You are a manager in Magpie & Co, responsible for the audit of the CS Group. An extract from the permanent audit file describing the CS Group's history and operations is shown below:

Permanent file (extract)

Crow Co was incorporated 100 years ago. It was founded by Joseph Crow, who established a small pottery making tableware such as dishes, plates and cups. The products quickly grew popular, with one range of products becoming highly sought after when it was used at a royal wedding.

The company's products have retained their popularity over the decades, and the Crow brand enjoys a strong identity and good market share.

Ten years ago, Crow Co made its first acquisition by purchasing 100% of the share capital of Starling Co. Both companies benefited from the newly formed CS Group, as Starling Co itself had a strong brand name in the pottery market. The CS Group has a history of steady profitability and stable management.

Crow Co and Starling Co have a financial year ending 31 July 2012, and your firm has audited both companies for several years.

(a) You have received an email from Jo Daw, the audit engagement partner:

To: Audit manager

From: Jo Daw

Regarding: CS Group audit planning

Hello

I have just been to a meeting with Steve Eagle, the finance director of the CS Group. We were discussing recent events which will have a bearing on our forthcoming audit, and my notes from the meeting are attached to this email. One of the issues discussed is the change in group structure due to the acquisition of Canary Co earlier this year.

Our firm has been appointed as auditor of Canary Co, which has a year ending 30 June 2012, and the terms of the engagement have been agreed with the client. We need to start planning the audits of the three components of the Group, and of the consolidated financial statements.

Using the attached information, you are required to:

(i) Identify and explain the implications of the acquisition of Canary Co for the audit planning of the individual and consolidated financial statements of the CS Group; (8 marks)

(ii) Evaluate the risks of material misstatement to be considered in the audit planning of the individual and consolidated financial statements of the CS Group; and (18 marks)

(iii) Recommend the principal audit procedures to be performed in respect of the goodwill initially recognised on the acquisition of Canary Co. (5 marks)

Thank you.

Attachment: Notes from meeting with Steve Eagle, finance director of the CS Group

Acquisition of Canary Co

The most significant event for the CS Group this year was the acquisition of Canary Co, which took place on 1 February 2012. Crow Co purchased all of Canary Co's equity shares for cash consideration of $125 million, and further contingent consideration of $30 million will be paid on the third anniversary of the acquisition, if the Group's revenue grows by at least 8% per annum.

Crow Co engaged an external provider to perform due diligence on Canary Co, whose report indicated that the fair value of Canary Co's net assets was estimated to be $110 million at the date of acquisition. Goodwill arising on the acquisition has been calculated as follows:

	$ million
fair value of consideration	
cash consideration	125
contingent consideration	30

	155
less fair value of identifiable net assets acquired	-110
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goodwill	45

To help finance the acquisition, Crow Co issued loan stock at par on 31 January 2012, raising cash of $100 million. The loan has a five-year term, and will be repaid at a premium of $20 million. 5% interest is payable annually in arrears. It is Group accounting policy to recognise financial liabilities at amortised cost.

Canary Co manufactures pottery figurines and ornaments. The company is considered a good strategic fit to the Group, as its products are luxury items like those of Crow Co and Starling Co, and its acquisition will enable the Group to diversify into a different market.

Approximately 30% of its sales are made online, and it is hoped that online sales can soon be introduced for the rest of the Group's products. Canary Co has only ever operated as a single company, so this is the first year that it is part of a group of companies.

Financial performance and position

The Group has performed well this year, with forecast consolidated revenue for the year to 31 July 2012 of $135 million (2011 – $125 million), and profit before tax of $8.5 million (2011 – $8.4 million). A breakdown of the Group's forecast revenue and profit is shown below:

	crow co	starling co	canary co	cs group
	$ million	**$ million**	**$ million**	**$ million**
revenue	69	50	16	135
profit before tax	3.5	3	2	8.5

Note: Canary Co's results have been included from 1 February 2012 (date of acquisition), and forecast up to 31 July 2012, the CS Group's financial year end.

The forecast consolidated statement of financial position at 31 July 2012 recognises total assets of $550 million.

Other matters

Starling Co received a grant of $35 million on 1 March 2012 in relation to redevelopment of its main manufacturing site. The government is providing grants to companies for capital expenditure on environmentally friendly assets.

Starling Co has spent $25 million of the amount received on solar panels which generate electricity, and intends to spend the remaining $10 million on upgrading its production and packaging lines.

On 1 January 2012, a new IT system was introduced to Crow Co and Starling Co, with the aim of improving financial reporting controls and to standardise processes across the two companies. Unfortunately, Starling Co's finance director left the company last week.

Required:

Respond to the email from the partner.

(b) Magpie & Co's ethics partner, Robin Finch, leaves a note on your desk:

'I have just had a conversation with Steve Eagle concerning the CS Group. He would like the audit engagement partner to attend the CS Group's board meetings on a monthly basis so that our firm can be made aware of any issues relating to the audit as soon as possible.

Also, Steve asked if one of our audit managers could be seconded to Starling Co in temporary replacement of its finance director who recently left, and asked for our help in recruiting a permanent replacement. Please provide me with a response to Steve which evaluates the ethical implications of his requests.'

Required:
Respond to the note from the partner. (6 marks)