

Professional Level – Options Module

# Advanced Audit and Assurance (United Kingdom)

Tuesday 8 June 2010

**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.

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

- 1 You are a senior audit manager in Vegas & Co, responsible for the audit of the Grissom Group, which has been an audit client for several years. The group companies all have a financial year ending 30 June 2010, and you are currently planning the final audit of the consolidated financial statements. The group's operations focus on the manufacture and marketing of confectionery and savoury snacks. Information about several matters relevant to the group audit is given below. These matters are all potentially material to the consolidated financial statements. None of the companies in the group are listed.

### Grissom Ltd

This is a non-trading parent company, which wholly owns three subsidiaries – Willows Ltd, Hodges Ltd and Brass Co, all of which are involved with the core manufacturing and marketing operations of the group. This year, the directors decided to diversify the group's activities in order to reduce risk exposure. Non-controlling interests representing long-term investments have been made in two companies – an internet-based travel agent, and a chain of pet shops. In the consolidated balance sheet, these investments are accounted for as associates, as Grissom Ltd is able to exert significant influence over the companies.

As part of their remuneration, the directors of Grissom Ltd receive a bonus based on the profit before tax of the group. In April 2010, the group finance director resigned from office after a disagreement with the chief executive officer over changes to accounting estimates. A new group finance director is yet to be appointed.

### Willows Ltd

This company manufactures and distributes chocolate bars and cakes. In July 2009, production was relocated to a new, very large factory. One of the conditions of the planning permission for the new factory is that Willows Ltd must, at the end of the useful life of the factory, dismantle the premises and repair any environmental damage caused to the land on which it is situated.

### Hodges Ltd

This company's operations involve the manufacture and distribution of packaged nuts and dried fruit. The government paid a grant in November 2009 to Hodges Ltd, to assist with costs associated with installing new, environmentally friendly, packing lines in its factories. The packing lines must reduce energy use by 25% as part of the conditions of the grant, and they began operating in February 2010.

### Brass Co

This company is a new and significant acquisition, purchased in January 2010. It is located overseas, in Chocland, a developing country, and has been purchased to supply cocoa beans, a major ingredient for the goods produced by Willows Ltd. It is now supplying approximately half of the ingredients used in Willows Ltd's manufacturing. Brass Co's financial statements are prepared using the local accounting rules of Chocland. The company uses local currency to measure and present its financial statements.

### Further information

Your firm audits all components of the group with the exception of Brass Co, which is audited by a small local firm, Sidle & Co, based in Chocland. Audit regulations in Chocland are not based on International Standards on Auditing.

You have just received the following email from Warwick Stokes, the audit engagement partner:

**To: Audit manager**  
**From: Warwick Stokes**  
**Re: Grissom Group audit planning**

Hello

I need you to get started on the planning for the audit of the consolidated financial statements of the Grissom Group. We will be holding an audit planning meeting next week, so can you put together some briefing notes to be used at that meeting? I want you to evaluate the principal audit risks, but do not consider issues to do with reliance on another auditor, as that will be dealt with separately. The briefing notes will be the basis of a discussion with the audit team.

Thanks,

Warwick.

**Required:**

- (a) **Respond to the email from the engagement partner.** (18 marks)

Professional marks will be awarded in part (a), for the format of the answer, and for the clarity of the evaluation. (2 marks)

- (b) **Explain the factors that should be considered, and the procedures that should be performed, in deciding the extent of reliance to be placed on the work of Sidle & Co.** (8 marks)

- (c) **Recommend the principal audit procedures that should be performed on:**

(i) **The classification of non-controlling investments made by Grissom Ltd;** (4 marks)

(ii) **The condition attached to the grant received by Hodges Ltd.** (4 marks)

**(36 marks)**

- 2 Mac Ltd is a large, private company, whose business activity is events management, involving the organisation of conferences, meetings and celebratory events for companies. Mac Ltd was founded 10 years ago by Danny Hudson and his sister, Stella, who still own the majority of the company's shares. The company has grown rapidly and now employs more than 150 staff in 20 offices.

You are a manager in the business advisory department of Flack & Co. Your firm has just been engaged to provide the internal audit service to Mac Ltd. In your initial conversation with Danny and Stella, you discovered that currently there is a small internal audit team, under the supervision of Lindsay Montana, a recently qualified accountant. Before heading up the internal audit department, Lindsay was a junior finance manager of the company. The members of the internal audit team will be reassigned to roles in the finance department once your firm has commenced the provision of the internal audit service.

Mac Ltd is not an existing client of your firm, and to gain further understanding of the company, you held a meeting with Lindsay Montana. Notes from this meeting are shown below.

**Notes of meeting held with Lindsay Montana on 1 June 2010**

The internal audit team has three employees, including Lindsay, who reports to the finance director. The other two internal auditors are currently studying for their professional examinations. The team was set up two years ago, and initially focused on introducing financial controls across all of Mac Ltd's offices. Nine months ago the finance director instructed the team to focus their attention on introducing operational controls in order to achieve cost savings due to a cash flow problem being suffered by the company. The team does not have time to perform much testing of financial or operational controls.

In the course of her work, Lindsay finds many instances of management policies not being adhered to, and the managers of each location are generally reluctant to introduce controls as they want to avoid bureaucracy and paperwork. As a result, Lindsay's recommendations are often ignored.

Three weeks ago, Lindsay discovered a fraud operating at one of the offices while reviewing the procedures relating to the approval of new suppliers and payments made to suppliers. The fraud involved an account manager authorising the payment of invoices received from fictitious suppliers, with payment actually being made into the account manager's personal bank account. Lindsay reported the account manager to the finance director, and the manager was immediately removed from office. This situation has highlighted to Danny and Stella that something needs to be done to improve controls within their organisation.

Danny and Stella are considering taking legal action against Mac Ltd's external audit provider, Manhattan & Co, because their audit procedures did not reveal the fraud.

Danny and Stella are deciding whether to set up an audit committee. Mac Ltd is not required to have an audit committee, but the external auditors recommend that a disclosure note explaining whether an audit committee has been established, is included in the annual report.

**Required:**

- (a) **Evaluate the benefits to Mac Ltd of outsourcing its internal audit function.** (6 marks)
- (b) **Explain the potential impacts on the external audit of Mac Ltd if the decision is taken to outsource its internal audit function.** (4 marks)
- (c) **Recommend procedures that could be used by your firm to quantify the financial loss suffered by Mac Ltd as a result of the fraud.** (4 marks)
- (d) **Prepare a report to be presented to Danny and Stella in which you:**
- (i) **Compare the responsibilities of the external auditor and of management in relation to the prevention and detection of fraud; and** (4 marks)
  - (ii) **Assess the benefits and drawbacks for Mac Ltd in establishing an audit committee.** (4 marks)

Professional marks will be awarded in respect of requirement (d) for the presentation of your answer, and the clarity of your discussion. (2 marks)

**(24 marks)**

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

- 3 (a) Auditors should accept some of the blame when a company on which they have expressed an unmodified audit opinion subsequently fails, and they should also do more to highlight going concern problems being faced by a company.

**Required:**

**Discuss this statement.**

(8 marks)

- (b) You are the manager responsible for the audit of Juliet Ltd, and you are planning the final audit of the financial statements for the year ending 30 June 2010. Juliet Ltd is a supplier of components used in the manufacture of vehicle engines. Due to a downturn in the economy, and in the automotive industry particularly, the company has suffered a decline in sales and profitability over the last two years, mainly due to the loss of several key customer contracts. Many of Juliet Ltd's fixed assets are impaired in value, and a significant number of debtors balances have been written off in the last six months.

In response to the deteriorating market conditions, the management of Juliet Ltd decided to restructure the business. The main manufacturing facility will be reduced in size by two-thirds, and investment will be made in new technology to make the remaining operations more efficient, and to enable the manufacture of a wider variety of components for use in different types of engines and machinery. In order to fund this restructuring, the management of Juliet Ltd approached the company's bank with a request for a significant loan. You are aware that without the loan, Juliet Ltd is unlikely to be able to restructure successfully, which will raise significant doubt over its ability to continue as a going concern.

Your firm has been asked to advise on the necessary forecasts and projections that the bank will need to see in order to make a decision regarding the finance requested. Management has also requested that your firm attend a meeting with the bank at which the forecasts will be discussed.

**Required:**

- (i) **Identify and explain the matters that should be considered, and the principal audit procedures to be performed in respect of the additional funding being sought.** (6 marks)
- (ii) **Comment on the ethical and other implications of the request for your firm to provide advice on the forecasts and projections, and to attend the meeting with the bank.** (6 marks)

**(20 marks)**

- 4 You are a manager in the audit department of Carter & Co, and you are dealing with several ethical and professional matters raised at recent management meetings, all of which relate to audit clients of your firm.
1. Fernwood Ltd has a year ending 30 June 2010. During this year, the company established a pension plan for its employees, and this year end the company will be recognising for the first time a pension deficit on the balance sheet, in accordance with FRS 17 *Retirement benefits*. The finance director of Fernwood Ltd has contacted the audit engagement partner, asking if your firm can provide a valuation service in respect of the amount recognised.
  2. The finance director of Hall Ltd has requested that a certain audit senior, Kia Nelson, be assigned to the audit team. This senior has not previously been assigned to the audit of Hall Ltd. On further investigation it transpired that Kia Nelson is the sister of Hall Ltd's financial controller.
  3. Collier Ltd has until recently kept important documents such as title deeds and insurance certificates in a safe at its head office. However, following a number of thefts from the head office the directors have asked if the documents could be held securely at Carter & Co's premises. The partners of Carter & Co are considering offering a custodial service to all clients, some of whom may want to deposit tangible assets such as paintings purchased as investments for safekeeping. The fee charged for this service would depend on the value of item deposited as well as the length of the safekeeping arrangement.
  4. Several audit clients have requested that Carter & Co provide technical training on financial reporting and tax issues. This is not a service that the firm wishes to provide, and it has referred the audit clients to a training firm, Gates Ltd, which is paying a referral fee to Carter & Co for each audit client which is referred.

**Required:**

**Identify and evaluate the ethical and other professional issues raised, in respect of:**

- |                   |           |
|-------------------|-----------|
| (a) Fernwood Ltd; | (6 marks) |
| (b) Hall Ltd;     | (6 marks) |
| (c) Collier Ltd;  | (5 marks) |
| (d) Gates Ltd.    | (3 marks) |

**(20 marks)**

- 5 (a) You are the partner responsible for the audit of Grimes Ltd, for the year ended 30 April 2010. Grimes Ltd's main operating activity is property development. The management of Grimes Ltd have asked that the audit report be issued by no later than 25 June 2010, and you are aware that Grimes Ltd is hoping to secure finance based on the audited financial statements. The audit manager has been reviewing the audit files and has noted several points for your review, both relating to material balances or transactions, which are described below:

A stated accounting policy of Grimes Ltd is to recognise revenue on the legal completion of a property sale. However, revenue on the sale of five properties, which were legally completed on 8 May 2010, has been recognised in the financial statements for the year ended 30 April 2010.

Properties being developed are recognised at cost, including directly attributable development costs, such as labour costs, materials and a proportion of overheads. For several large development projects, the project manager was unable to provide evidence to verify the costs included, saying that his computer files had been corrupted by a virus, and that no other records had been kept regarding the costs allocated to the properties. The audit team has therefore not been able to conclude on the audit work performed on the valuation of these properties at the year end.

**Required:**

**For each of the two matters above:**

- (i) **Explain and recommend the further actions to be taken by the audit partner in respect of the matters outlined above, and** (6 marks)
- (ii) **Evaluate the potential impact on the auditor's report of these matters.** (4 marks)

Note: marks will be allocated equally between the two matters.

- (b) You are also responsible for providing guidance to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence. They have also heard that in the UK, following the introduction of the Companies Act 2006, it is possible to restrict liability by making a liability limitation agreement with an audit client.

**Required:**

- (i) **Explain FOUR methods that may be used by an audit firm to reduce exposure to litigation claims;** (4 marks)
- (ii) **Assess the potential implications for the profession, of audit firms signing a liability limitation agreement with their audit clients.** (6 marks)

**(20 marks)**

**End of Question Paper**