

Professional Level – Options Module

Advanced Audit and Assurance (United Kingdom)

Monday 11 June 2012



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)

ACCA

Section A – BOTH questions are compulsory and MUST be attempted

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

Crow Ltd and Starling Ltd 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 Ltd earlier this year. Our firm has been appointed as auditor of Canary Ltd, 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 Ltd 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 Ltd. (5 marks)

Thank you.

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

Acquisition of Canary Ltd

The most significant event for the CS Group this year was the acquisition of Canary Ltd, which took place on 1 February 2012. Crow Ltd purchased all of Canary Ltd'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 Ltd engaged an external provider to perform due diligence on Canary Ltd, whose report indicated that the fair value of Canary Ltd'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 |
| | <hr/> |
| | 155 |
| Less: fair value of identifiable net assets acquired | (110) |
| | <hr/> |
| Goodwill | 45 |
| | <hr/> |

To help finance the acquisition, Crow Ltd 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 Ltd 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 Ltd and Starling Ltd, 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 Ltd 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 Ltd £ million | Starling Ltd £ million | Canary Ltd £ million | CS Group £ million |
|-------------------|-----------------------|---------------------------|-------------------------|-----------------------|
| Revenue | 69 | 50 | 16 | 135 |
| Profit before tax | 3.5 | 3 | 2 | 8.5 |

Note: Canary Ltd'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 Ltd 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 Ltd 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 Ltd and Starling Ltd, with the aim of improving financial reporting controls and to standardise processes across the two companies. Unfortunately, Starling Ltd's finance director left the company last week.

Required:

Respond to the email from the partner.

(31 marks)

Note: the split of the mark allocation is shown within the email.

(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 Ltd 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)

(37 marks)

**This is a blank page.
Question 2 begins on page 6.**

- 2 (a) You are a manager in Lapwing & Co. One of your audit clients is Hawk Ltd which operates commercial real estate properties typically comprising several floors of retail units and leisure facilities such as cinemas and health clubs, which are rented out to provide rental income.

Your firm has just been approached to provide an additional engagement for Hawk Ltd, to review and provide a report on the company's business plan, including forecast financial statements for the 12-month period to 31 May 2013. Hawk Ltd is in the process of negotiating a new bank loan of £30 million and the report on the business plan is at the request of the bank. It is anticipated that the loan would be advanced in August 2012 and would carry an interest rate of 4%. The report would be provided by your firm's business advisory department and a second partner review will be conducted which will reduce any threat to objectivity to an acceptable level.

Extracts from the forecast financial statements included in the business plan are given below:

Statement of comprehensive income (extract)

| | Note | FORECAST 12 months to 31 May 2013 £'000 | UNAUDITED 12 months to 31 May 2012 £'000 |
|-----------------------------------|------|--|---|
| Revenue | | 25,000 | 20,600 |
| Operating expenses | | (16,550) | (14,420) |
| Operating profit | | 8,450 | 6,180 |
| Profit on disposal of Beak Retail | 1 | 4,720 | – |
| Finance costs | | (2,650) | (1,690) |
| Profit before tax | | 10,520 | 4,490 |

Statement of financial position

| | Note | FORECAST 31 May 2013 £'000 | UNAUDITED 31 May 2012 £'000 |
|-------------------------------------|------|----------------------------------|-----------------------------------|
| Assets | | | |
| Non-current assets | | | |
| Property, plant and equipment | 2 | 330,150 | 293,000 |
| Current assets | | | |
| Inventory | | 500 | 450 |
| Receivables | | 3,600 | 3,300 |
| Cash and cash equivalents | | 2,250 | 3,750 |
| | | 6,350 | 7,500 |
| Total assets | | 336,500 | 300,500 |
| Equity and liabilities | | | |
| Equity | | | |
| Share capital | | 105,000 | 100,000 |
| Retained earnings | | 93,400 | 92,600 |
| Total equity | | 198,400 | 192,600 |
| Non-current liabilities | | | |
| Long-term borrowings | 2 | 82,500 | 52,500 |
| Deferred tax | | 50,000 | 50,000 |
| Current liabilities | | | |
| Trade payables | | 5,600 | 5,400 |
| Total liabilities | | 138,100 | 107,900 |
| Total equity and liabilities | | 336,500 | 300,500 |

Notes:

1. Beak Retail is a retail park which is underperforming. Its sale is currently being negotiated, and is expected to take place in September 2012.
2. Hawk Ltd is planning to invest the cash raised from the bank loan in a new retail and leisure park which is being developed jointly with another company, Kestrel Ltd.

Required:

In respect of the engagement to provide a report on Hawk Ltd's business plan:

- (i) Identify and explain the matters that should be considered in agreeing the terms of the engagement; and**

Note: You are NOT required to consider ethical threats to objectivity. (6 marks)

- (ii) Recommend the procedures that should be performed in order to examine and report on the forecast financial statements of Hawk Ltd for the year to 31 May 2013.** (10 marks)

- (b)** You are also responsible for the audit of Jay Ltd, a company with a year ended 30 September 2011, in relation to which an unmodified audit report was issued in December 2011. Jay Ltd operates two separate divisions both of which manufacture food supplements – 'Jay Sport' manufactures food supplements targeted at athletes, and 'Jay Plus' is targeted at the general public. The audit engagement partner, Bill Kingfisher, sent you the following email this morning:

To: Audit manager

From: Bill Kingfisher, audit engagement partner, Jay Ltd

Regarding: Jay Ltd – financial results

Hello

I have just received some worrying news from the finance director of Jay Ltd. The company's latest results are not looking good – I have attached an extract from the latest management accounts for your information.

It seems that one of the key ingredients used in the 'Jay Sport' range has been found to have harmful side effects, so very few sales from that range have been made in the current financial year. The company is struggling to manage its working capital and meet interest payments on loans.

In light of all this, the directors are anxious about the future of the company, and I have been asked to attend a meeting with them tomorrow to discuss their concerns over the financial performance and position of Jay Ltd.

I am asking you to prepare briefing notes for my use in the meeting with the directors, in which you:

- (i) Examine the financial position of Jay Ltd and determine whether the company is insolvent; and** (4 marks)

- (ii) Evaluate, reaching a recommendation, the options available to the directors in terms of the future of the company.** (9 marks)

Thank you.

Attachment: Extract from Jay Ltd's management accounts at 31 May 2012 (unaudited)

Statement of financial position

| | £'000 |
|---|---------------|
| Property, plant and equipment | 12,800 |
| Inventory | 500 |
| Trade receivables | 400 |
| Cash | 0 |
| Total assets | 13,700 |
| Share capital | 100 |
| Retained earnings | (1,050) |
| Long-term borrowings (secured with a fixed charge over property, plant and equipment) | 12,000 |
| Trade payables (including employees wages of £300,000) | 1,250 |
| Bank overdraft | 1,400 |
| Total equity and liabilities | 13,700 |

Statement of Comprehensive Income (extract)

| | Figures for the 8 months to 31 May 2012 | | |
|------------------------|---|------------|----------------|
| | 'Jay Sport' | 'Jay Plus' | Jay Ltd |
| | £'000 | £'000 | £'000 |
| Revenue | 50 | 1,450 | 1,500 |
| Operating costs | (800) | (1,200) | (2,000) |
| Operating loss/profit | (750) | 250 | (500) |
| Finance costs | | | (800) |
| Loss before tax | | | (1,300) |

Required:

Respond to the partner's email.

(13 marks)

Note: the split of the mark allocation is shown within the partner's email.

Professional marks will be awarded in part (b) for the presentation and clarity of your answer.

(4 marks)

(33 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a)** You are a manager in Lark & Co, responsible for the audit of Heron Ltd, an owner-managed business which operates a chain of bars and restaurants. This is your firm's first year auditing the client and the audit for the year ended 31 March 2012 is underway. The audit senior sends a note for your attention:

'When I was auditing revenue I noticed something strange. Heron Ltd's revenue, which is almost entirely cash-based, is recognised at £5.5 million in the draft financial statements. However, the accounting system shows that till receipts for cash paid by customers amount to only £3.5 million. This seemed odd, so I questioned Ava Gull, the financial controller about this. She said that Jack Heron, the company's owner, deals with cash receipts and posts through journals dealing with cash and revenue. Ava asked Jack the reason for these journals but he refused to give an explanation.

'While auditing cash, I noticed a payment of £2 million made by electronic transfer from the company's bank account to an overseas financial institution. The bank statement showed that the transfer was authorised by Jack Heron, but no other documentation regarding the transfer was available.

'Alarmed by the size of this transaction, and the lack of evidence to support it, I questioned Jack Heron, asking him about the source of cash receipts and the reason for electronic transfer. He would not give any answers and became quite aggressive.'

Required:

- (i) Discuss the implications of the circumstances described in the audit senior's note; and** (6 marks)
(ii) Explain the nature of any reporting that should take place by the audit senior. (3 marks)

- (b)** You are also responsible for the audit of Coot Ltd, and you are currently reviewing the working papers of the audit for the year ended 28 February 2012. In the working papers dealing with payroll, the audit junior has commented as follows:

'Several new employees have been added to the company's payroll during the year, with combined payments of £125,000 being made to them. There does not appear to be any authorisation for these additions. When I questioned the payroll supervisor who made the amendments, she said that no authorisation was needed because the new employees are only working for the company on a temporary basis. However, when discussing staffing levels with management, it was stated that no new employees have been taken on this year. Other than the tests of controls planned, no other audit work has been performed.'

Required:

In relation to the audit of Coot Ltd's payroll:

Explain the meaning of the term 'professional skepticism', and recommend any further actions that should be taken by the auditor. (6 marks)

(15 marks)

- 4 You are a senior manager in the audit department of Raven & Co. You are reviewing two situations which have arisen in respect of audit clients, which were recently discussed at the monthly audit managers' meeting:

Grouse Ltd is a significant audit client which develops software packages. Its managing director, Max Partridge, has contacted one of your firm's partners regarding a potential business opportunity. The proposal is that Grouse Ltd and Raven & Co could jointly develop accounting and tax calculation software, and that revenue from sales of the software would be equally split between the two firms. Max thinks that Raven & Co's audit clients would be a good customer base for the product.

Plover Ltd is a private hospital which provides elective medical services, such as laser eye surgery to improve eyesight. The audit of its financial statements for the year ended 31 March 2012 is currently taking place. The audit senior overheard one of the surgeons who performs laser surgery saying to his colleague that he is hoping to finish his medical qualification soon, and that he was glad that Plover Ltd did not check his references before employing him. While completing the subsequent events audit procedures, the audit senior found a letter from a patient's solicitor claiming compensation from Plover Ltd in relation to alleged medical negligence resulting in injury to the patient.

Required:

Identify and discuss the ethical, commercial and other professional issues raised, and recommend any actions that should be taken in respect of:

(a) Grouse Ltd; and (8 marks)

(b) Plover Ltd. (7 marks)

(15 marks)

- 5** You are the partner responsible for performing an engagement quality control review on the audit of Snipe Ltd. You are currently reviewing the audit working papers and draft audit report on the financial statements of Snipe Ltd for the year ended 31 January 2012. The draft financial statements recognise revenue of £8·5 million, profit before tax of £1 million, and total assets of £175 million.

- (a)** During the year Snipe Ltd's factory was extended by the self-construction of a new processing area, at a total cost of £5 million. Included in the costs capitalised are borrowing costs of £100,000, incurred during the six-month period of construction. A loan of £4 million carrying an interest rate of 5% was taken out in respect of the construction on 1 March 2011, when construction started. The new processing area was ready for use on 1 September 2011, and began to be used on 1 December 2011. Its estimated useful life is 15 years.

Required:

In respect of your file review of non-current assets:

Comment on the matters that should be considered, and the evidence you would expect to find regarding the new processing area. (8 marks)

- (b)** Snipe Ltd has in place a defined benefit pension plan for its employees. An actuarial valuation on 31 January 2012 indicated that the plan is in deficit by £10·5 million. The deficit is not recognised in the statement of financial position. An extract from the draft audit report is given below:

Auditor's opinion

In our opinion, because of the significance of the matter discussed below, the financial statements do not give a true and fair view of the financial position of Snipe Ltd as at 31 January 2012, and of its financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Explanation of adverse opinion in relation to pension

The financial statements do not include the company's pension plan. This deliberate omission contravenes accepted accounting practice and means that the accounts are not properly prepared.

Required:

Critically appraise the extract from the proposed audit report of Snipe Ltd for the year ended 31 January 2012.

Note: you are NOT required to re-draft the extract of the audit report.

(7 marks)

(15 marks)

End of Question Paper