

Professional Level – Options Module

Advanced Audit and Assurance (United Kingdom)

Monday 3 June 2013



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)

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

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The question paper begins on page 3.**

Section A – BOTH questions are compulsory and MUST be attempted

1 You are an audit manager in Hound & Co, responsible for the audit of Parker Ltd, a new audit client of your firm. You are planning the audit of Parker Ltd’s financial statements for the year ending 30 June 2013, and you have just attended a meeting with Ruth Collie, the finance director of Parker Ltd, where she gave you the projected results for the year. Parker Ltd designs and manufactures health and beauty products including cosmetics.

Parker Ltd was incorporated 20 years ago and was founded by Peter Parker and his sister Polly, who retain a controlling interest in the company. The company’s manufacturing base is in the Midlands and it employs 4,000 people, approximately half of these at the main factory and distribution centre. Parker Ltd sells its products to supermarkets and high street retailers and aims to establish an internet-based revenue stream within the next two years.

The previous audit firm, Muzzle & Co, resigned last year. The resignation was prompted by the closure of Muzzle & Co’s office in the Midlands and the retirement of the partner responsible for the audit of Parker Ltd. Peter and Polly did not want to liaise with a new partner in a distant location, and approached Hound & Co to tender for the audit due to the proximity of its large audit department to Parker Ltd’s head office in the Midlands.

You have just received an email from Harry Shepherd, the audit engagement partner:

To: Audit manager
From: Harry Shepherd, Partner
Subject: Parker Ltd

Hello

I understand you met with Ruth Collie at Parker Ltd recently and that you are planning the forthcoming audit. To bring me up to date on this new client, I would like you to use the information obtained in your meeting to prepare briefing notes for my use in which you evaluate the audit risks to be considered in planning the audit of the financial statements. You should also identify further information that would help to perform the assessment of audit risk. In your briefing notes you should also discuss any ethical or professional issues raised, and recommend the relevant actions to be taken by our firm.

Thank you.

Parker Ltd – Statement of profit or loss and other comprehensive income

| | Notes | 30 June 2013 Projected £'000 | 30 June 2012 Actual £'000 |
|---------------------|-------|------------------------------------|---------------------------------|
| Revenue | | 7,800 | 8,500 |
| Cost of sales | 1 | (5,680) | (5,800) |
| Gross profit | | 2,120 | 2,700 |
| Operating expenses | | (1,230) | (1,378) |
| Operating profit | | 890 | 1,322 |
| Finance costs | | (155) | (125) |
| Profit before tax | | 735 | 1,197 |
| Taxation | | (70) | (300) |
| Profit for the year | | 665 | 897 |

Note 1: Cost of sales includes £250,000 relating to a provision for a potential fine payable. The advertising regulatory authority has issued a notice of a £450,000 fine payable by Parker Ltd due to alleged inappropriate claims made in an advertising campaign. The fine is being disputed and the matter should be resolved in August 2013.

Parker Ltd – Statement of financial position

| | Notes | 30 June 2013 Projected £'000 | 30 June 2012 Actual £'000 |
|--------------------------------------|-------|------------------------------------|---------------------------------|
| Non-current assets | | | |
| Property, plant and equipment | | 21,500 | 19,400 |
| Intangible asset – development costs | 2 | 2,250 | – |
| | | <u>23,750</u> | <u>19,400</u> |
| Current assets | | | |
| Inventory | | 2,600 | 2,165 |
| Trade receivables | | 900 | 800 |
| Cash | | – | 1,000 |
| | | <u>3,500</u> | <u>3,965</u> |
| Total assets | | <u><u>27,250</u></u> | <u><u>23,365</u></u> |
| Equity | | | |
| Share capital | | 8,000 | 8,000 |
| Revaluation reserve | 3 | 2,500 | 2,000 |
| Retained earnings | | 1,275 | 1,455 |
| | | <u>11,775</u> | <u>11,455</u> |
| Non-current liabilities | | | |
| 2% preference shares | | 3,125 | 3,125 |
| Bank loan | | 3,800 | 2,600 |
| Obligations under finance leases | | 4,900 | 4,000 |
| | | <u>11,825</u> | <u>9,725</u> |
| Current liabilities | | | |
| Trade payables | | 1,340 | 1,000 |
| Taxation | | 50 | 300 |
| Obligations under finance leases | | 860 | 685 |
| Provisions | | 500 | 200 |
| Overdraft | | 900 | – |
| | | <u>3,650</u> | <u>2,185</u> |
| Total equity and liabilities | | <u><u>27,250</u></u> | <u><u>23,365</u></u> |

Note 2: The development costs relate to a new range of organic cosmetics.

Note 3: All of the company's properties were revalued on 1 January 2013 by an independent, professionally qualified expert.

Notes from your meeting with Ruth Collie

Business review

Parker Ltd is facing difficult trading conditions. Consumer spending is depressed due to recession in the economy. The health and beauty market remains very competitive and a major competitor launched a very successful new cosmetics range during the year, which led to a significant decline in sales of one of Parker Ltd's most successful brands. It has been necessary to cut prices on some of the company's product ranges in an attempt to maintain market share. However, a new brand using organic ingredients is being developed and is due to launch in September 2013.

Financial matters

Cash flow has been a problem this year, largely due to the cash spent on developing the new product range. Cash was also needed to pay dividends to both equity and preference shareholders. To help to reduce cash outflows, some new assets were acquired under finance leases and an extension to the company's bank loan was negotiated in December 2012.

Human resources

In December 2012 Parker Ltd's internal audit team performed a review of the operation of controls over the processing of overtime payments in the human resources department. The review found that the company's specified internal controls procedures in relation to the processing of overtime payments and associated tax payments were not always being followed. Until December 2012 this processing was split between the human resources and finance departments. Since then, the processing has been entirely carried out by the finance department.

Expansion plans

Management is planning to expand Parker Ltd's operations into a new market relating to beauty salons. This is a growing market, and there is synergy because Parker Ltd's products can be sold and used in the salons. Expansion would be through the acquisition of an existing company which operates beauty salons. A potential target, Beauty Boost Ltd, has been identified and preliminary discussions have taken place between the management of the two companies. Parker Ltd's managing director has asked for our firm's advice about the potential acquisition, and specifically regarding the financing of the transaction. Beauty Boost Ltd is an audit client of our firm, so we have considerable knowledge of its business.

New plant and equipment

Management is considering installing new plant and equipment into the factory in 2014, depending on the success of the new organic cosmetics range, at a potential cost of £200,000. There is potential for the assets to be leased if cash is not available for the capital expenditure.

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 Kennel & Co, a firm of Chartered Certified Accountants, is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 2012. The audit of the consolidated financial statements for the year ended 28 February 2013 is nearing completion.

You are a manager in the audit department of Kennel & Co, and you have just received a note from Barry Bark, one of the audit partners:

'I need your help with a couple of matters relating to the Retriever Group. The audit engagement partner has fallen ill and I have taken on responsibility for this client.

'First, one of the audit juniors has made some comments about how the audit was planned and carried out. To help me to understand the implications of these comments can you evaluate the quality control, ethical and other professional matters arising in relation to the planning and performance of the Group audit.

'Second, the audit committee of the Group has contacted Kennel & Co to discuss a theft that took place in the warehouse on 1 June 2013. Details of the incident are provided below. In short, our firm has been asked to perform a forensic investigation into the amount that can be claimed from the insurance provider. In relation to this, I need you to identify and explain the matters to be considered and the steps to be taken in planning the forensic accounting service. You should also recommend the procedures to be performed in determining the amount of the claim. It is thought that the amount of the claim will be immaterial to the Group's financial statements, and there is no ethical threat in Kennel & Co's forensic accounting department providing the forensic accounting service.

'As this is the first involvement that you have had with the Group, I have also provided you with some background information.'

Retriever Group – Business background and extract from draft financial statements

The Group was formed six years ago and has grown rapidly to become a well-known manufacturer of high-tech mobile phones and laptop computers. It uses the very latest technology in its products and brings new designs to market every six months. To keep up with competition, a lot is invested in research and development, and expensive advertising campaigns are continually used to promote the latest innovations to its products.

The Group comprises a parent company and three subsidiaries, and there are plans to acquire a new subsidiary in the Far East in order to begin product development in that market. The Group is structured such that one of the subsidiaries conducts most of the research and development but generates little revenue.

The draft consolidated financial statements recognises revenue of £250 million (£210 million – 2012), profit before tax of £23 million (£20 million – 2012) and total assets of £180 million (£170 million – 2012).

Audit junior's comments

'The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to be low risk. He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement.

'Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything.

'I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because one of the Group's subsidiaries has been loss-making this year, creating unutilised tax losses. As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her – I worked it out to be £20 million. The audit manager said this saved time as we now would not have to audit the deferred tax figure.

'The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful.'

Note from Group audit committee

On 1 June 2013, there was a burglary at the Group's warehouse where inventory is stored prior to despatch to customers. CCTV filmed the thieves loading a lorry belonging to the Group with boxes containing finished goods. The last inventory count took place on 30 April 2013.

The Group has insurance cover in place which covers the cost of assets lost as a result of theft. The Group's internal audit department, which would normally carry out this kind of work, is very short staffed at the moment, so we would like to engage Kennel & Co to provide a forensic investigation into the amount that can be claimed under our insurance cover. The provision of this non-audit service by your firm's forensic accounting department would adhere to the Group's corporate governance policy as long as the service is conducted by non-audit personnel.

Required:

Respond to the instructions from the audit partner.

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3** You are the manager responsible for the audit of Setter Stores Ltd, a company which operates supermarkets across the country. The final audit for the year ended 31 January 2013 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of £300 million, revenue of £620 million and profit before tax of £47.5 million.

Three issues from the audit working papers are summarised below:

(a) Assets held for sale

Setter Stores Ltd owns a number of properties which have been classified as assets held for sale in the statement of financial position. The notes to the financial statements state that the properties are all due to be sold within one year. On classification as held for sale, in October 2012, the properties were re-measured from carrying value of £26 million to fair value less cost to sell of £24 million, which is the amount recognised in the statement of financial position at the year end. (8 marks)

(b) Sale and leaseback arrangement

A sale and leaseback arrangement involving a large property complex was entered into on 31 January 2013. The property complex is a large warehousing facility, which was sold for £37 million, its fair value at the date of the disposal. The facility had a carrying value at that date of £27 million. The only accounting entry recognised in respect of the proceeds raised was to record the cash received and recognise a non-current liability classified as 'Obligations under finance lease'. The lease term is for 20 years, the same as the remaining useful life of the property complex, and Setter Stores Ltd retains the risks and rewards associated with the asset. (7 marks)

(c) Distribution licence

The statement of financial position includes an intangible asset of £15 million, which is the cost of a distribution licence acquired on 1 September 2012. The licence gives Setter Stores Ltd the exclusive right to distribute a popular branded soft drink in its stores for a period of five years. (5 marks)

Required:

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of each of the issues described above.

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

(20 marks)

4 You are a manager in Groom & Co, a firm of Chartered Certified Accountants. You have just attended a monthly meeting of audit partners and managers at which client-related matters were discussed. Information in relation to two clients, which were discussed at the meeting, is given below:

(a) Spaniel Ltd

The audit report on the financial statements of Spaniel Ltd, a long-standing audit client, for the year ended 31 December 2012 was issued in April 2013, and was unmodified. In May 2013, Spaniel Ltd's audit committee contacted the audit engagement partner to discuss a fraud that had been discovered. The company's internal auditors estimate that £4.5 million has been stolen in a payroll fraud, which has been operating since May 2012.

The audit engagement partner commented that neither tests of controls nor substantive audit procedures were conducted on payroll in the audit of the latest financial statements as in previous years' audits there were no deficiencies found in controls over payroll. The total assets recognised in Spaniel Ltd's financial statements at 31 December 2012 were £80 million. Spaniel Ltd is considering suing Groom & Co for the total amount of cash stolen from the company, claiming that the audit firm was negligent in conducting the audit.

Required:

Explain the matters that should be considered in determining whether Groom & Co is liable to Spaniel Ltd in respect of the fraud. (12 marks)

(b) Bulldog Ltd

Bulldog Ltd is a clothing manufacturer, which has recently expanded its operations overseas. To manage exposure to cash flows denominated in foreign currencies, the company has set up a treasury management function, which is responsible for entering into hedge transactions such as forward exchange contracts. These transactions are likely to be material to the financial statements. The audit partner is about to commence planning the audit for the year ending 31 July 2013.

Required:

Discuss why the audit of financial instruments is particularly challenging, and explain the matters to be considered in planning the audit of Bulldog Ltd's forward exchange contracts. (8 marks)

(20 marks)

- 5** You are the manager responsible for the audit of the Poodle Group (the Group) and you are completing the audit of the consolidated financial statements for the year ended 31 March 2013. The draft consolidated financial statements recognise revenue of £18 million (2012 – £17 million), profit before tax of £2 million (2012 – £3 million) and total assets of £58 million (2012 – £59 million). Your firm audits all of the components of the Group, apart from an overseas subsidiary, Toy Ltd, which is audited by a small local firm of accountants and auditors.

The audit senior has left a file note for your attention. You are aware that the Group's annual report and financial statements are due to be released next week, and the Group is very reluctant to make any adjustments in respect of the matters described.

Toy Ltd

The component auditors of Toy Ltd, the overseas subsidiary, have been instructed to provide the Group audit team with details of a court case which is ongoing. An ex-employee is suing Toy Ltd for unfair dismissal and has claimed £500,000 damages against the company. To comply with local legislation, Toy Ltd's individual financial statements are prepared using a local financial reporting framework. Under that local financial reporting framework, a provision is only recognised if a cash outflow is virtually certain to arise. The component auditors obtained verbal confirmation from Toy Ltd's legal advisors that the damages are probable, but not virtually certain to be paid, and no provision has been recognised in either the individual or consolidated financial statements. No other audit evidence has been obtained by the component auditors.

Trade receivable

On 1 June 2013, a notice was received from administrators dealing with the winding up of Terrier Ltd, following its insolvency. The notice stated that the company should be in a position to pay approximately 10% of the amounts owed to its trade payables. Poodle Ltd, the parent company of the Group, includes a balance of £1.6 million owed by Terrier Ltd in its trade receivables.

Chairman's statement

The draft chairman's statement, to be included in the Group's annual report, was received yesterday. The chairman comments on the performance of the Group, stating that he is pleased that revenue has increased by 20% in the year.

Required:

Assess the implications of the matters described above for the completion of the Group audit, and describe the impact on the Group audit report if any adjustments considered necessary are not made.

(20 marks)

End of Question Paper