

Professional Level – Options Module

# Advanced Audit and Assurance (United Kingdom)

Monday 2 June 2014



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

This 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 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)

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The question paper begins on page 3.**

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

- 1 You are a manager in Dando & Co, a firm of Chartered Certified Accountants, responsible for the audit of the Adams Group. Your firm was appointed as auditor in January 2014, and the audit engagement partner, Joss Dylan, has sent you the following email:

**To: Audit manager**  
**From: Joss Dylan**  
**Regarding: Adams Group audit planning**

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**Hello**

I need you to begin planning the audit of the Adams Group (the Group), which is a significant new client for our firm. We have been trying to build our market share, especially in the audit of retail organisations, so winning the tender to audit the Group was important to our firm. The Group audit needs to be complete by the end of September 2014 in time for the Annual General Meeting, scheduled for 1 October 2014.

As you know, we have been appointed to audit the Group financial statements, and we have also been appointed to audit the financial statements of the parent company and of all subsidiaries of the Group except for an overseas subsidiary, Lynott Co, which is audited by a local firm, Clapton & Co. All components of the Group have the same year end of 31 May, report under IFRS and in the same currency.

I have provided you with some information about the Group's general background and activities, and extracts from the draft financial statements. Using this information, you are required to evaluate the audit risks to be considered in planning the audit of the Group, and identify and explain any additional information which would be relevant to your evaluation. We can then request that this information is made available as soon as possible.

We also need to find out more about Clapton & Co, as they will be auditing Lynott Co and we have not worked with them before. Please explain the matters to be considered, and the procedures to be performed, in respect of planning to use the work of Clapton & Co.

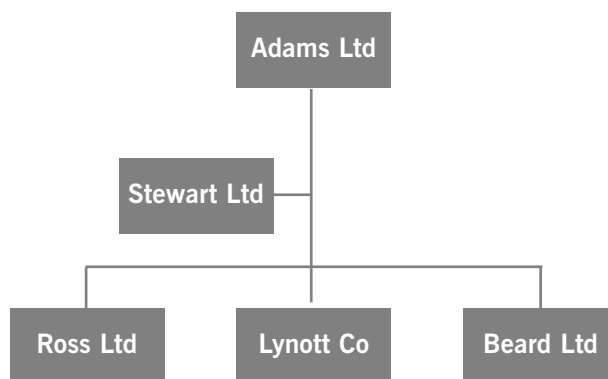
Please present your response as briefing notes for my attention.

**Thank you.**

**Background information**

The Group operates in the textile industry, buying cotton, silk and other raw materials to manufacture a range of goods including clothing, linen and soft furnishings. Goods are sold under the Adams brand name, which was acquired by Adams Ltd many years ago and is held at its original cost in the Group statement of financial position.

The Group structure and information about each of the components of the Group is shown below:



Ross Ltd, Lynott Co and Beard Ltd are all wholly owned, acquired subsidiaries which manufacture different textiles. Adams Ltd also owns 25% of Stewart Ltd, a company which is classified as an associate in the Group statement of financial position at a value of £12 million at 31 May 2014. The shares in Stewart Ltd were acquired in January 2014 for consideration of £11.5 million. Other than this recent investment in Stewart Ltd, the Group structure has remained unchanged for many years.

The Group is not listed. However, the board follows the principles of the UK Corporate Governance Code where possible. There is an audit committee and internal audit function, and in December 2013 several new non-executive directors were appointed.

#### Information relevant to each of the subsidiaries

Ross Ltd manufactures luxury silk clothing, with almost all of its output sold through approximately 200 department stores. Ross Ltd's draft statement of financial position recognises assets of £21.5 million at 31 May 2014. Any silk clothing which has not been sold within 12 months is transferred to Lynott Co, where the silk material is recycled in its manufacturing process.

Lynott Co is located overseas, where it can benefit from low cost labour in its factories. It produces low price fashion clothing for the mass market. A new inventory system was introduced in December 2013 in order to introduce stronger controls over the movement of inventory between factories and stores. Lynott Co is audited by Clapton & Co, and its audit reports in all previous years have been unmodified. Clapton & Co is a small accounting and audit firm, but is a member of an international network of firms. Lynott Co's draft statement of financial position recognises assets of £24 million at 31 May 2014.

Beard Ltd manufactures soft furnishings. The company is cash-rich, and surplus cash is invested in a large portfolio of investment properties, which generate rental income. The Group's accounting policy is to measure investment properties at fair value. Beard Ltd's draft statement of financial position recognises assets of £28 million at 31 May 2014, of which investment properties represent £10 million.

#### Other information

As part of management's strategy to increase market share, a bonus scheme has been put in place across the Group under which senior managers will receive a bonus based on an increase in revenue.

Adams Ltd imposes an annual management charge of £800,000 on each of its subsidiaries, with the charge for each financial year payable in the subsequent August.

#### Extracts from draft Group consolidated financial statements

##### Draft consolidated statement of profit or loss and other comprehensive income

	Year ended 31 May 2014 £'000 Draft	Year ended 31 May 2013 £'000 Actual
Revenue	725,000	650,000
Cost of sales	(463,000)	(417,500)
Gross profit	262,000	232,500
Other income – rental income	200	150
Operating expenses	(250,000)	(225,000)
Profit before tax	12,200	7,650
Income tax expense	(2,500)	(2,000)
<b>Profit for the year</b>	<b>9,700</b>	<b>5,650</b>
<b>Other comprehensive income:</b>		
Gain on investment property revaluation	1,000	3,000
<b>Total comprehensive income</b>	<b>10,700</b>	<b>8,650</b>

Draft consolidated statement of financial position

	31 May 2014 £'000 Draft	31 May 2013 £'000 Actual
<b>Non-current assets</b>		
Property, plant and equipment	50,000	45,000
Investment property	10,000	7,500
Intangible asset – brand name	8,000	8,000
Investment in associate	12,000	–
	<u>80,000</u>	<u>60,500</u>
<b>Current assets</b>		
Inventory	12,000	6,000
Receivables	5,500	6,600
Cash	10,000	22,000
	<u>27,500</u>	<u>34,600</u>
<b>Total assets</b>	<u>107,500</u>	<u>95,100</u>
<b>Equity and liabilities</b>		
Share capital	55,000	55,000
Retained earnings	34,000	24,600
	<u>89,000</u>	<u>79,600</u>
<b>Current liabilities</b>		
Trade payables	16,000	13,500
Tax payable	2,500	2,000
	<u>18,500</u>	<u>15,500</u>
<b>Total equity and liabilities</b>	<u>107,500</u>	<u>95,100</u>

**Required:**

**Respond to the email from the audit partner.**

(31 marks)

Professional marks will be awarded for the presentation, logical flow and clarity of explanation of the briefing notes.

(4 marks)

**(35 marks)**

- 2 (a) You are a manager in Hunt & Co, a firm which offers a range of services to audit and non-audit clients. You have been asked to consider a potential engagement to review and provide a report on the prospective financial information of Waters Ltd, a company which has been an audit client of Hunt & Co for six years. The audit of the financial statements for the year ended 30 April 2014 has just commenced.

Waters Ltd operates a chain of cinemas across the country. Currently its cinemas are out of date and use projectors which cannot show films made using new technology, which are becoming more popular. Management is planning to invest in all of its cinemas in order to attract more customers. The company has sufficient cash to fund half of the necessary capital expenditure, but has approached its bank with a loan application of £8 million for the remainder of the funds required. Most of the cash will be used to invest in equipment and fittings, such as new projectors and larger screens, enabling new technology films to be shown in all cinemas. The remaining cash will be used for refurbishment of the cinemas.

The draft forecast statements of profit or loss for the years ending 30 April 2015 and 2016 are shown below, along with the key assumptions which have been used in their preparation. The unaudited statement of profit or loss for the year ended 30 April 2014 is also shown below. The forecast has been prepared for use by the bank in making its lending decision, and will be accompanied by other prospective financial information including a forecast statement of cash flows.

**Forecast statement of profit or loss**

	Year ended 30 April 2014 Unaudited £'000	Note relevant to forecast information	Year ending 30 April 2015 Forecast £'000	Year ending 30 April 2016 Forecast £'000
Revenue	35,000	1	43,000	46,000
Operating expenses	(28,250)	2	(31,500)	(32,100)
Operating profit	<u>6,750</u>		<u>11,500</u>	<u>13,900</u>
Finance costs	(1,700)		(2,000)	(1,900)
Profit before tax	<u>5,050</u>		<u>9,500</u>	<u>12,000</u>

**Note 1:** The forecast increase in revenue is based on the following assumptions:

- (i) All cinemas will be fitted with new projectors and larger screens to show new technology films by September 2014.
- (ii) Ticket prices will increase from £7.50 to £10 from 1 September 2014.

**Note 2:** Operating expenses include mainly staff costs, depreciation of property and equipment, and repairs and maintenance to the cinemas.

**Required:**

**Explain the matters to be considered by Hunt & Co before accepting the engagement to review and report on Waters Ltd's prospective financial information. Assuming the engagement is accepted, describe the examination procedures to be used in respect of the forecast statement of profit or loss.** (12 marks)

- (b) Hunt & Co has provided non-audit services such as corporate finance and tax planning for Coxon Ltd in the past. Coxon Ltd ran a chain of high street stores selling books, CDs and computer games. Unfortunately, it could not compete with internet sites selling the same goods at a much cheaper price, and since 2012 the company had been loss making. The company was placed into compulsory liquidation last week due to being unable to pay its debts as they fall due.

The finance director, James Corgan, has contacted your firm, seeking advice on several issues to do with the liquidation; his comments are shown in the note below:

'We had thought for some time that the company was in financial difficulties, having lost market share to competitors, but we hoped to turn the company around. Things came to a head in January 2014 when the accounts showed a net liabilities position for the first time, and several loan covenants had been breached. However, we decided to continue to trade in order to maximise cash inflows, keep staff employed for a few

months longer, and try to negotiate finance from new providers. During this period we continued to order goods from several suppliers.

However, the cash position deteriorated and in May 2014 creditors applied to the court for the compulsory winding up of the company. The court has appointed liquidators who are about to commence the winding up.

As you can imagine, myself and the other directors are very worried about the situation. Please provide me with explanations on the following matters. We have heard that we may be personally liable for some of the company's debts. Is this correct, and what are the potential consequences for us? Also, can you explain the impact of the compulsory liquidation process for our employees and for creditors?

**Required:**

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

(13 marks)

**(25 marks)**

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

- 3 (a)** You are an audit manager in Rose & Co, responsible for the audit of Cooper Ltd. You are reviewing the audit working papers relating to the financial year ended 31 January 2014. Cooper Ltd is a manufacturer of chemicals used in the agricultural industry. The draft financial statements recognise profit for the year to 31 January 2014 of £15 million (2013 – £20 million) and total assets of £240 million (2013 – £230 million).

The audit senior, Max Turner, has brought several matters to your attention:

Cooper Ltd's factories are recognised within property, plant and equipment at a carrying value of £60 million. Half of the factories produce a chemical which is used in farm animal feed. Recently the government has introduced a regulation stipulating that the chemical is phased out over the next three years. Sales of the chemical are still buoyant, however, and are projected to account for 45% of Cooper Ltd's revenue for the year ending 31 January 2015. Cooper Ltd has started to research a replacement chemical which is allowed under the new regulation, and has spent £1 million on a feasibility study into the development of this chemical.

In October 2013, Cooper Ltd's finance director, Hannah Osbourne, purchased a car from the company. The carrying value of the car at the date of its disposal to Hannah was £50,000, and its market value was £75,000. Cooper Ltd raised an invoice for £50,000 in respect of the disposal, which is still outstanding for payment.

**Required:**

**Comment on the matters to be considered and explain the audit evidence you should expect to find during your review of the audit working papers in respect of each of the issues described above. (15 marks)**

- (b)** Max noticed that a section of the audit file had not been completed on the previous year's audit. The incomplete section relates to expenditure incurred in the year to 31 January 2013, which appears not to have been audited at all in the prior year. The expenditure of £1.2 million was incurred in the development of an internally generated brand name. The amount was capitalised as an intangible asset at 31 January 2013, and that amount is still recognised at 31 January 2014.

**Required:**

**Explain the implications of this matter for the completion of the audit, and any other professional issues raised, recommending any actions to be taken by the auditor. (5 marks)**

**(20 marks)**



- 4 You are a manager in Ryder & Co, a firm of Chartered Certified Accountants, and you have taken on the responsibility for providing support and guidance to new members of the firm. Ryder & Co has recently recruited a new audit junior, Sam Tyler, who has come across several issues in his first few months at the firm which he would like your guidance on. Sam's comments and questions are shown below:
- (a) I know that auditors are required to assess risks of material misstatement by developing an understanding of the business risks of an audit client, but I am not clear on the relationship between business risk and risk of material misstatement. Can you explain the two types of risk, and how identifying business risk relates to risk of material misstatement? (4 marks)
  - (b) I worked on the interim audit of Crow Ltd, a manufacturing company which outsources its payroll function. I know that for Crow Ltd, payroll is material. How does the outsourcing of payroll affect our audit planning? (4 marks)
  - (c) Crow Ltd is tendering for an important contract to supply Hatfield Ltd. I know that Hatfield Ltd is also an audit client of our firm, and I have heard that Crow Ltd's management has requested our firm to provide advice on the tender it is preparing. What matters should our firm consider in deciding whether to provide advice to Crow Ltd on the tender? (5 marks)
  - (d) I also worked on the audit of Campbell Ltd, where I heard the managing director, Ting Campbell, discussing a potential new business opportunity with the audit engagement partner. Campbell Ltd is an events organiser, and is planning to run a programme of nationwide events for accountants, at which speakers will discuss technical updates to financial reporting, tax and audit regulations. Ting proposed that our firm could invest some cash in the business opportunity, supply the speakers, market the events to our audit clients, and that any profit made would be shared between Ryder & Co and Campbell Ltd. What would be the implications of our firm considering this business opportunity? (7 marks)

**Required:**

**For each of the issues raised, respond to the audit junior, explaining the ethical and professional matters arising from the audit junior's comments.**

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

**(20 marks)**

- 5 (a) It has been suggested that the auditor's report could be improved by the inclusion of specific disclosures in respect of going concern matters, improving the quality and usefulness of the auditor's report issued.

**Required:**

**Discuss this statement.**

(8 marks)

- (b) You are an audit manager in Taylor & Co, a firm of Chartered Certified Accountants, responsible for the audit of Marr Ltd, with a year ended 28 February 2014. The draft financial statements recognise profit for the year of £11 million. The audit for the year end is nearing completion, and several matters have been highlighted for your attention by the audit senior, Xi Smith. The matters have been discussed with management and will not be adjusted in the financial statements:

1. In January 2014 a major customer went into administration. There was a balance of £2.5 million owing to Marr Ltd from this customer at 28 February 2014, which is still included in trade receivables.
2. A court case began in December 2013 involving an ex-employee who is suing Marr Ltd for unfair dismissal. Lawyers estimate that damages of £50,000 are probable to be paid. The financial statements include a note describing the court case and quantifying the potential damages but no adjustment has been made to include it in the statement of financial position or the statement of profit or loss.

Xi Smith has produced a draft audit report for your review, an extract of which is shown below:

**Basis for opinion and disclaimer of opinion**

We have performed our audit based on a materiality level of £1.5 million. Our audit procedures have proven conclusively that trade receivables are materially misstated. The finance director of Marr Ltd, Rita Gilmour, has refused to make an adjustment to write off a significant trade receivables balance. Therefore in our opinion the financial statements of Marr Ltd are materially misstated and we therefore express a disclaimer of opinion because we do not think they show a true and fair view.

**Emphasis of Matter paragraph**

Marr Ltd is facing a legal claim for an amount of £50,000 from an ex-employee. In our opinion this amount should be recognised as a provision but it is not included in the statement of financial position. We draw your attention to this breach of the relevant IFRS.

**Required:**

**Critically appraise the proposed auditor's report of Marr Ltd for the year ended 28 February 2014.**

Note: You are NOT required to re-draft the extracts from the auditor's report.

(12 marks)

**(20 marks)**

**End of Question Paper**