

Professional Level – Options Module

# Advanced Audit and Assurance (United Kingdom)

September/December 2015



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This question paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

**Do NOT open this question paper until instructed by the supervisor.  
During reading and planning time only the question paper may  
be annotated. You must NOT write in your answer booklet until  
instructed by the supervisor.**

**This question paper must not be removed from the examination hall.**

The Association of Chartered Certified Accountants

# Paper P7 (UK)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

**Section A – BOTH questions are compulsory and MUST be attempted**

1 You are a manager in the audit department of Mondrian & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of Dali plc, a listed company specialising in the design and manufacture of equipment and machinery used in the quarrying industry. You are planning the audit of the financial statements for the year ending 31 December 2015. The projected financial statements for the 2015 year end recognise revenue of £138 million (2014 – £135 million), profit before tax of £9.8 million (2014 – £9.2 million) and total assets of £90 million (2014 – £85 million). Dali plc became listed in the UK on 1 March 2015, and is hoping to achieve a listing on a foreign stock exchange in June 2016.

You have just received the following email from the audit engagement partner.

**To: Audit manager**  
**From: Audit engagement partner, Sam Hockney**  
**Regarding: Audit planning – Dali plc**

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**Hello**

I need you to start planning the audit of Dali plc. I know you are new to this audit client, so I have provided you with some background information, the results of some preliminary analytical review performed by one of the audit team members, and notes from a discussion I had with the company’s audit committee yesterday.

I require you to prepare briefing notes for use in the audit planning meeting which will be held next week. The notes should contain an evaluation of the audit risks to be considered in planning the audit of Dali plc, and you should also recommend the additional information which is relevant to the evaluation of audit risk.

Your briefing notes should also contain an explanation of the principal audit procedures to be performed in respect of the valuation of work in progress, and the recognition and measurement of the government grant.

**Thank you.**

**Company background**

Dali plc was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction. Its customer base is located solely in the UK but most of the components used in Dali plc’s manufacturing process are imported from foreign suppliers.

The company operates several manufacturing sites where the machinery is designed and manufactured. Some of the sites provide employment in economically deprived areas, and Dali plc is keen to promote its success in community engagement and to demonstrate the positive social impact of its activities in these areas.

The machines and equipment made by Dali plc are mostly made to order in the company’s manufacturing sites. Customers approach Dali plc to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Dali plc also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment.

**Notes from meeting with Dali plc audit committee**

This year has been successful from a strategic point of view in that Dali plc achieved its stock exchange listing in March 2015, and in doing so raised a significant amount of equity finance. The company’s corporate governance was reviewed as part of the flotation process, resulting in the recruitment of three new non-executive directors and a new finance director. The company already had an internal audit department in place prior to the flotation, and the department’s reports indicate that no significant issues have arisen in relation to systems and controls over financial reporting during this financial year.

In March 2015, a cash-settled share-based payment plan was introduced for senior executives, who will receive a bonus on 31 December 2017. The amount of the bonus will be based on the increase in Dali plc’s share price from

that at the date of the flotation, when it was £2.90, to the share price at 31 December 2017. On the advice of the newly appointed finance director, no accounting entries have been made in respect of the plan, but the details relating to it will be disclosed in the notes to the financial statements.

The finance director recommended that the company's manufacturing sites should be revalued. An external valuation was performed in June 2015, resulting in a revaluation surplus of £3.5 million being recognised in equity. The finance director has informed the audit committee that no deferred tax needs to be provided in respect of the valuation because the property is part of continuing operations and there is no plan for disposal.

In July 2015, a government grant of £10 million was received as part of a government scheme to subsidise companies which operate in economically deprived areas. Specifically £2 million of the grant compensates the company for wages and salaries incurred in the year to 31 December 2015. The remaining grant relates to the continued operations in the deprived area, with a condition of the grant being that the manufacturing site in that area will remain operational until July 2020.

All of the company's engineering sites will be closed at the year end to allow the inventory counts to take place. According to the most recent management accounts which are available, at 30 November 2015 work in progress is valued at £12 million (2014 – £9.5 million) and the majority of these orders will not be complete until after the year end. In recent weeks several customers have returned equipment due to faults, and Dali plc offers a warranty to guarantee that defective items will be replaced free of charge.

**Preliminary analytical review (extract) and other financial information**

	Based on projected figures to 31 December 2015	Based on audited figures to 31 December 2014
Operating margin	15%	13%
Inventory days	175 days	150 days
Receivables collection period	90 days	70 days
Trade payables payment period	60 days	55 days
Earnings per share	75 pence per share	–
Share price	£3.50	–

**Required:**

**Respond to the instructions in the audit partner's email.** (31 marks)

Professional marks will be awarded for the presentation of the briefing notes and for the clarity of explanations provided. (4 marks)

**(35 marks)**

2 Malevich & Co is a firm of Chartered Certified Accountants offering audit and assurance services to a large portfolio of clients. You are a manager in the audit department responsible for the audit of two clients, Kandinsky Ltd and Viola Ltd.

(a) Kandinsky Ltd is a manufacturer of luxury food items including chocolate and other confectionery which are often sold as gift items individually or in hampers containing a selection of expensive items from the range of products. The company has a financial year ended 31 July 2015, much of the planned audit work has been completed, and you are reviewing issues which have been raised by the audit senior. Due to an economic recession sales of products have fallen sharply this year, and measures have been implemented to support the company's cash flow. You are aware that the company only has £150,000 in cash at the year end.

Extracts from the draft financial statements and other relevant information are given below.

	Note	July 2015 (Draft) £'000	July 2014 (Actual) £'000
Revenue		2,440	3,950
Operating expenses		(2,100)	(2,800)
Finance charge		(520)	(500)
(Loss)/profit before tax		(180)	650
Total assets		10,400	13,500
Long-term liabilities – bank loan	1	3,500	3,000
Short-term liabilities – trade payables	2	900	650
Disclosed in notes to financial statements:			
Undrawn borrowing facilities	3	500	1,000
Contingent liability	4	120	–

**Notes:**

1. The bank loan was extended in March 2015 by drawing on the borrowing facilities offered by the bank. The loan carries a fixed interest rate and is secured on the company's property including the head office and manufacturing site. The first repayment of loan capital is due on 30 June 2016 when £350,000 is due to be paid.
2. Kandinsky Ltd renegotiated its terms of trade with its main supplier of cocoa beans, and extended payment terms from 50 days to 80 days in order to improve working capital.
3. The borrowing facilities are due to be reviewed by the bank in April 2016 and contain covenants including that interest cover is maintained at 2, and the ratio of bank loan to operating profit does not exceed 4:1.
4. The contingent liability relates to a letter of support which Kandinsky Ltd has provided to its main supplier of cane sugar which is facing difficult trading conditions.

**Required:**

**In respect of the audit of Kandinsky Ltd:**

**Identify and explain the matters which may cast significant doubt on Kandinsky Ltd's ability to continue as a going concern; and recommend the audit procedures to be performed in relation to the going concern matters identified.** (13 marks)

(b) You are also responsible for the audit of Viola Ltd, a small engineering company located in the Midlands with a financial year ended 31 March 2015. The audit report for the financial year then ended, which was issued in September 2015, contained an Emphasis of Matter paragraph outlining the going concern issues facing the company, but was otherwise unmodified.

The finance director of Viola Ltd phoned you yesterday to discuss some recent developments at the company. His comments are shown in the note below:

'I am getting in touch to update you on our situation and to ask for your firm's advice.'

As you know, in the last financial year the company lost several contracts and we had to make a number of staff redundant. In recent months further contracts have been lost and Viola Ltd has faced severe working capital problems, resulting in the sale of some of our plant in order to meet liabilities as they fall due. We are restricted on the assets which can be sold as the company's bank loan is secured by a floating charge over non-current assets. In November 2015 the accounts recognised net liabilities of £500,000 and without securing further finance, the future of the company does not look good.

We are tendering for three new contracts to supply components to local car manufacturers. However, our bank is reluctant to extend our borrowing facilities until the contracts are secured, which may not be for another few months.

My fellow directors are becoming concerned about the possibility of our creditors applying for compulsory liquidation of the company, which we want to avoid if possible. We also wish to avoid a creditor's voluntary liquidation. Can you please advise me on the alternatives which are available given the company's precarious financial situation? I need you to explain the procedures involved with any alternatives which you can recommend, and describe the impact on the employees and directors of the company.'

**Required:**

**Respond to the instructions in the note from the finance director.**

(12 marks)

**(25 marks)**

**Section B – TWO questions ONLY to be attempted**

- 3** You are a manager in the assurance department at Raphael & Co, a firm of Chartered Certified Accountants. Your firm has been appointed by Sanzio Ltd to perform a due diligence review of a potential acquisition target, Titian Tyres Ltd. As part of the due diligence review and to allow for negotiation of an appropriate offer price, Sanzio Ltd has requested that you identify and value all the assets and liabilities of Titian Tyres Ltd, including items which may not currently be reported in the statement of financial position.

Sanzio Ltd is a large, privately owned company operating solely in the UK, which sells spare parts and accessories for cars, vans and bicycles. Titian Tyres Ltd is a national chain of vehicle service centres, specialising in the repair and replacement of tyres, although the company also offers a complete range of engine and bodywork services as well. If the acquisition is successful, the management of Sanzio Ltd intends to open a Titian Tyres service centre in each of its stores.

One of the reasons for Titian Tyres Ltd's success is their internally generated customer database, which records all customer service details. Using the information contained on the database software, the company's operating system automatically informs previous customers when their vehicle is due for its next service via email, mobile phone text or automated letter. It also informs a customer service team to telephone the customer if they fail to book a service within two weeks of receiving the notification. According to the management of Titian Tyres Ltd, repeat business makes up over 60% of annual sales and management believes that this is a distinct competitive advantage over other service centres.

Titian Tyres Ltd also recently purchased a licence to distribute a new, innovative tyre which was designed and patented in the United States. The tyre is made of 100% recycled materials and, due to a new manufacturing process, is more hardwearing and therefore needs replacing less often. Titian Tyres Ltd paid £5 million for the licence in January 2015 and the company is currently the sole, licenced distributor in the UK.

During a brief review of Titian Tyres Ltd's financial statements for the year ended 30 June 2015, you notice a contingent liability disclosure in the notes relating to compensation claims made after the fitting of faulty engine parts during 2014. The management of Titian Tyres Ltd has stated that the fault lies with the manufacturer of the part and that they have made a claim against the manufacturer for the total amount sought by the affected customers.

**Required:**

- (a) Describe the purpose of a due diligence assignment and compare the scope of a due diligence assignment with that of an audit of historical financial statements.** (6 marks)
- (b) (i) Recommend, with reasons, the principal additional information which should be made available to assist with your valuation of Titian Tyres Ltd's intangible assets.**
- (ii) Explain the specific enquiries you should make of Titian Tyres Ltd's management relevant to the contingent liability disclosed in the financial statements.**

**Note:** The total marks will be split equally between each part. (14 marks)

**(20 marks)**

4 You are a manager in Monet & Co, a firm of accountants which has 12 offices and 30 partners, 10 of whom are members of ACCA. As an expert in ethics and professional conduct, you have been asked to advise the partners on the following issues, which were raised at a recent meeting.

- (a) An advertisement has been drafted as part of the firm's drive to increase the number of clients. It is suggested that it should be placed in a number of quality national as well as local newspapers:

Have you had enough of your accountant charging you too much for poor quality services?  
Does your business need a kick-start?

Look no further; Monet & Co provides the most comprehensive range of finance and accountancy services in the UK as well as having the UK's leading tax team who are just waiting to save you money.

Still not sure? We guarantee to be cheaper than your existing service provider and for the month of January we are offering free business advice to all new audit clients.

Drop in and see us at your local office for a free consultation.

Monet & Co, Chartered Certified Accountants.

(7 marks)

- (b) The planning for the audit of Renoir Ltd's financial statements for the year ending 31 March 2016 will commence shortly. In preparation the audit partner telephoned Renoir Ltd's finance director, Jim Cassatt, to set up a planning meeting and to remind him that fees relating to a tax engagement from the previous year were still outstanding. Mr Cassatt raised concerns about the conduct of the previous audit, stating numerous examples of when he and his staff had been interrupted when they were busy. He stated that he wanted guarantees that this year's audit will be more efficient, less intrusive and cheaper, otherwise he will seek an alternative auditor. (7 marks)
- (c) Your firm audits the publisher Homer Winslow Ltd. During its recent audit, the company's finance director commented on growing competition in the digital publishing sector. One rapidly expanding competitor, Pissarro Ltd, was specifically referred to. You are aware that your firm recently acquired another accountancy firm, Maar Associates, and that Pissarro Ltd is one of their clients. It is hoped that the audit of Pissarro Ltd will be transferred to your department to take advantage of your specialism in media and publishing. (6 marks)

**Required:**

**Evaluate each of the issues described above, commenting on the ethical and professional issues raised and recommend any actions necessary in response to the issues identified.**

Note: The split of the mark allocation is shown against each of the issues above.

**(20 marks)**

- 5 You are an audit manager at Rockwell & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of the Hopper Group, a listed audit client which supplies ingredients to the food and beverage industry worldwide.

The audit work for the year ended 30 June 2015 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. During the year the Hopper Group purchased a new subsidiary company, Seurat Sweeteners Ltd, which has expertise in the research and design of sugar alternatives. The draft financial statements of the Hopper Group for the year ended 30 June 2015 recognise profit before tax of £495 million (2014 – £462 million) and total assets of £4,617 million (2014: £4,751 million).

An extract from the draft audit report, which has been prepared by the audit senior, is shown below:

**Basis of modified opinion (extract)**

In their calculation of goodwill on the acquisition of the new subsidiary, the directors have failed to recognise consideration which is contingent upon meeting certain development targets. The directors believe that it is unlikely that these targets will be met by the subsidiary company and, therefore, have not recorded the contingent consideration in the cost of the acquisition. They have disclosed this contingent liability fully in the notes to the financial statements. We do not feel that the directors' treatment of the contingent consideration is correct and, therefore, do not believe that the criteria of the relevant standard have been met. If this is the case, it would be appropriate to adjust the goodwill balance in the statement of financial position.

We believe that any required adjustment may materially affect the financial statements. Therefore, in our opinion, the financial statements do not give a true and fair view of the financial position of the Hopper Group and of the Hopper Group's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

**Emphasis of Matter Paragraph**

We draw attention to the note to the financial statements which describes the uncertainty relating to the contingent consideration described above. The note provides further information necessary to understand the potential implications of the contingency.

**Required:**

- (a) **Critically appraise the draft audit report of the Hopper Group for the year ended 30 June 2015, prepared by the audit senior.**

**Note: You are NOT required to re-draft the extracts from the audit report.** (10 marks)

- (b) The audit of the new subsidiary, Seurat Sweeteners Ltd, was performed by a different firm of auditors, Fish Associates. During your review of the communication from Fish Associates, you note that they were unable to obtain sufficient appropriate evidence with regard to the breakdown of research expenses. The total of research costs expensed by Seurat Sweeteners Ltd during the year was £1.2 million. Fish Associates has issued a qualified audit opinion on the financial statements of Seurat Sweeteners Ltd due to the inability to obtain sufficient appropriate evidence.

**Required:**

**Comment on the actions which Rockwell & Co should take as the auditor of the Hopper Group, and the implications for the auditor's report on the Hopper Group financial statements.** (6 marks)

- (c) **Discuss the quality control procedures which should be carried out by Rockwell & Co prior to the audit report on the Hopper Group being issued.** (4 marks)

**(20 marks)**

**End of Question Paper**