

Professional Level – Options Module

# Advanced Audit and Assurance (United Kingdom)

Tuesday 4 December 2007

**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

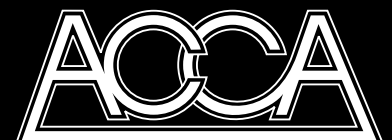
Section B – TWO questions ONLY to be attempted

**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)

**This is a blank page.  
The question paper begins on page 3.**

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

- 1 Your client, Island Ltd, is a manufacturer of machinery used in the coal extraction industry. You are currently planning the audit of the financial statements for the year ended 30 November 2007. The draft financial statements show turnover of £125 million (2006 – £103 million), profit before tax of £5.6 million (2006 – £5.1 million) and total assets of £95 million (2006 – £90 million). Your firm was appointed as auditor to Island Ltd for the first time in June 2007.

Island Ltd designs, constructs and installs machinery for five key customers. Payment is due in three instalments: 50% is due when the order is confirmed (stage one), 25% on delivery of the machinery (stage two), and 25% on successful installation in the customer's coal mine (stage three). Generally it takes six months from the order being finalised until the final installation.

At 30 November, there is an amount outstanding of £2.85 million from Jacks Mine Ltd. The amount is a disputed stage three payment. Jacks Mine Ltd is refusing to pay until the machinery, which was installed in August 2007, is running at 100% efficiency.

One customer, Sawyer Ltd, communicated in November 2007 via its lawyers with Island Ltd, claiming damages for injuries suffered by a drilling machine operator whose arm was severely injured when a machine malfunctioned. Kate Shannon, the chief executive officer of Island Ltd, has told you that the claim is being ignored as it is generally known that Sawyer Ltd has a poor health and safety record, and thus the accident was their fault. Two orders which were placed by Sawyer Ltd in October 2007 have been cancelled.

Work in progress is valued at £8.5 million at 30 November 2007. A physical stock count was held on 17 November 2007. The chief engineer estimated the stage of completion of each machine at that date. One of the major components included in the coal extracting machinery is now being sourced from overseas. The new supplier, Locke Ltd, is located in Spain and invoices Island Ltd in euros. There is a trade creditor of £1.5 million owing to Locke Ltd recorded within current liabilities.

All machines are supplied carrying a one year warranty. A warranty provision is recognised on the balance sheet at £2.5 million (2006 – £2.4 million). Kate Shannon estimates the cost of repairing defective machinery reported by customers, and this estimate forms the basis of the provision.

Kate Shannon owns 60% of the shares in Island Ltd. She also owns 55% of Pacific Ltd, which leases a head office to Island Ltd. Kate is considering selling some of her shares in Island Ltd in late January 2008, and would like the audit to be finished by that time.

**Required:**

- (a) **Using the information provided, identify and explain the principal audit risks, and any other matters to be considered when planning the final audit for Island Ltd for the year ended 30 November 2007.**

Note: your answer should be presented in the format of briefing notes to be used at a planning meeting.  
Requirement (a) includes 2 professional marks. (13 marks)

- (b) **Explain the principal audit procedures to be performed during the final audit in respect of the estimated warranty provision in the balance sheet of Island Ltd as at 30 November 2007.** (5 marks)

- (c) (i) **Identify and describe FOUR quality control procedures that are applicable to the individual audit engagement; and** (8 marks)

(ii) **Discuss TWO problems that may be faced in implementing quality control procedures in a small firm of Chartered Certified Accountants, and recommend how these problems may be overcome.** (4 marks)

**(30 marks)**

- 2 You are the manager responsible for the audit of Sci-Tech Ltd, a pharmaceutical research company. You are planning the substantive audit procedures to be used in the forthcoming audit of intangible assets and operating expenses. Relevant extracts from the financial statements are as follows:

	30 November 2007 (draft) £000	30 November 2006 £000
<b>Balance Sheet</b>		
<b>Intangible assets: Development costs</b>		
Cost	2,750	2,000
Accumulated amortisation	(1,450)	(850)
	1,300	1,150
<b>Total assets</b>	<b>18,500</b>	<b>15,000</b>
<b>Profit and Loss Account</b>		
<b>Turnover</b>	4,500	3,800
<b>Operating expenses include:</b>		
Research costs	160	200
Amortisation of development costs	600	450
Salary expenses	380	400
<b>Profit before tax</b>	<b>1,800</b>	<b>1,530</b>

The following is an extract from the notes to the draft financial statements:

*'Expenditure on product development is capitalised as an intangible asset from the point at which it is probable that future economic benefits will result from the product once completed. Any product development costs which do not meet the above criteria are expensed as incurred as research costs. Two products are currently in the development phase: Medex, an antiseptic cream; and Flortex, a medicine to reduce the symptoms of fever.*

*Amortisation of development costs commences with commercial production, the amortisation period being the estimated life span of the product. Currently two products are being amortised over the following periods:*

1. Plummet Cold Cure            five years
2. Blingo Cough Cure           three years.'

During the initial planning of the audit, the audit senior made the following note on the working papers:

*'Bio-Cert Ltd is the main competitor of our client. It appears that Bio-Cert Ltd is developing a rival product to Flortex. This rival product is expected to be launched in June 2008, six months prior to the expected launch of Flortex.'*

Sci-Tech Ltd decided to outsource its payroll function, commencing in June 2007. The service is being provided by ProPay Ltd, a small local company. All of the accounting records relating to payroll are maintained and kept by ProPay Ltd. In previous years the audit of salary expenses was performed using a systems based approach with limited substantive procedures.

Sci-Tech Ltd receives funding from governmental health departments, as well as several large charitable donations. This funding represents on average 25% of the company's research and development annual expenditure. The amount of funding received is dependent on three key performance indicator (KPI) targets being met annually. All three of the targets must be met in order to secure the government funding.

Extracts from Sci-Tech Ltd's operating and financial review are as follows:

KPI target	Draft KPI 2007	Actual KPI 2006
Pharmaceutical products donated free of charge to health care charities: 1% turnover	0.8% turnover	1.2% turnover
Donations to, and cost of involvement with, local community charities: 0.5% turnover	0.6% turnover	0.8% turnover
Accidents in the work place: Less than 5 serious accidents per year	4 serious accidents	2 serious accidents

In addition to performing the financial statement audit, your firm is engaged to provide an assurance opinion on the KPIs disclosed in the operating and financial review.

**Required:**

- (a) **Define 'outsourcing' and explain the matters to be considered in planning the audit of salary expense.**

Note: requirement (a) includes 2 professional marks. (9 marks)

- (b) (i) **Explain the matters you should consider to determine whether capitalised development costs are appropriately recognised; and** (5 marks)

(ii) **Describe the evidence you would seek to support the assertion that development costs are technically feasible.** (3 marks)

- (c) **Describe the audit procedures you should perform to determine the validity of the amortisation rate of five years being applied to development costs in relation to Plummet.** (5 marks)

- (d) (i) **Discuss why it may not be possible to provide a high level of assurance over the stated key performance indicators; and** (4 marks)

(ii) **Describe the procedures to verify the number of serious accidents in the year ended 30 November 2007.** (4 marks)

**(30 marks)**

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

**3** You are an audit manager in Webb & Co, a firm of Chartered Certified Accountants. Your audit client, Mulligan Ltd, designs and manufactures wooden tables and chairs. The business has expanded rapidly in the last two years, since the arrival of Patrick Tiler, an experienced sales and marketing manager.

The directors want to secure a loan of £3 million in order to expand operations, following the design of a completely new range of wooden garden furniture. The directors have approached LCT Bank for the loan. The bank's lending criteria stipulate the following:

'Loan applications must be accompanied by a detailed business plan, including an analysis of how the finance will be used. LCT Bank need to see that the finance requested is adequate for the proposed business purpose. The business plan must be supported by an assurance opinion on the adequacy of the requested finance.'

The £3 million finance raised will be used as follows:

	<b>£000</b>
Construction of new factory	1,250
Purchase of new machinery	1,000
Initial supply of timber raw material	250
Advertising and marketing of new product	500

Your firm has agreed to review the business plan and to provide an assurance opinion on the completeness of the finance request. A meeting will be held tomorrow to discuss this assignment.

**Required:**

- (a) Identify and explain the matters relating to the assurance assignment that should be discussed at the meeting with Mulligan Ltd.** (8 marks)
  
- (b) State the enquiries you would make of the directors of Mulligan Ltd to ascertain the adequacy of the £3 million finance requested for the new production facility.** (7 marks)

During the year the internal auditor of Mulligan Ltd discovered several discrepancies in the stock records. In a statement made to the board of directors, the internal auditor said:

'I think that someone is taking items from the warehouse. A physical stock count is performed every three months, and it has become apparent that about 200 boxes of flat-packed chairs and tables are disappearing from the warehouse every month. We should get someone to investigate what has happened and quantify the value of the loss.'

**Required:**

- (c) Define 'forensic accounting' and explain its relevance to the statement made by the internal auditor.** (5 marks)

**(20 marks)**

- 4 You are an audit manager in Nate & Co, a firm of Chartered Certified Accountants. You are reviewing three situations, which were recently discussed at the monthly audit managers' meeting:
- (1) Nate & Co has recently been approached by a potential new audit client, Fisher Ltd. Your firm is keen to take the appointment and is currently carrying out client acceptance procedures. Fisher Ltd was recently incorporated by Marcellus Fisher, with its main trade being the retailing of wooden storage boxes.
  - (2) Nate & Co provides the audit service to CF Ltd, a national financial services organisation. Due to a number of errors in the recording of cash deposits from new customers that have been discovered by CF Ltd's internal audit team, the directors of CF Ltd have requested that your firm carry out a review of the financial information technology systems. It has come to your attention that while working on the audit planning of CF Ltd, Jin Sayed, one of the juniors on the audit team, who is a recent information technology graduate, spent three hours providing advice to the internal audit team about how to improve the system. As far as you know, this advice has not been used by the internal audit team.
  - (3) LA Shots Ltd is a manufacturer of bottled drinks, and has been an audit client of Nate & Co for five years. Two audit juniors attended the annual stock count last Monday. They reported that Brenda Mangle, the new production manager of LA Shots Ltd, wanted the stock count and audit procedures performed as quickly as possible. As an incentive she offered the two juniors ten free bottles of 'Super Juice' from the end of the production line. Brenda also invited them to join the LA Shots Ltd office party, which commenced at the end of the stock count. The stock count and audit procedures were completed within two hours (the previous year's procedures lasted a full day), and the juniors then spent four hours at the office party.

**Required:**

- (a) **Define 'money laundering' and state the procedures specific to money laundering that should be considered before, and on the acceptance of, the audit appointment of Fisher Ltd.** (5 marks)
- (b) **With reference to CF Ltd, explain the ethical and other professional issues raised.** (9 marks)
- (c) **Identify and discuss the ethical and professional matters raised at the stock count of LA Shots Ltd.** (6 marks)

**(20 marks)**

- 5 You are the audit manager for three clients of Bertie & Co, a firm of Chartered Certified Accountants. The financial year end for each client is 30 September 2007.

You are reviewing the audit senior's proposed audit reports for two clients, Alpha Plc and Deema Ltd.

Alpha Plc permanently closed several factories in May 2007, with all costs of closure finalised and paid in August 2007. The factories all produced the same item, which contributed 10% of Alpha Plc's total turnover for the year ended 30 September 2007 (2006 – 23%). The closure has been discussed accurately and fully in the chairman's statement and Directors' Report. However, the closure is not mentioned in the notes to the financial statements, nor separately disclosed on the financial statements.

The audit senior has proposed an unmodified audit opinion for Alpha Plc as the matter has been fully addressed in the chairman's statement and Directors' Report.

In October 2007 a legal claim was filed against Deema Ltd, a retailer of toys. The claim is from a customer who slipped on a greasy step outside one of the retail outlets. The matter has been fully disclosed as a material contingent liability in the notes to the financial statements, and audit working papers provide sufficient evidence that no provision is necessary as Deema Ltd's lawyers have stated in writing that the likelihood of the claim succeeding is only possible. The amount of the claim is fixed and is adequately covered by cash resources.

The audit senior proposes that the audit opinion for Deema Ltd should not be qualified, but that an emphasis of matter paragraph should be included after the audit opinion to highlight the situation.

Hugh Ltd was incorporated in October 2006, using a bank loan for finance. Turnover for the first year of trading is £750,000, and there are hopes of rapid growth in the next few years. The business retails luxury hand made wooden toys, currently in a single retail outlet. The two directors (who also own all of the shares in Hugh Ltd) are aware that due to the small size of the company, the financial statements do not have to be subject to annual external audit, but they are unsure whether there would be any benefit in a voluntary audit of the first year financial statements. The directors are also aware that a review of the financial statements could be performed as an alternative to a full audit. Hugh Ltd currently employs a part-time, part-qualified accountant, Monty Parkes, who has prepared a year end balance sheet and profit and loss account, and who produces summary management accounts every three months.

**Required:**

- (a) Evaluate whether the audit senior's proposed audit report is appropriate, and where you disagree with the proposed report, recommend the amendment necessary to the audit report of:
- (i) Alpha Plc; (6 marks)
  - (ii) Deema Ltd. (4 marks)
- (b) Describe the potential benefits for Hugh Ltd in choosing to have a financial statement audit. (4 marks)
- (c) With specific reference to Hugh Ltd, discuss the objective of a review engagement and contrast the level of assurance provided with that provided in an audit of financial statements. (6 marks)

**(20 marks)**

**End of Question Paper**