate contracts. These gains are classified in finance costs. The group entered into forward exchange rate contracts to manage the increased foreign exchange rate risk from Frackmaster being a US based acquisition with a US\$ functional currency.

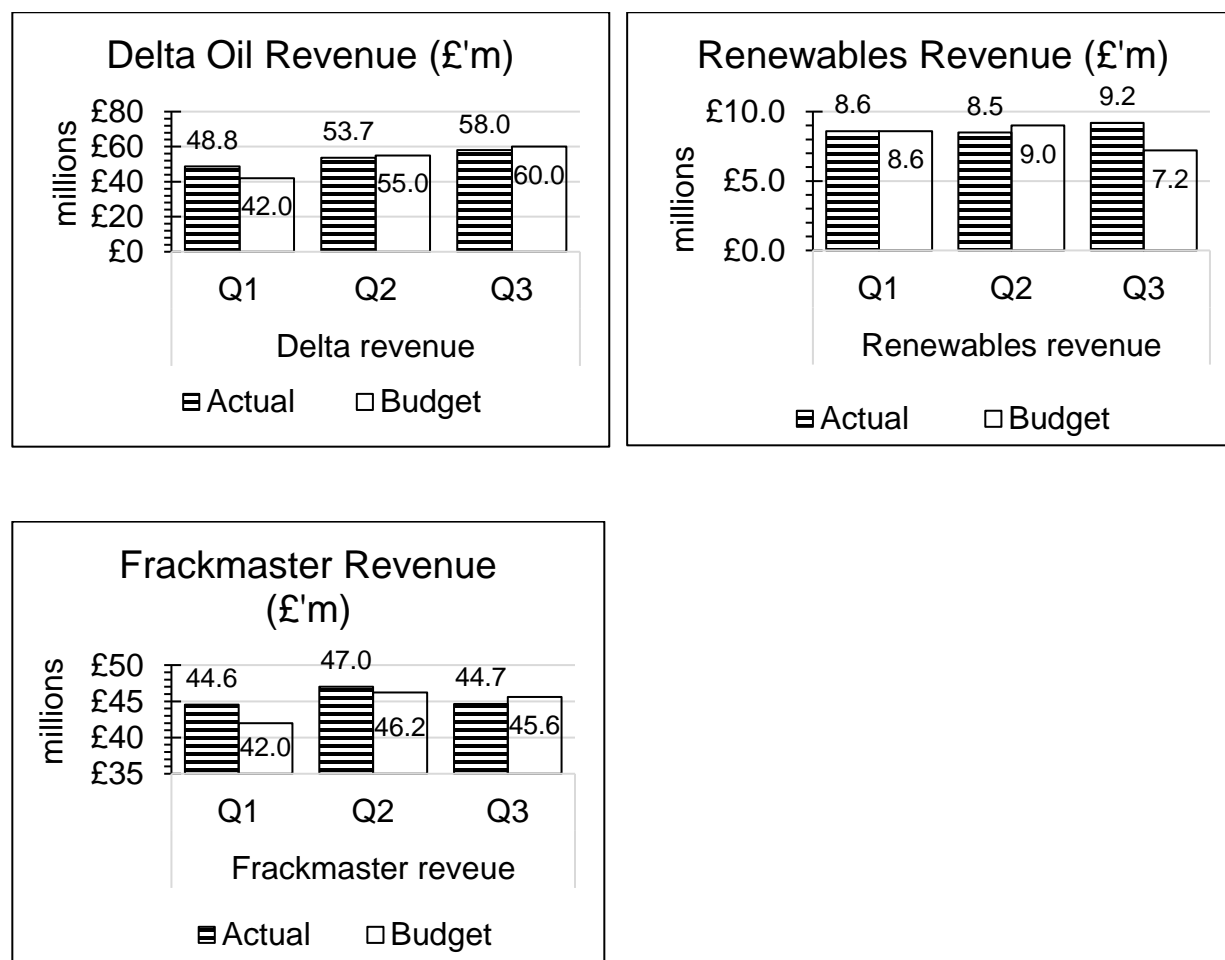
### Liquidity ratios

Liquidity ratios at 31 May 2022 compared to 31 May 2021 are set out below for the three segments.

Segment	Current ratio	Quick ratio	Debtor days	Creditor days
Delta Oil	<b>1.7</b> (2021: 1.6)	<b>0.8</b> (2021: 0.7)	<b>72</b> (2021: 70)	<b>64</b> (2021: 62)
Renewables	<b>1.2</b> (2021: 1.5)	<b>0.4</b> (2021: 0.7)	<b>85</b> (2021: 62)	<b>59</b> (2021: 57)
Frackmaster	<b>1.4</b> (2021: 1.5)	<b>1.1</b> (2021: 1.2)	<b>65</b> (2021: 67)	<b>78</b> (2021: 77)

## APPENDIX 1 (QUESTION 3) (continued)

### Revenue analysis for nine-month period to 31 May 2022 per segment



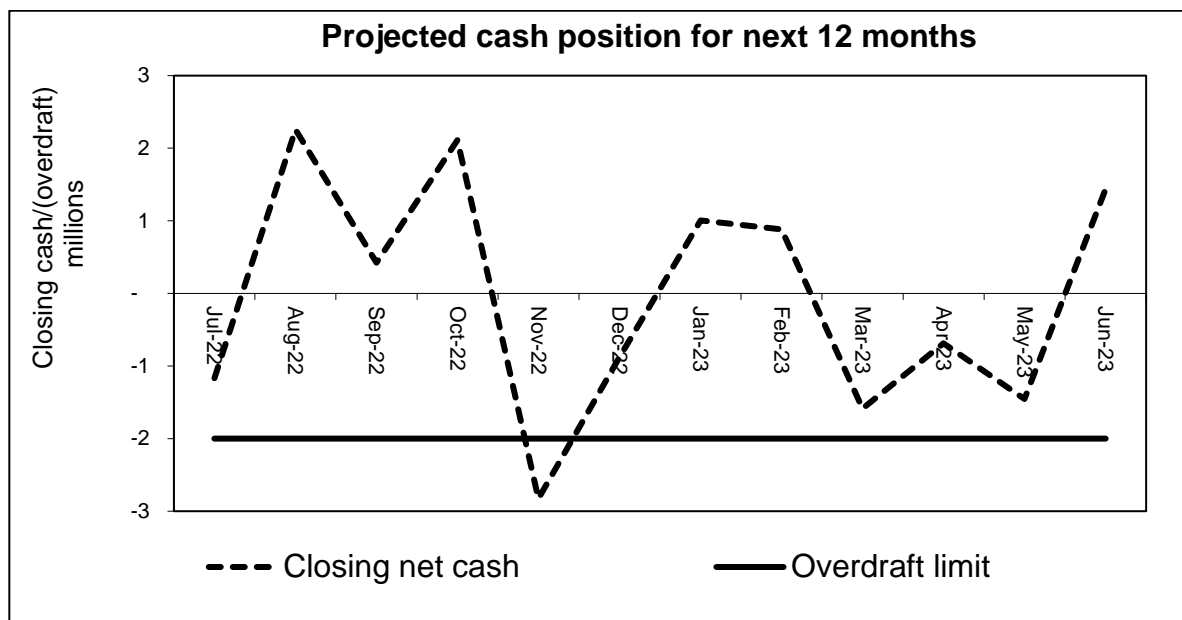
### Commentary on revenue performance for board

- Delta Oil and Frackmaster quarter one results were impacted by an unexpected recovery of oil prices.
- Renewables revenue has seen a surge in quarter 3 as demand for clean energy is rapidly increasing in the UK following government legislation and emission targets.



## APPENDIX 1 (QUESTION 3) (continued)

### Projected cash position for next 12 months



### Commentary on projected cash position for board

- Delta Oil group has a £2m limit on its existing overdraft facility which expires on 31 July 2023. Management are currently in discussions with the bank for an increase in the overdraft limit.
- Overdraft facility utilisation is conditional on the group being in compliance with the terms of the lending covenants which requires the group maintain net profit before tax of at least 10% of revenue.

## **APPENDIX 2 (QUESTION 3) – Extracts from investment appraisal analysis for acquisitions of Progressive Renewables Limited and Permian Fracking Inc**

### Progressive Renewables Limited

The company was formed three years ago and operates in the renewables energy sector. A 30 year offshore windfarm licence in the North Sea is the main source of revenue.

The company is projecting an operating loss of £8m for 2021-22. However, this sector is fast growing and it is expected, within the next five years, that this will become a profitable operation.

### Permian Fracking Inc

The company has fracking licences across the Permian Basin in North America and has active oil production facilities spread across 10 locations. The production facilities are mature and have an estimated 25 year remaining life at current production rates.

In addition to sites already in production, there are a number of exploration licences which expire over the next five years.

While there has been negative publicity against granting new fracking licenses in the US, management consider it is unlikely that renewals for existing licences, supported by feasibility studies, will be denied.

### **APPENDIX 3 (QUESTION 3) - Extract of email from Melanie Forrest to Steven Milner**

“It was good to catch up with you last week. I thought I would give you a high level overview of developments in the finance team and financial reporting environment. We have recruited a new group accountant to help with the increased volume of work and the need to prepare a revised monthly consolidation income statement and other relevant financial information following the acquisition of Renewables and Frackmaster.

The respective financial controllers for these businesses submit monthly financial reporting packs. Both companies still operate legacy accounting packages which are different from the existing group accounting package. We have developed a template for the segment reporting in an attempt to standardise and streamline the process.

Frackmaster historically prepared their US\$ financial information under US GAAP based accounting policies. In the case of our accounts we do not think there are significant differences between US GAAP and IFRS and therefore there are no amendments to Frackmaster’s results before submitting the monthly financial reporting pack.

Once the group accountant amalgamates the financial information, the monthly financial performance pack is generated. The pack is reviewed by senior management prior to circulation to the board. Our new group structure and consolidation is not complex and I expect it will be straightforward to audit.”

#### **QUESTION 4 (18 marks)**

You are the audit manager at the completion stage of the audit of Reconnect, a public sector body and public interest entity based in Ayr, Scotland for the year ended 31 March 2022.

Reconnect is an arms-length public body, which is sponsored by a central government department. They provide development support to rural areas of Scotland, to encourage new housing and enterprise opportunities, and improve physical and cyber infrastructure. Applications are usually from Community Development Trusts set up by the residents in the rural areas. Reconnect has a list of approved suppliers that must be engaged to fulfill the grant application.

The criteria used to assess each grant application is complex and there is much media and local council discussion about the selection of projects and the varying level of funding awarded. Several Members of the Scottish Parliament have been contacted by constituents concerned with inconsistencies in the application for the funding process.

A number of outstanding matters were identified during the audit and noted by the audit senior (Appendix 1).

Reconnect is a net expenditure body with overall net expenditure of £9,577,000 and materiality has been set at £95,000 for the financial statements and at £40,000 for the regularity opinion.

#### **Required:**

1. Evaluate each of the outstanding matters explaining any potential impact on the financial statements and, where applicable, any further actions or audit evidence that would be required.  
**(10 marks)**
2. Evaluate the potential implications for the audit report, including the financial statement opinion and regularity opinion, if any, for each of the outstanding matters.  
**(8 marks)**

**(18 marks)**

## **APPENDIX 1 (QUESTION 4) – Outstanding matters from audit fieldwork prepared by audit senior**

### *Grant applications*

Audit work identified that the assessment and awarding of grants did not always comply with the framework of authority in place. There were two instances where identical project applications from different Rural Community Trusts were declined. However, a third application was accepted. The monetary value of each of the grants was £55,000. No satisfactory explanation has been forthcoming from management to conclude on the different treatments identified.

### *Legal issue*

It was noted that legal action had been taken against Reconnect due to unsatisfactory completion of work by a supplier that had been approved for grant funding. The supplier, Smooth Builders, had completed the building of a small business complex in Kirkmichael. During the year, the Kirkmichael Rural Community Trust spent £100,000 to remedy poor workmanship by Smooth Builders and have taken legal action against Reconnect to be recompensed for this. No provision for any potential compensation costs have been made in the financial statements.

### *Subsequent event*

In a press article from a reputable national newspaper, dated 2 May 2022, it has been alleged that Reconnect had been routinely paying funding to approved suppliers before receipt of appropriate claim forms. The audit team did not find any evidence of this during the audit work performed, although it did have to chase Reconnect's Grant Application team a number of times for supporting paperwork for a number of claims paid out during the year. Photocopies of claim forms were eventually provided and the audit team agreed the payment details to Reconnect's bank statements.

As evidence was provided, management did not want to discuss the matter any further. However, the audit team noted that, following the release of the article, Eve Prunus, the Grant Application Manager, was placed on gardening leave.

### *Staffing issues*

During the year, Reconnect has had serious staffing issues. The Chief Financial Officer, Adam, has only been in his post for one month, following a nine month vacancy for the position.

The Deputy Finance Officer has also been on extended paternity leave for the last eight months, with various short-term contract temporary staff used to fill the position.

The recent incident regarding the Grant Application Manager further adds to these concerns. Since key financial positions have been vacant, there was deemed to be an increased risk of misstatement of the controls and record keeping of Reconnect. The audit team were instructed by the audit partner to apply a higher level of professional scepticism and to place more reliance on substantive work. With the exception of the matters noted above, the audit team did not detect any other potential errors or issues with the financial statements as a result of the staffing issues.



## TEST OF PROFESSIONAL SKILLS

June 2022  
Assurance and Data

### SOLUTION

This solution has been prepared by CA Learning as a complete solution and includes explanatory notes where appropriate. As such, the solution is more detailed than would be expected of a candidate in the allocated time.

This solution is prepared based on a cut-off date of 30 November 2020.

## QUESTION 1 (40 marks) – LFS

### Requirement 1

a i) Key control identification	a ii) Evaluation of why a key control	b) Test of control
A reconciliation of the PPE register to the NL is carried out monthly by a finance clerk and reviewed by the financial controller (FC).	This reduces the risk that the underlying PPE records ie the PPE register, does not agree to the NL which could result in misstatement in the financial statements.	Request a copy of the reconciliation carried out by the finance clerk and inspect for evidence of the FC signature and investigation of any reconciling items.
Only the finance department can make changes to the PPE register.	This reduces the risk that unauthorised amendments are made to the PPE register, whether deliberately or in error, which could result in misstatement in the underlying records used to support the financial statements.	Using audit data analytics, review access records for the PPE register confirming that only finance staff members have ability to access.
<p>All PPE expenditure requisition forms require approval by the purchasing director and are agreed to the approved capex budget.</p> <p>Any requisitions that are not part of the rolling capex budget require secondary approval by the FC or board depending on value.</p>	This reduces the risk that PPE is acquired that is not fit for purpose or in line with business needs and could result in PPE being overstated in the financial statements.	<p>For a sample of purchase requisitions made during the year, inspect for approval by the purchasing director and reconcile with the capex budget.</p> <p>For any requisitions that do not reconcile to the capex budget confirm that they have been subject to secondary approval by Janet and, if above £10,000, by the board.</p>

All production line PPE is subject to monthly maintenance checks.	This reduces the risk that PPE is damaged and unsuitable for use in the business which could impact the valuation of the PPE in the financial statements.	Inspect the monthly maintenance logs to ensure that all production lines have been subject to appropriate maintenance checks.
Vehicles are fitted with GPS trackers and registered with a monitoring company in case of theft.	This reduces the risk of theft of the vehicles which could impact their valuation in the financial statements.	Inspect a sample of vehicles for evidence of trackers and inspect agreement with monitoring company to confirm registered.
Access to vehicle keys is restricted and all drivers must sign out keys before being used.	This reduces the risk of unauthorised use or theft of vehicles which could impact their valuation in the financial statements.	Inspect access to vehicle keys confirming that only the site manager and foreman have access.  OR  For a sample of vehicles in use by employees, confirm that they have been signed out by the relevant user.
All sites are covered by fire and security systems.	This reduces the risk of theft or damage of PPE which could impact the valuation of PPE in the financial statements.	View the security systems in use by visiting the centralised monitoring station at head office to confirm they are operating correctly.



A desktop valuation of owned and leased premises is carried out annually by FC with any significant changes corroborated by a third party valuer.	This reduces the risk that the carrying value of PPE is inappropriate and misstated in the financial statements.	Inspect the results of the desktop valuation ensuring that it has been fully completed and that action has been taken to corroborate any significant movements with a third party valuer.
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## **Requirement 2 – Memo to the audit partner regarding PPE asset verification locations in the audit program of LFS for the year ended 30 June 2022**

### **Birmingham head office**

It is recommended we visit the Birmingham head office site to perform PPE physical verification.

This site holds the largest number of PPE categories and makes up 43% of overall forecast PPE at 30 June 2022.

There has been a programme of updating the computer equipment at this location with the provision of new laptops and tablets for the sales teams. However, the old equipment is still in use with the new equipment unable to be verified. This raises concerns over the accuracy of assets recorded. These portable items are also noted to be expensive and, due to their nature, may be more susceptible to theft which could have an impact on the value of assets recorded in the financial statements.

The meeting rooms at this site have been subject to significant refurbishment to a very high standard, yet all of the expenditure is deemed to be capex expenditure. It is recommended that we attend the counts to confirm the nature of this refurbishment and that it has not been misclassified.

## **Birmingham distribution hub**

It is recommended we visit the Birmingham distribution hub to perform PPE physical verification.

The development of the site has effectively doubled the size of the warehouse, indicating significant financial investment which may be material in value. All costs of this project have been capitalised, including the works to increase the energy efficiency on the existing warehouse, some of which could be deemed to be revenue in nature and would result in potential overstatement of the PPE register.

Despite the significant development and reallocation from the Luton distribution hub, the value of assets at the Birmingham distribution hub is not forecast to increase significantly at 30 June 2022. This could indicate that assets have not yet been moved or have been omitted from the PPE register for this location.

## **Oxford manufacturing site**

It is recommended we visit the Oxford manufacturing distribution hub to perform PPE physical verification.

Three of the four production lines were subject to substantial maintenance during the year with the replacement of numerous significant components. This means that there will be substantial changes within the PPE register for the Oxford site which require verification.

In addition, the fourth production line at the Oxford site was not in use due to a reduction in demand. If the production line is not in use by the business then it may require impairment and its current state should be confirmed.

## **Luton distribution hub**

It is recommended that the Luton Distribution hub be visited as a part of the physical fixed asset verification process for the following reasons:

There is a significant change in the number of assets held at this site as a result of the upcoming closure, resulting in a greater chance of error in the PPE register.

A recent visit to the site by the IA team indicated assets in use that had been removed from the PPE register at the request of the site foreman. These were items of value, but of a generally portable nature, and this discovery could indicate potential theft and we need to obtain assurance that other assets listed can be located.

## **French sites**

It is recommended that the French sites be considered for visitation as a part of the physical fixed asset verification process for the following reasons:

Physical verification by the IA has only been conducted remotely with the assistance of the onsite team, indicating that IA has not actually visited the site and therefore it may be inappropriate to place reliance on their work for this location.

It is very unusual that the value of the assets at the French sites has not changed year on year which could indicate that the records are not up to date.

### **Requirement 3 – Evaluation of the proposal to use Paul Davies as the external surveyor and whether it is likely that reliance can be placed on his work by the external audit team**

We will need to evaluate the skills and competence, capabilities and objectivity of the surveyor.

#### *Competence*

Paul Davies is a fully qualified chartered surveyor, having completed his professional qualifications earlier this year. Therefore he holds appropriate certification and membership of a professional body and is likely to be suitably qualified to carry out the valuation work.

#### *Capabilities*

The valuer has only qualified recently and therefore may not have significant experience. However, as a former employee of Carter Lucas Valuations Ltd he may have had some prior experience in valuation work with LFS.

The valuers most recent experience since forming his own firm has been domestic valuations, and this may indicate a lack of capability in the commercial field.

It has also been indicated that the fee for the proposed services may be much lower than that of Carter Lucas Valuations Ltd which could indicate that the work may not be as thoroughly conducted due to the lack of review, raising a concern that it cannot be relied upon by the audit team.

### *Objectivity*

It has been indicated that, based on the results of this work, the valuer could be engaged to undertake further services for LFS. This could lead to a lack of objectivity and the valuation results being overly favourable in order to provide a positive impression to the board.

### *Conclusion*

Given the potential lack of experience over the types of properties being valued and potential risks over the objectivity of the surveyor we may not be able to place reliance on the expert and further audit procedures will be required to form a conclusion.

## QUESTION 2 (20 marks) – Smile

Identify the weaknesses, evaluate the implications and recommend improvements to Smile's data management processes

Weakness	Evaluation	Recommendation
Smile holds any debit/credit card details that have been used for patients.	Per the seven key characteristics of data, the data must be relevant to the needs of the business.  Debit/credit card details of clients are not relevant for the data insight function that is being proposed.	Debit/credit card details are not needed and therefore should be removed.
A back-up of customer details to the cloud is performed weekly, however this has not been tested in 12 months.	Data may not be backed up correctly or recoverable from the cloud, resulting in incomplete records in the event of a system failure.	There should be regular testing of the backup of customer details on a monthly basis.
Full profiles of patients (including payment information) can be seen by every staff member in the practice, not just the dentist in charge of the patient.	There are inadequate security measures in place that could lead to data theft and breaches of GDPR resulting in potential fines or penalties if Smile is held responsible.	Smile must update their software to ensure that full profiles are only available to the specified dentist in charge.
The company has been subject to a data hack due to out-of-date firewalls and cyber protection.	This constitutes a GDPR data breach and may result in financial penalties from the Information Commission Office (ICO). A fine of up to the higher of 20 million Euros or 4% of the company's worldwide turnover may be issued.	Improve firewall and cyber protection to ensure it is adequate for a large business.  The breach must also be reported to the ICO.

Approximately 20% of client data is saved as PDF files and unable to be interrogated in its current form.	In its current form, Smile would be unable to interrogate the data to allow more detailed analysis and therefore the data may not be useful for decision making.	Data files should be saved in a more appropriate format in order to allow interrogation and analysis. eg csv.
The treatment information held is grouped into high level categories.	The data may not be granular enough to provide useful market information to dentists and the data insight module is unable to meet the intended needs of its users.	To provide meaningful analysis, treatment information needs to be more granular, for example treatments to be itemised per client and include prices paid per treatment.
Smile plans to use all client data for the insights module, some of which is 14 years old.	Customers only wish to use analysis from the last three years due to changes in the treatment market. If Smile were to use older data it may not be relevant for market comparisons that will aid customers in strategic decisions.	To allow for meaningful analysis the data insights module should be programmed to only use client data from the past three years to ensure relevant conclusions can be made.
Client data held has not been manipulated in any way or reviewed since captured with some data now 14 years old.  No retention policy is in place for client data.	GDPR states that personal data can only be held for as long as it is needed, unless it is made anonymous.  As there is data that has not been used it should have been anonymised.	A data retention policy should be established for client data and data reviewed to mitigate against any breaches in GDPR.  Any data held that is no longer to be used should be removed or anonymised.

### QUESTION 3 (22 marks) – Delta Oil

#### Requirement 1: Evaluation of group audit risks

##### *Acquisition accounting*

The group has acquired two new subsidiaries in the year. One of these subsidiaries currently reports under US GAAP and there is a risk that the acquisition is not correctly accounted for in the financial statements.

##### *Impairment of goodwill*

The group has recognised goodwill on the acquisition of the two new subsidiaries. Renewables is currently forecasting operating losses and there has been negative press which may impact the renewal of operating licences for fracking. This may result in goodwill being impaired.

##### *Decommissioning obligations*

The group is required to estimate legal decommissioning obligations. The decommissioning liabilities for the respective components comprise complex judgments and estimates. This increases the risk that these are not accounted for correctly in the financial statements.

##### *Forward contracts*

The group has entered into forward exchange contracts to manage the increased foreign exchange risk from Frackmaster. Measurement and accounting for forward exchange rate contracts is a complex area. There is a risk that these contracts are not accounted for correctly in the financial statements.

##### *Increase in Renewables debtor days*

There has been a significant increase in debtors days for Renewables. This may indicate potential issues with recoverability of debtor balances resulting in debtors being overstated.

##### *Variances in quarter 1 and quarter 3 revenue compared to budget*

There have been significant variances against budget for Delta Oil and Frackmaster in quarter 1 and Renewables for quarter 3 with revenue exceeding budget. While management has indicated that these increases are due to better than expected performance in markets there is a risk that revenue has been incorrectly accounted for and overstated.

### *Going concern*

There is a forecast breach of the group's overdraft facility in November 2022 and the group have still to agree an increase in the overdraft facility limit and renewal of the facility after 31 July 2023. There is a risk that the bank may not agree to the increase and withdraw the facility as a result of the breach.. The bank may also not agree to renew the facility with the expiry date being within 12 months of the financial year end.. This may call into question the going concern status of the group.

### *Bank covenants*

Under the covenants imposed for the group's overdraft facility, the group is required to maintain net profit before tax of at least 10% of revenue and are currently just above this at 11.5%. There is a risk that the financial statements are manipulated in order to ensure compliance with the covenants. Furthermore, the potential plans for a listing on the London Stock Exchange may provide further incentive for management to manipulate results in order to make the group financial position more favourable.

### *Different accounting systems*

The acquired subsidiaries operate on their own accounting packages which are different from the group consolidation package. This could result in potential errors in the consolidation if the different accounting packages do not produce information consistent with the other group members and manual adjustments are required.

### *Foreign currency translation*

The financial information for Frackmaster is reported in US\$. There is a risk that the balances are not converted using an appropriate exchange rate resulting in a misstatement in the group financial statements.

### *Alignment of accounting policies*

The group plans to use financial information from Frackmaster for the consolidation based on US GAAP, whereas the group reports under IFRS. There may be significant differences between US GAAP and IFRS accounting standards resulting in the financial information within the consolidated financial statements being inappropriate and inconsistent with the required framework.



**Requirement 2 – Recommend a level for overall group materiality and the trivial threshold, give explanations justifying your value**

Profit before tax (PBT) has been selected as an appropriate benchmark as the group is profit making and profitability is a key focus of the users of the financial statements. An appropriate range for materiality is therefore between 5% and 10% of profit before tax.

The profit before tax for the 9 months is £37.3m – extrapolated for 12 months, the group profit before tax is £49.7m.. The range for materiality is therefore £2.5million to £5 million.

Overall group materiality has been set at £2.5m at the lower end of the range as a result of the higher risk of material misstatement as a result of the audit risks identified within the group, including a specific risk over the net profit before tax to revenue % maintained by the company in order to comply with bank covenants.

The trivial threshold has been set at 5% of overall materiality, £125,000.

## **QUESTION 4 (18 marks) – Reconnect**

### **Requirement 1 – Evaluation of outstanding matters**

#### **Grant applications**

Practice Note 10 specifies that regularity is the concept that transactions that are reflected in the financial statements of an audit entity must be in accordance with the framework of authority. By potentially finding inconsistencies in the application of the framework, some level of assurance must be sought by the audit team on this matter to support the regularity opinion.

The audit team should review the three detailed grant applications and relevant correspondence, agreement to the framework of authority and documentation of the conclusions reached to ensure consistent.

Representation from management could also be sought providing assurance that its transactions all conformed with the framework under which Reconnect operates.

#### **Legal issue**

Legal action has been taken against Reconnect, but no provision has been made for any potential compensation. If the legal action were to be upheld then there would be a risk that provisions are understated within the financial statements.

Review the correspondence between Reconnect and the lawyers of Kirkmichael Rural Community Trust for any information regarding potential settlement and the value of any compensation.

Obtain confirmation from Reconnect's lawyer as to the value of the compensation claim and the likelihood of this being awarded against Reconnect.

#### **Subsequent event**

External fraud may be particularly high where public sector bodies issue money to third parties. Given the delays in receipt of the supporting documentation for fund forms and that originals have not been provided, there is a risk that the audit team has not received appropriate supporting documentation to conclude on the audit testing performed and that there are underlying issues with the appropriateness of grant payments made by Reconnect.

We should obtain the original grant claim forms submitted for the grant claims tested and, if necessary, consider extending our audit testing.

We should confirm the reasons for the placing of the Grant Application Manager on gardening leave and whether this is relation to the investigations raised.

## **Staffing issues**

Due to Reconnect experiencing excess turnover of senior finance staff, it may have affected their ability to produce the financial records underlying the financial statements. As this matter has had a significant impact on the direction of the efforts of the audit team it should be considered as a Key Audit Matter under ISA(UK) 701.

No further issues have been identified as a result of this matter so no further audit evidence is required.

## **Requirement 2 – Impact on audit report and opinions**

### **Grant applications**

We are required to provide a separate regularity opinion on whether, in all material respects, expenditure has been applied for the purposes intended.

If documentation is not available that demonstrates the framework being correctly applied in all cases, then the auditor can state that the transactions do not conform to the relevant framework. The level of the potential misstatement is above the regularity materiality level but unlikely to be pervasive. This would result in a qualified (except for) regularity opinion.

### **Legal issue**

If the audit evidence confirms a settlement is likely and management refuses to provide for the compensation being sought, then the issue would be deemed material but not pervasive as the matter is confined to a specific item in the financial statements and only 1% of overall net expenditure. If no provision is made then we would issue a qualified 'except for' opinion.

### **Subsequent event**

If we are unable to obtain the relevant evidence from management we have a potential limitation of scope. Given the nature of the matter and that it relates to the appropriateness of transactions relating to its core activity it is likely that this would be deemed both material and pervasive. We would issue a disclaimer of opinion for both the financial statement opinion and regularity opinion.

## **Staffing issues**

As there is no evidence of misstatement or issues arising as a result of this matter there is no impact on the audit opinion. However as this has been identified as a key audit matter it should be disclosed appropriately in the audit report and include the following:

- A description of why the matter was considered to be important;
- How the matter was addressed in the audit; and
- A reference to any related disclosure in the financial statements.

<b>Marking Schedule</b>  <b>Assurance and Data</b>  <b>June 2022</b>  <b>Question 1 – LFS</b>	<b>Candidate No.</b>	
	<b>Batch No.</b>	
	<b>Marker No.</b>	

	Marks available	Marker marks	Marks awarded
<b>Requirement 1(a)(i) – Key Control Identification</b>			
Reconciliation of PPE register			
Only finance department can make changes			
Approval of requisitions			
Monthly maintenance checks			
GPS trackers			
Access to vehicle keys			
Fire and security systems			
Desktop valuations			
Other			
<b>Restricted to (4½ marks available)</b>	<b>4</b>		
<b>Requirement 1(a)(ii) – Key Control Evaluation</b>			
Reconciliation of PPE register			
Only finance department can make changes			
Approval of requisitions			
Monthly maintenance checks			
GPS trackers			
Access to vehicle keys			
Fire and security systems			
Desktop valuations			
Other			
<b>Restricted to (8 marks available)</b>	<b>8</b>		
<b>Requirement 1(b) – Key Control Tests</b>			
Reconciliation of PPE register			
Only finance department can make changes			
Approval of requisitions			
Monthly maintenance checks			
GPS trackers			
Access to vehicle keys			
Fire and security systems			
Desktop valuations			
Other			
<b>Total marks awarded (9 marks available)</b>	<b>8</b>		
<b>Requirement 2 – Fixed Asset Verification Locations</b>			
Birmingham head office			
Birmingham distribution hub			
Oxford manufacturing site			
Luton distribution hub			
French sites			
Other			
<b>Total marks awarded (16½ marks available)</b>	<b>14</b>		

<b>Requirement 3 – Evaluation of proposed expert</b>			
Evaluation of expert			
Competence			
Capabilities			
Objectivity			
Conclusion			
Other			
<b>Restricted to (7 marks available)</b>	<b>6</b>		
<b>Total marks awarded</b>	<b>40</b>		

<b>Marking Schedule</b>	<b>Candidate No.</b>	
<b>Assurance and Data</b>	<b>Batch No.</b>	
<b>June 2022</b>		
<b>Question 2 – Smile</b>		

	Marks available	Marker marks	Marks awarded
<b>Requirement 1 – Smile’s data management processes</b>			
Debit/credit card details not relevant			
Back up not tested			
Inadequate profile security			
Out of date firewalls protection			
PDF files			
Lack of granular information			
Data up to 14 years old			
No review of data/lack of retention policy			
Other			
Restricted to (21½ marks available)	20		
Total marks awarded	20		

<b>Marking Schedule</b>	<b>Candidate No.</b>	
<b>Assurance and Data</b>	<b>Batch No.</b>	
<b>June 2022</b>		
<b>Question 3 – Delta</b>		

	Marks available	Marker marks	Marks awarded
<b>Requirement 1 – Evaluation of group audit risks</b>			
Acquisition accounting			
Impairment of goodwill			
Decommissioning obligations			
Forward contracts			
Increase in Renewables debtors days			
Variances in quarter 1 and quarter 3 revenue compared to budget			
Going concern			
Bank covenants			
Different accounting systems			
Foreign currency translation			
Alignment of accounting policies			
Other			
<b>Restricted to (19 marks available)</b>	<b>17</b>		
<b>Requirement 2 – Group materiality and trivial threshold</b>			
PBT benchmark			
PBT due to profit making group			
PBT materiality range			
Extrapolation of 9 month results to 12 months			
Calculation of range			
Conclusion			
Calculated group trivial threshold			
<b>Restricted to (5½ marks available)</b>	<b>5</b>		
<b>Total marks awarded</b>	<b>22</b>		



<b>Marking Schedule</b>  <b>Assurance and Data</b>  <b>June 2022</b>  <b>Question 4 – Reconnect</b>	<b>Candidate No.</b>	
	<b>Batch No.</b>	
	<b>Marker No.</b>	

	Marks available	Marker marks	Marks awarded
<b>Requirement 1 – Evaluation outstanding matters</b>			
Grant applications			
Legal issue			
Subsequent event			
Staffing issues			
<b>Restricted to (12 marks available)</b>	<b>10</b>		
<b>Requirement 2 – Impact on audit report and opinions</b>			
Grant applications			
Legal issue			
Subsequent event			
Staffing issues			
<b>Restricted to (10 marks available)</b>	<b>8</b>		
<b>Total marks awarded</b>	<b>18</b>		