ILPA
INTERNATIONAL LEARNING PLATFORM FOR ACCOUNTANCY

Cover Sheet

CASE STUDIES
Auditing

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CASE DESCRIPTION

INTRODUCTION TO THE CASE

You have been working as a Certified Public Accountant (CPA) for six years in the audit firm 'Europestars'. Europestars is a medium-sized national CPA firm and member of the international network 'Allstars'. The firm provides auditing, preparation and review of the clients' financial statements. Furthermore, Europestars provides tax work including the preparation of income tax returns, tax planning, and consulting and advice involving information systems, mergers and acquisitions. Most of the clients are in the wholesale and the automotive supply industry.

Europestars has a Client Acceptance Policy that sets out principles to determine whether to accept a new client or a new engagement. These principles are fundamental to maintaining quality, managing risk, protecting the firm and meeting regulatory requirements.

As part of the client acceptance process, Europestars carefully considers the risk characteristics of a prospective client and conducts several due diligence procedures. Before Europestars accepts a new engagement or client, Europestars determines if it can commit sufficient resources to deliver a high quality audit. The approval process is rigorous, and no new audit engagement may be accepted without the approval of Europestars Managing Partner. Europestars dedicates significant time and resources to the strict implementation of their client acceptance policy. All prospective audit engagements are classified as either 'High Risk', 'Moderate Risk' or 'Low Risk'.

Europestars has set up a team to prepare a recommendation to the Managing Partner for every client acceptance decision in 2xx1.

Your managing partner at Europestars met the chairman of the audit committee of a company called '4-Airlines' in the last week of November 2xx1. The chairman indicated that the company has decided to change its current auditor after some difficult negotiations and disagreements.

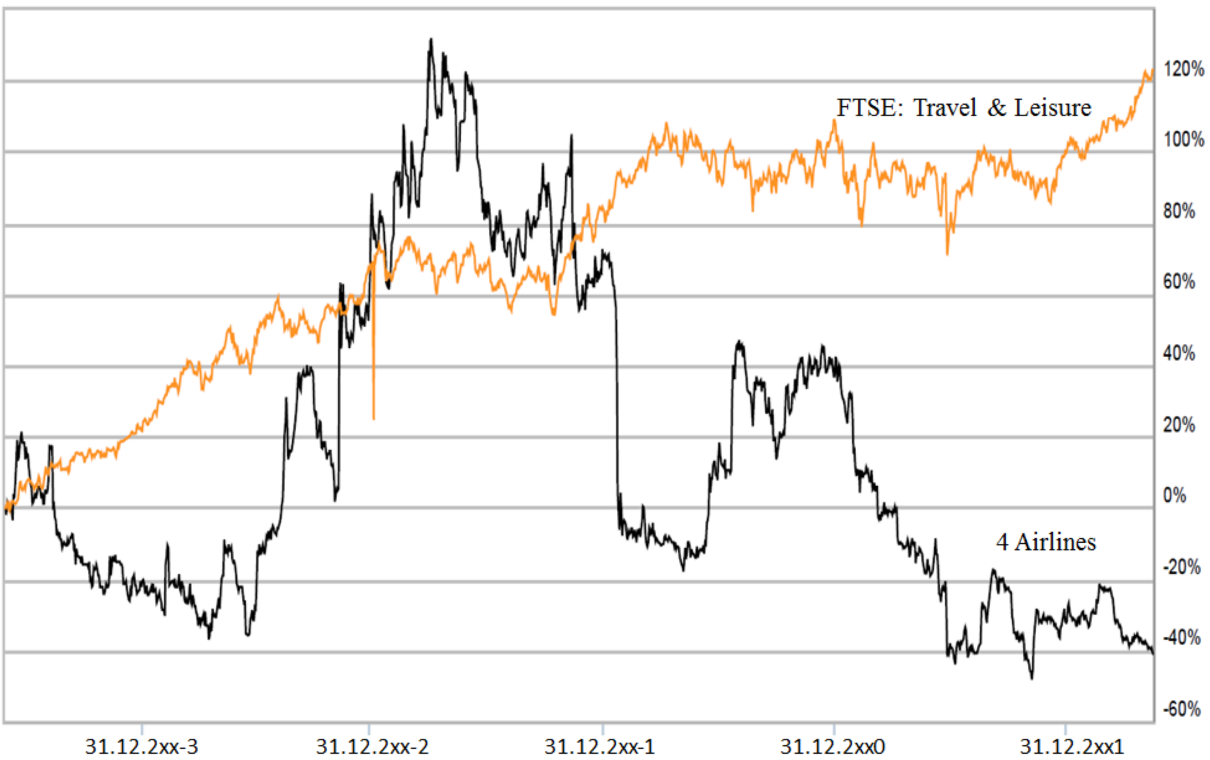
4-Airline's annual financial statements of the last ten years have been audited by other audit firms (mandatory audit). The chairman of the audit committee indicates that 4-Airlines has not signed an audit engagement contract with a new auditor yet, but needs a decision from Europestars within a short time frame, as the fiscal year of 4-Airlines ends on December 31.

The managing partner of Europestars, Mrs. Mary Taler, is highly interested in having a client in the air transport service sector, especially one with the favourable market position and growth potential of 4-Airlines. Most of Europestars' current audit clients are in the wholesale and the automotive supply industry. Thus, the managing partner feels that the engagement presents an excellent opportunity for Europestars to enter a new market. Knowing the risks involved, the potential responsible partner for the 4-Airlines engagement for the year 2xx1, Mrs. Sabine Schmid, wants to make sure the client acceptance decision is carefully considered in accordance with Europestars client acceptance policy.

BACKGROUND ABOUT THE COMPANY '4-AIRLINES'

4-Airlines is the first audit client of Europestars in the air transport services sector, though the company has already had a few other clients in the transportation sector. The company was founded ten years ago. 4-Airlines issued shares through an initial public offering (IPO) seven years ago and has been traded on the London Stock Exchange. Until now, it operates only in the European airspace. The following graph shows the share price development of 4-Airlines in comparison to the Financial Times Stock Exchange index (FTSE sector Travel & Leisure) for the last five years.

London Stock Exchange – 4 Airlines Share Price 5 Years



4-Airlines wants to hire Europestars to issue an audit opinion on their 2xx1 financial statements. The company has also expressed an interest in obtaining help to optimise their recently installed new information technology (IT) system and the integrated IT-controls.

During a meeting with 4-Airlines' representatives, the following information was obtained about the company and the air transport industry.

Company overview:

4-Airlines' audited December 31, 2xx0 financial statements report total assets of € 840 million, sales revenue of € 861 million, and net loss of € 53.5 million.

The company operates in two segments: ‘4-Airlines Passenger’, which comprises of the company's main scheduled Europe passenger operations and revenue ancillary to the provision of those services, and ‘4-Airlines Aviation Services’ (4AAS), which focuses on providing aviation services to customers in Western Europe. The 4AAS supports 4-Airlines’ European activities, as well as serving third-party customers. Its ‘One Stop to the World’ program provides access to long-haul destinations for its customers, through its international code-sharing partners at main hubs within the 4-Airlines’ network. The company has over 50 new routes focused on connecting its bases to regional centres in Europe, such as London, Vienna, Rotterdam, Dusseldorf, Amsterdam, Paris and Rome.

As 4-Airlines wants to aggressively expand from a continental to an intercontinental market, 4-Airlines plans to use capital from a loan or share capital in the course of a second public offering.

Since the implementation of a new IT System, there have been ongoing difficulties with the company's new accounting system.

The representatives of 4-Airlines note that the earnings vary considerably in recent years, but 4-Airlines enjoys a good reputation and high acceptance among customers.

Last year the company received a qualified audit opinion related to the valuation issues. 4-Airlines has changed auditors two times within the past seven years.

Management:

The CEO of 4-Airlines, Mr. Erich Red, is a very experienced manager. He has a hierarchical leadership style and always strives for market expansion. Mr. Red dominates the management's operating and financing decision-making process. He is not satisfied with the share price of 4-Airlines.

In March 2xx1 the Chief Financial Officer (CFO), Mr. Dagobert Free, resigned from 4-Airlines. The reason for the CFO to leave 4-Airlines was described by the management as being caused by ‘personal issues’. A successor CFO, Mr. Donald Haid, was appointed in July 2xx1. He holds a Master degree in Accounting and has eight years of experience in the airline industry. In 2xx1, a new reward system for the CEO and part of the executive team was introduced. Annual performance based bonuses were set. The current Head of the Controlling and IT department of 4-Airlines, Mr. Erich Black, does not seem to feel comfortable with the company’s new IT system.

A client background check reveals that the current CFO three years ago was sentenced to a fine for theft in a department store. The background check revealed no other legal or ethical problems with any other of the 4-Airlines’ executives.

Accounting* and Information *Systems:

4-Airlines has implemented a new, integrated central accounting system in early 2xx1.

This new complex IT system provides:

- An aviation services management, which is a full featured module for processing service requests with integrated accounting;
- An accounting and finance module that provides necessary tools for managerial and financial accounting, allowing detailed tracking, reporting and analysis of financial transactions;
- A human resources module for the processing of employees' documents, salary and bonuses management, and
- A Unit Load Devices' (ULD) control module that helps to control the entire company ULD stock, to track their movements' history and current location.

The former CFO mainly handled last year's implementation of the new system. Due to transition problems, the implementation of this new IT system has not yet been completed and 4-Airlines is still working to modify it to meet the company's needs. The accounting staff is dissatisfied with some features of the financial accounting module of the IT system and have an ongoing training demand. The internal controls associated to the accounting procedures still don't seem to work adequately.

There are still some problems regarding the cost calculation, sales invoices overdue and payables control, e-ticketing and booking over the internet, control for spare parts, materials, and supplies for aircraft maintenance.

These circumstances have created serious troubles for 4-Airline's management and personnel as, among others, reports on receivables and payables outstanding were drafted inaccurately. As for the online flight ticket booking system, there have been many cases when the number of tickets booked and purchased for a flight exceeded the total number of seats in the respective plane. Due to that issue, the company had to pay penalties in 2xx1 of € 3 million.

Your office has never audited a company with the specific IT system as the one used at 4-Airlines. However, your IT team is fairly confident that they will be able to diagnose 4-Airlines' control weaknesses and help 4-Airlines overcome current difficulties, as they are experienced in the field of IT-consulting.

Prices, Financing, and Currencies:

4-Airlines' reporting and operating results may be significantly affected by price and currency fluctuations. Credit risks arise from deposits with banks and credit exposure to commercial customers. However, sales to private customers are mainly settled by using credit card companies. In order to protect margins against fluctuations of the fuel price, the expected fuel consumption is hedged to some extent. Following the acquisition of aircrafts with future deliveries, 4-Airlines will have ongoing financing activities. Financing is diversified through sale-and-leaseback transactions and long-term loan financing. A second public offering is also considered.

***The Industry**:*

During the last years, the passenger air transport has recorded a constant increase, however with small decreases in two, due to the global economic crisis. In 2xx1 at the industry level, airlines generated a return on invested capital exceeding the cost of that capital. Put simply, for the first time in history airlines made a normal level of profitability. The decrease in the oil price is a major driver of improved profitability. All indications suggest that in 2xx2 a continued improvement in financial performance will take place.

Profitable airlines are able to invest in product improvements, fund the growth of stronger networks, and purchase modern, fuel-efficient airplanes. In addition, it helps passengers to continue to enjoy great deals on air travel as the costs have fallen by 57% over the last two decades. The spread of profitability is not yet outstanding. Geographically, about two-thirds of the industry's profits worldwide are generated by airlines based in North America, and while passenger traffic is enjoying robust growth, the cargo business is continuously facing doldrums.

The expansion of the European Union, the visa requirement elimination for some countries and the free movement of people within the Schengen Area are positive factors for the passenger traffic within the European Union, leading to the increase of both the number of flight routes and the number of passengers.

Another key marker of improved performance is safety. Looking at jet operations, there was one major accident for every 3 million flights in 2xx1. That is a significant improvement on the five-year average.

A problem in the industry is that security threats continue to loom. The list of security challenges includes terrorism, cyber-attacks, and the overflight of conflict zones.

***Predecessor Auditor**:*

For new engagements, the ISAs require that the potential new auditor communicates with the predecessor auditor to determine if there are any reasons for not accepting the engagement. When you met Donald Haid, 4-Airlines' CFO, to request permission to communicate with the predecessor auditor, he did not seem to like talking about the previous auditor. He informed you that the predecessor auditor and 4-Airlines' management had disagreed on some valuation and presentation issues during the prior year's audit. In Mr. Haid's opinion, the issues where minor problems and where caused by an insufficient understanding of 4-Airlines' business, environment and industry. Furthermore, the previous auditor was not technically skilled enough to support 4-Airlines with its new IT system. Mr. Haid also indicated that the previous auditor - issued a qualified opinion on the financial statements for the year 2xx0 due to the IT-system problems -and other issues. Mr. Haid said that 4-Airlines is convinced that Europestars has competent staff to help optimise the IT system. Regarding accounting issues, 4-Airline's management is convinced that Europestars has a better knowledge of the airline business and the environment. Europestars has been highly recommended to the CFO by a friend who is a member in the same golf club as the managing partner of Europestars. After some hesitation, permission was granted from 4-Airlines to communicate with the former auditor.

An appointment was scheduled with Mrs. Julia Strong, the managing partner of the previous audit firm. At this meeting, Mrs. Strong did not appear to be surprised that 4-Airlines was seeking a new audit firm. She said that her firm had assumed when they had considered qualifying their year 2xx0 opinion that it would be their last year on the job. In general, working with the management of 4-Airlines was always very comfortable. The CEO and the other members of the management appear to be people of integrity. However, the CEO was always unhappy with the audit fees and always saw accounting issues as minor and unimportant details. He is very interested in stimulating growth and becoming CEO of a large intercontinental airline company. Moreover Mrs. Strong indicated that the problems her firm faced with 4-Airlines were primarily related to the complexities and problems with 4-Airlines' new IT system and management's tendency to aggressive accounting in order to meet investors' and creditors' requirements. The CEO and the CFO of 4-Airlines argued vehemently against adjustments of the financial statements. Mrs. Strong believes that this was particularly due to the low share price and the capital requirements of 4-Airlines.

Independence Issues:

As part of Europestars' quality control policies and procedures, every three months the staff in the assurance service line of Europestars is required to file an updated disclosure of their personal share investments. The review of the disclosures - as part of the process of considering 4-Airlines as a potential client - shows that there appears to be no share ownership issue except that a partner in another firm of the 'Allstars' network owns shares in a venture capital fund. This fund has invested in 4-Airlines' shares. This investment represents just over 0.2 percent of the value of the fund's total investments. The partner's total investment in the fund is currently valued at about € 30,000. No other independence issues were detected.

Financial Statements:

The client acceptance recommendation team received from 4-Airlines the financial statements for 2xx0, and the preliminary balance sheet and profit and loss account for the year 2xx1. The balance sheet and the profit and loss accounts for both years are attached to this case study. Mrs. Sabine Schmid, the partner who will be in charge of the 4-Airlines engagement, wants the team to check which information from the financial statements might be helpful in determining whether or not to accept 4-Airlines as a new audit client.

FINANCIAL STATEMENTS 2XX1 AND 2XX0

(preliminary) Balance Sheet Year ended 31 December 2xx1		
	2xx1 € thou.	2xx0 € thou.
Non-current assets		
Intangible assets	19,950	13,200
Property, plant and equipment	320,550	283,650
Other non-current assets	61,050	57,000
Restricted cash	11,700	10,650
Deferred tax asset	16,950	13,200
Derivative financial instruments	1,200	300
	431,400	378,000
Current assets		
Inventories	9,600	10,650
Trade receivables	49,800	49,200
Other receivables	102,300	98,250
Cash and cash equivalents	245,400	283,200
Derivative financial instruments	14,550	21,150
	421,650	462,450
Total assets	853,050	840,450
Current liabilities		
Trade and other payables	(156,450)	(144,450)
Deferred income	(127,050)	(115,650)
Borrowings	(22,050)	(19,500)
Provisions	(63,450)	(77,850)
Derivative financial instruments	(28,200)	(28,350)
	(397,200)	(385,800)
Non-current liabilities		
Borrowings	(141,750)	(159,300)
Deferred tax liabilities		(450)
Provisions	(46,350)	(36,450)
Deferred income	(11,100)	(12,450)
Employee benefits	(22,950)	(31,500)
Derivative financial instruments	(2,400)	(3,900)
Liability for share-based payments		(600)
	(224,550)	(244,650)
Total liabilities	(621,750)	(630,450)
Net assets (Equity)	231,300	210,000

(preliminary) Income Statement Year ended 31 December 2xx1		
	2xx1 € thou.	2xx0 € thou.
Revenue	935,700	861,150
Consisting of:		
Passenger revenue	857,550	792,900
Contract flying revenue	20,850	17,400
Revenue from other activities	57,300	50,850
Revenue	935,700	861,150
Staff costs	(149,700)	(135,750)
Fuel	(152,400)	(158,250)
Airport and en route charges	(181,050)	(163,050)
Ground operations	(123,750)	(103,650)
Maintenance	(31,950)	(33,450)
Depreciation and amortisation	(48,150)	(42,000)
Aircraft rental charges	(118,950)	(120,900)
Marketing and distribution costs	(37,800)	(41,100)
Other operating gains/(losses)	6,900	(1,500)
Other operating expenses	(85,650)	(80,550)
Operating profit/(loss)	13,200	(19,050)
Investment income	1,200	1,200
Finance costs	(6,000)	(2,250)
Other losses	(4,200)	(15,300)
Profit/(loss) before tax	4,200	(35,400)
Tax credit/(charge)	6,150	(150)
Profit/(loss) after tax of continuing operations	10,350	(35,550)
Loss on discontinued operations		(18,000)
Profit/(loss)	10,350	(53,550)

INTERNATIONAL LEARNING PLATFORM FOR ACCOUNTANCY

INDUSTRY RATIOS

	2xx1	2xx0
Return on Equity (RoE)	18.52%	12.10%
Return on Assets (RoA)	3.78%	2.75%
Operating Profit Margin	8.3%	4.7%
Assets to Equity	5.92	5.38
Accounts Receivable Turnover	16.5	22.5
Average Collection Period	22.1	16.6
Debt to Equity	4.9	4.4
Times Interest Earned	5.19	4.37
Current Ratio	0.72	0.75
Share of Fuel Cost in Total Cost	27.30%	31.30%
Share of Aircraft Leases in Total Cost	10.50%	12.50%

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AUDITING

CASE STUDY

CLIENT ACCEPTANCE DECISION

LEARNING OBJECTIVES – CLIENT ACCEPTANCE DECISION

1. Explain the objective of the client acceptance process
2. Understand the types of information relevant for evaluating a new audit client
3. List some of the steps an auditor should take in deciding whether to accept a prospective client
4. Understand the necessary level of knowledge of a client's business to accept the client
5. Identify and evaluate factors important for the client acceptance decision
6. Describe the procedures for communicating with a prior (predecessor) auditor
7. Understand the auditor's responsibility in using the work of experts
8. Understand the process of making and justifying a recommendation regarding client acceptance
9. Know the components of the terms of audit engagements
10. Understand the factors that influence the audit fee
11. Understand what an audit engagement letter includes and why these contents are important.

CLIENT ACCEPTANCE DECISION

As stated within the case description you have to decide about accepting the client 4-Airlines. To fulfil this task please answer the questions on the next page and prepare a short memo including some arguments supporting your decision.

WORK TASK – CLIENT ACCEPTANCE DECISION

Group discussion (up to 5 students) of the following questions and preparation of presentation slides for each question.

1. An auditor has to collect information for the client acceptance decision. Define at least five procedures that an auditor should perform to collect relevant information for his/her decision whether to accept 4-Airlines as client or not.
2. To get a first impression about 4-Airlines' financial situation and performance, use the financial information integrated in the case to calculate liquidity ratios (i.e. Accounts Receivable Turnover, Debt to Equity and Current Ratios), profitability ratios (i.e. ROE, ROA, Profit Margin, Share of Fuel Cost in Total Cost, Share of Aircraft Leases in Total Cost) and solvency ratios (i.e. Asset to Equity, Times Interest Earned). Also, compare 4-Airlines' ratios to the industry ratios provided in the case. Identify and discuss any major differences. Try to analyse which risks may result from modifications to the balance sheet and income statement with respect to key figures for the auditor.
3. Are there other financial matters that should be considered before accepting 4-Airlines as a client?
4. Beside financial matters, other aspects should be considered before accepting 4-Airlines as a client. What non-financial matters mentioned in this case study could be relevant for the client acceptance decision? How important are each of these non-financial matters?
5. 4-Airlines expects that Europestars will help to optimise the new IT system. What are the pros and cons when an audit firm provides both auditing and IT consulting services? Discuss whether European regulation and the IFAC code of ethics will allow Europestars to help 4-Airlines with their IT system and at the same time to carry out a statutory audit of the financial statements.
6. As indicated in the case, one of the partners in another firm of the 'Allstars' network has invested in a venture capital fund that owns shares of 4-Airlines Equity. Does this fact violate the auditor's independence? Discuss why or why not, and consider the consequences.

Your team has to make a recommendation to the managing partner as to whether Europestars should accept the audit engagement of the 4-Airlines Company. What would you recommend? Include consideration of reasons both for and against acceptance and use both financial and non-financial information to justify your recommendation.

AUDITING

CASE STUDY

RISK & MATERIALITY ASSESSMENT

LEARNING OBJECTIVES – DETERMINING MATERIALITY

1. Identify business risks for the air transport service sector
2. Identify and evaluate the factors important in assessing an audit client's business risk and the risk of material misstatement
3. Identify and understand the implications of key inherent and business risks associated with a new client
4. Determine planning materiality for an audit client
5. Provide support for your materiality decisions

DETERMINING MATERIALITY

After you have accepted 4-Airlines as a new client, you are provided with the preliminary December 31, 2xx1 financial statement. For the purpose of risk assessment please use the information given in the description of the case. To fulfil this task please answer the questions on the next page. For determining materiality please use the Risk Assessment sheet in the Appendix.

WORK TASK - DETERMINING MATERIALITY

Group discussion (up to five students) of the following questions and preparation of presentation slides for each question.

1. What risks should be considered when materiality is determined? Identify at least seven risks applicable to the case study.

2. Briefly list and discuss the five or six most important critical factors or risk areas that will likely affect how the audit is conducted.

3. Quantify the risks regarding management issues, accounting environment, operating environment and audit issues and determine a general risk level of the '4-Airlines' audit, on an evaluation scale from one to five. (please use the risk assessment sheet given in the appendix)
4. Show the impact of the analysis you have performed within task 3 on the materiality.
5. Determine the materiality, as well as other materiality-related aspects according to ISA 320 (e.g. performance materiality), relying on the information presented within the case study and the annexes.
6. Describe the relevance of the materiality in planning the audit engagement and specify if the materiality determined based on the unaudited financial statements can be changed while the audit is in progress.
7. While performing the audit, the team identifies five errors related to the valuation or the disclosure of the items in the financial statements. What is the impact of the identified errors on the audit opinion from the standpoint of the materiality?

APPENDIX – RISK ASSESSMENT FORM

Risk factor	1 Very low	2 Low	3 Medium	4 High	5 Very high
Management issues (8)					
The client's financial position					
The client's liquidity					
The extent to which the financial statements are used by a third party					
The experience and the management knowledge of those in charge with the governance					
The attitude of the management towards the financial reporting					
The frequent change of the auditors					
The previous experience related to the management control capability					
Proper remuneration of the activities, in accordance with their nature and associated performance					
Accounting environment (9)					
Skills of the accounting employees					
Attitude of Accounting Department's personnel					
Risk of inaccurate, inadequate or overdue financial information					
Previous proof on earnings management					
Frequency and materiality of transactions which are difficult to audit					
New or complex accounting policies					
Complex company and accounting structure, associated to the size of the client					
Breaks or falls of the accounting system					
Evidence suggesting that problems may arise, associated to the manner in which operations are accounted for					

Operating environment (6)					
Nature of the field – growth/fall, new/old					
Changes in profitability/liquidity ratio					
Threats to the return generated by the activities					
Intended material purchases / external investments					
General performance level of the sector					
Important client / Renowned client					
Audit issues (4)					
Records related to previous qualifications or modifications (regarding opinions and/or reporting)					
Reporting fundamental uncertainties, including issues related to the going concern assumption					
The probability to encounter difficulties in collecting audit evidence					
Unusual transactions, or industry specific transactions, as well as practices difficult to audit					
TOTAL					
Relevance assigned to each risk					
Inherent risk level for each class					
Total inherent risk					