

ISRE 2400 Case study: "Engagements to Review Financial Statements"

You are the audit senior for Purnell & Co and Turbo Co is a longstanding audit client of your firm. You have started the planning for the audit of Turbo Co for the year ended 31st December 2019, and obtained the following information from the previous year's file and from preliminary discussions with management.

Background and revenue sources

Turbo is a magazine publisher. It publishes a number of titles, all of which are weekly or monthly car and motorcycle magazines. The magazines are sold to supermarkets and newsagents who then sell them to the general public. Turbo generates its income in two ways; from the sale of the magazines and from selling advertising space in the magazines, to companies who want to promote their cars or motorcycles. The revenue split has typically been around 50% in total for each sale type. The key advertisers are large household names in the car and motorcycle industry. Turbo has to negotiate contracts with these advertisers for the provision of advertising space. These contracts can vary in length and can range from between one month and six months. The contract will set out all details of the arrangement, including the price of the adverts, the number or size of the adverts and how often the advertisements will appear. An invoice is raised on the date of the first advertisement and the advertisers pay within ten days of this for shorter contracts. For six-month contracts the advertising fees are paid for by Turbo's customers in two instalments (half of the fee on the first date of advertising and the rest after three months). If recurring contracts have not been re-signed by the date advertising is meant to start, Turbo raises an invoice based on the last contract and the paperwork is sorted out later. In respect of the magazine sales Turbo offers the supermarkets and newsagents up to 45 days' credit but many of the newsagents are struggling financially and tend to take longer than this to pay their invoices.

Trading conditions

In the last ten years the market for the magazines has become more and more competitive, resulting in Turbo needing to discount magazine prices. There is also increasing pressure from online competition and Turbo's revenue has been gradually decreasing over the last few years. This year has been a particularly bad year because difficult economic conditions have resulted in reductions in advertising revenue, as many of the car and motorcycle manufacturers that advertise in the magazines have seen their marketing budgets slashed and have renegotiated their contract terms.

Other relevant information

Turbo does not employ journalists or photographers for its magazines. Instead, it uses the best self-employed journalists, commentators and photographers in the industry. However, due to their numerous commitments these freelancers often get behind on their paperwork and don't get around to sending in their invoices to Turbo until a month or more after they have written their article or provided the photos requested.

Turbo prints its own magazines and as a result has a significant amount of plant and equipment. Turbo has been around for a number of years now and the equipment had become quite old and inefficient compared to that used by newly formed competitors. As a

result, in June 2019 extensive refurbishment of the printing equipment took place and this expenditure will be material to the financial statements. The heavy investment in refurbishment and declining revenues has seen Turbo operate close to its overdraft limit during the last six months. Key contracts are to be renewed in January. Although there is likely to be a small profit for the year, the management accounts for last six months show an operating loss.

The company would like to apply for a bank loan to ease cash flow concerns and has discussed this with its bank. However, the initial response from the bank was not overwhelmingly positive due to the competitive market Turbo operates in. As a result, Turbo needs to produce a cash flow forecast for the bank showing where the cash will be generated to pay back any loan. The bank also wants to see audited financial statements for the year to 31st December 2019, before the end of March 2020.

The forecasts currently being put together will include Turbo's plan to make popular titles available to the public online in exchange for a subscription fee. Online advertising fees will also be included in the forecast. However, the website will need to be quite complex and the investment in it will be significant.

Planning

Procedures for the review of financial statements to address the key risk areas will include:

Risk area	Audit response
Contracts for adverts may span year end and the timing of invoicing does not necessarily reflect the timing of adverts. Invoicing for half or the whole contract coincides with the advert start date. Therefore there is a risk that sales are recognised early and not matched appropriately to costs, overstating revenue in the financial statements.	In relation to a sample of contracts in place at the year-end or commencing near to the year end – it should be checked that revenue is recognised in the financial statements according to the timing of the adverts. Any deferred or accrued income should be recalculated and traced to the financial statements.
If recurring contracts have not been re-signed by the date advertising is meant to start an invoice is raised for the same amount as before but it is known that key customers are renegotiating contracts. Key contracts are to be renewed in January and invoiced amounts for these may not reflect the revenue due if contracts are still being negotiated.	Procedures planned for the audit should include a review of renewal invoices close to the year end and these should be traced to contracts to ensure the correct amount and proportion of revenue has been included in respect of these.
Receivables may be overvalued, as newsagents are taking credit beyond the agreed 45 day limit. This could indicate poor credit control which could result in uncollectable receivable balances.	The auditors should undertake external confirmation of receivables balance to ensure they exist and extend cash-after-date testing to test recoverability of receivables. Customer correspondence files should be reviewed for evidence of any disputes.
There is a risk that Turbo may not be a going concern due to falling revenues, losses	Ask management for their assessment as to whether Turbo is a going concern and how

and poor cash flow.	they arrived at their conclusions and obtain written representation on their conclusion. Review any contracts that have recently been renegotiated and compare to previous contract to ascertain the extent to which revenues are falling.
There is increased competition from new entrants and online publications. Unless the bank provides additional finance the business may struggle to continue for the foreseeable future. Whether finance is obtained is dependent on the forecasts being prepared.	When available, review the forecasts prepared by management, paying particular attention to the appropriateness of the assumptions made and the sensitivity of forecasts to changes in variable factors. Review post-year-end management accounts to identify any significant changes in the performance of the business and compare with the forecast to assess the accuracy of them.
Turbo's bank intends to rely on the audited financial statements when making a decision to provide loan finance. As a result, management have an incentive to overstate profits by manipulating balances which are reliant on an element of judgement.	Particular attention should be directed to judgemental areas in the financial statements for instance any provisions reversed and revenue recognition policies. An independent partner review should be undertaken for judgemental areas of the financial statements.
Material refurbishment of printing equipment has taken place and there is a risk some repair costs have been included as noncurrent assets and vice versa. Non-current assets and repair costs could be misstated.	An analysis of the refurbishment costs should be reviewed and traced to invoices. The invoice descriptions and supporting documents should be reviewed to assess the nature of the expenditure. Once established as either capital or revenue it should be traced to the general ledger and the financial statements to ensure it has been classified correctly as an asset or repairs.
The company plans to embark on a costly project in an area it has no experience of – online publishing for subscriptions. This may add to its going concern problems by putting additional strain on cash flows without generating adequate returns, given that Turbo seems to be later to market with this than competitors.	Discuss the project with management including their assumptions for growth and returns and compare with the forecasts when available. Review any formal planning documents and quotes from businesses bidding for the website construction to assess the level of expenditure likely to be needed.

Required:

Turbo's bank has said it would like a report from the external auditors to confirm the accuracy of the forecast. Following this request, Turbo has asked if you will examine the cash flow forecast when it has been prepared and then provide a report for the bank.

Sample Report

REVIEW REPORT TO XYZ BANK

We have reviewed the accompanying cash flow statement of Turbo Company for the year ended 31st December 2019. The financial statements are the responsibility of the Company's management. Our responsibility is to issue a report on the cash flow statement based on our review.

We conducted our review in accordance with the International Standard on Review Engagements 2400. This Standard requires that we plan and perform the review to obtain moderate assurance as to whether the financial statements are free of material misstatement. A review is limited primarily to inquiries of company personnel and analytical procedures applied to financial data and thus provides less assurance than an audit. We have not performed an audit and, accordingly, we do not express an audit opinion.

Based on our review, except for the effects of the risks areas noted above, nothing has come to our attention that causes us to believe that the accompanying financial statements do not give a true and fair view or are not presented fairly, in all material respects in accordance with International Accounting Standards.

PRACTITIONER

Date

Address

Note: Level of assurance over accuracy of forecasts

Purnell & Co will be unable to confirm the accuracy of the forecast as requested by the bank. The forecast will be based on assumptions made by management at Turbo and it will not be possible to gain enough evidence to confirm that these are completely accurate.

Due to the uncertainties of the future cash flows included in the forecast, the bank should be informed that only a limited level of assurance can be provided in any report, expressed in the form of negative assurance. The report will set out the types of procedures undertaken and the assumptions made by management. If no irregularities were found during the work performed, the report states that nothing had come to the attention of Purnell & Co that would cause them to believe that management's assumptions do not provide a reasonable basis for the cash forecast.

The negative assurance expressed is a lower level of assurance than the reasonable assurance provided in the statutory audit of financial statements. In the auditor's report on financial statements, a positive form of expression of the practitioner's conclusion is given rather than a negative one. The auditor expresses an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

References

ACCA. (2016). *ACCA F8 - Audit and Assurance Revision Kit*. Retrieved from <https://www.studocu.com/en/document/the-university-of-da-nang/audit-and-assurance/lecture-notes/acca-f8-audit-and-assurance-revision-kit-2016-pdfdrivecom/4710563/view>

