PROFESSIONAL LEVEL EXAMINATION

MONDAY 8 DECEMBER 2014

(2½ hours)

AUDIT AND ASSURANCE

This paper consists of **SIX** short-form questions (20 marks) and **THREE** long-form questions (80 marks).

1. Ensure your candidate details are on the front of your answer booklet.

2. Answer each question in black ballpoint pen only.

Short-form Questions (1 – 6)

3. Answer the short-form questions in note form only. Complete sentences are not required.

4. Answers to short-form questions must be submitted in numerical order.

Long-form Questions (7 – 9)

5. Answers to each long-form question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.

6. The examiner will take account of the way in which answers are presented.

7. When the assessment is declared closed, you must stop writing immediately. If you continue to write (even completing your candidate details on a continuation booklet), it will be classed as misconduct.

IMPORTANT Question papers contain confidential information and must NOT be removed from the examination hall. **DO NOT TURN OVER UNTIL YOU ARE INSTRUCTED TO BEGIN WORK**	You MUST enter your candidate number in this box.

1. Your firm's business plan states "in respect of tenders for new external audit work, we will be aggressive in our prices to win the work, specifically where the prospective client is likely to generate significant additional fees from non-audit services such as tax and advisory work".

   Identify the ethical issues presented by this statement. **(3 marks)**

2. Your firm sets its senior employees targets for generating fees from their external audit clients, including fees for non-audit services. One of the criteria for progression within the firm is achieving these targets.

   Identify and explain the threat to the objectivity of the senior employees and state, with reasons, whether or not these arrangements are appropriate. **(3 marks)**

3. Your firm is the external auditor of Magpies Ltd (Magpies) for the year ended 30 November 2014. On 15 November 2014, the directors of Magpies engaged a firm of expert property valuers to provide an independent valuation of the company's freehold land and buildings. The directors intend to recognise freehold land and buildings at this valuation in the financial statements for the year ended 30 November 2014.

   State the audit procedures that your firm should plan to undertake to determine whether reliance can be placed on the valuation provided by the firm of expert property valuers. **(3 marks)**

4. During your firm's external audit of Bluebirds Ltd (Bluebirds), the audit manager informed the firm that he intends to resign and accept an invitation to become the financial controller of Bluebirds. The audit manager first discussed the role with Bluebirds' finance director at the planning meeting for this year's audit, two months ago.

   Identify and explain the threats to objectivity in respect of this matter and state how your firm should address these issues. **(3 marks)**

5. Your firm is the external auditor of Peacock Energy plc (Peacock) for the year ended 30 November 2014. Peacock is a company engaged in the extraction of oil and gas. On 29 September 2014 an oil rig exploded causing extensive damage to the surrounding environment. The legal issues are complex and could take many years to resolve. Expert lawyers acting for Peacock have advised that the possible range of outcomes in respect of compensation payable by Peacock could be a liability between zero and £30 billion. The total assets of Peacock at 30 November 2014 are £291 billion.

   State, with reasons, the implications for the auditor's report on Peacock's financial statements for the year ended 30 November 2014 if the directors of Peacock:

   (i) adequately disclose; or
   (ii) do not disclose

   this issue in the notes to the financial statements. **(4 marks)**

6. Explain why it is important for an external audit firm to assess the integrity of a prospective client's management prior to accepting an audit engagement. **(4 marks)**

QUESTION 6 COMPLETES THE SHORT-FORM QUESTIONS
LONG-FORM QUESTIONS (7 – 9) FOLLOW

7 Your firm has recently been appointed as the external auditor of Hyena Ltd (Hyena), an unlisted company, which operates fitness clubs across the UK. The outgoing auditors did not seek re-appointment following the conclusion of the previous year's audit.

You are the senior responsible for planning the external audit for the year ended 30 November 2014 and the engagement partner has asked you to consider the following key areas of audit risk:

(1) Revenue
(2) Payroll
(3) Fitness equipment

The engagement partner has provided you with the following extracts from the financial statements and additional information to assist with your analytical procedures:

Statement of profit or loss for the year ended 30 November

	2014 (draft) £'000	2013 (audited) £'000
Revenue	94,123	75,937
Profit before tax	15,522	10,188

Statement of financial position as at 30 November

Non-current assets		
Fitness equipment	11,749	9,049

Additional information to assist with analytical procedures

	2014 (draft)	2013 (actual)
Number of fitness clubs (all operating for a full year)	150	135
Payroll		
Employees' total gross pay (£'000)	50,150	47,225
Average number of employees in year	2,959	2,685
Company-wide pay rise (effective 1 December 2013)	2%	-
Fitness equipment		
Loss on sale of fitness equipment	(1,650)	-
Depreciation charge for fitness equipment	(1,941)	(1,890)

The engagement partner has also provided you with the following information:

Hyena's fitness clubs are of similar size and layout and are equipped with the latest fitness equipment. Revenue grew steadily at approximately 5% pa over the five years ended 30 November 2013. However, the number of fitness clubs remained constant at 135 during this period. On 1 December 2013 Hyena opened 15 new fitness clubs.

Customers pay by one of three methods:

- on a pay-per-session basis in cash or by debit card at the fitness club reception;
- by monthly subscription paid by direct debit into Hyena's head office bank account; or
- by payment in advance to head office for a discounted annual package. The annual package runs for 12 months from the date the package is paid for.

In September 2014, the company launched a new online registration and subscription management system. Initially, Hyena suffered operational problems with the system resulting in some monthly subscriptions being paid twice. Management is confident that refunds have been made for all monthly subscriptions that were affected.

Reports by Hyena's internal audit function highlighted a number of deficiencies in the payroll system and this led to the directors outsourcing the management of the payroll to Zebra Ltd, a payroll service organisation, from 1 June 2014. A follow up report by the internal audit function confirms that these deficiencies have now been addressed.

Hyena replaces the fitness equipment in each fitness club over a five-year period. The fitness equipment is imported from manufacturers in the USA who invoice Hyena in US dollars. All costs associated with setting up the equipment, including time spent by Hyena's employees, are capitalised. The cost less any estimated residual value is depreciated on a straight-line basis over the estimated useful life of the fitness equipment**.**

During a meeting with Hyena's finance director, she:

(i) requested that the engagement partner is appointed as a non-executive director and attends the audit committee's quarterly meetings so your audit firm can be made aware of any issues promptly;

(ii) requested that your firm calculates the amounts to be included in respect of taxation in the financial statements; and

(iii) offered members of the audit team a free one-year package to a fitness club of their choice.

The proposed fees for audit and non-audit services amount to 1% of the firm's annual fee income.

Requirements

(a) State the responsibilities of an **outgoing** firm of external auditors relating to a change of appointment as set out in the ICAEW Code of Ethics. Give reasons for each of the responsibilities.

You are not required to refer to the Companies Act 2006 provisions in respect of the auditor who has not sought re-appointment. **(6 marks)**

(b) Justify why the items listed as (1) to (3) in the scenario have been identified as key areas of audit risk and, for each item, describe the procedures that should be included in the audit plan in order to address those risks.

You should present your answer in a two-column format using the headings:

(i) Justification; and
(ii) Procedures to address each risk.

Your answer should include reference to the results of your analytical procedures.

(26 marks)

(c) Explain the threats to objectivity of the audit firm arising from the matters listed as (i) to (iii) in the scenario and describe the safeguards, if any, that should be put in place to mitigate those threats. **(8 marks)**

Total: (40 marks)

8 The University of Downton (the University) has recently bought a disused freehold factory adjacent to its campus. The University wants to expand and has received planning permission to demolish the factory and construct an engineering workshop and classrooms for teaching purposes.

Rob Grantham, the University's finance director, has prepared cash flow forecasts in respect of the expansion plans for the five years ending 31 December 2019, which are to be submitted to the University's bank in support of a loan to finance the project. The University has requested that your firm examines and provides an assurance report on the cash flow forecasts.

Rob has provided the following additional information about the project:

- Three firms have submitted tenders for the demolition and site clearance work and these are awaiting evaluation by the University.
- Tenders have not yet been invited for the building contract but the build cost has been estimated by the University's director of estates at £2,500 per square metre.
- Landscaping works are expected to be minimal as the new building will occupy the whole of the site.
- The University currently has no engineering provision, therefore all equipment for the workshops and classrooms will be purchased.
- The whole project will be managed on behalf of the University by Crawley and Co, a firm of quantity surveyors.
- The University is applying for a government grant to assist with the building cost. The grant amounts to 40% of the building cost and is payable to the University on completion of the build. However, the grant is conditional on the workshop and classrooms being in use by 1 September 2016.
- To help finance the project the University is planning to sell playing fields, identified by the University's estates strategy as being surplus to requirements, to a property developer.
- Investment appraisals show that, once completed, the project is expected to generate additional cash inflows from student fees which will be in excess of the additional running costs incurred.

Your firm is currently finalising its terms of engagement with the University for the review of the cash flow forecasts. Rob has asked for an explanation of the following phrases used in your firm's draft engagement letter:

(i) "We will request from management written confirmation concerning representations made to us in connection with the examination."

(ii) "The level of assurance will not be the same as for an external audit."

Requirements

(a) From the information provided in the scenario, identify the key **receipts** and **payments** that you would expect to be included in the cash flow forecasts for the five years ending 31 December 2019 in respect of the expansion plans. For each receipt and payment, you should identify the specific matters you would consider when reviewing the reasonableness of the assumptions underlying that receipt or payment. **(12 marks)**

(b) Draft a response to Rob which:

(i) lists the general representations that should be obtained from management as part of the assurance work on the cash flow forecasts and explains why such representations are required; and

(ii) explains how and why the level of assurance provided by the report on the cash flow forecasts differs from the level of assurance provided by an auditor's report on annual financial statements. **(8 marks)**

Total: (20 marks)

9a You are responsible for the external audit of Speedy Shifters plc (Speedy), a haulage contractor operating from a head office and 65 depots throughout the UK. During the external audit for the year ended 30 November 2014, you identified the following significant internal control deficiencies:

(1) Speedy does not keep a list of approved suppliers from which to purchase replacement parts for its fleet of trucks and vans.

(2) Speedy does not have a business continuity plan to enable it to recover its management information and finance systems quickly in the event of a systems failure.

(3) Drivers at some depots are regularly scheduled to exceed the legal limit for driving hours, because of a shortage of drivers.

(4) The audit committee has not complied with its own terms of reference which require it to:

- approve annual plans of work to be undertaken by the internal audit function; and
- monitor the effectiveness of the internal audit function through the use of performance measures.

Requirement

Draft points for inclusion in your firm's report to those charged with governance and management at Speedy. For each internal control deficiency identified above, you should outline the possible consequence(s) of the deficiency and provide recommendation(s) to address each deficiency.

You should present your answer in a two-column format using the headings:

(i) Consequences; and
(ii) Recommendations. **(14 marks)**

9b Your firm is the external auditor of Letterbox Group Ltd (Letterbox) for the year ended 30 November 2014. Letterbox is an international trading group with a head office in London. On 1 November 2014, Letterbox acquired 100% of the ordinary share capital of Pampas Holdings (Pampas), a company operating in South America, which is audited by Santos, another firm of external auditors.

Your enquiries have found that Santos will not grant your firm access to its external audit working papers nor provide any other information in respect of their audit of Pampas. The directors of Letterbox have stated that your firm will not be given access to the accounting records of Pampas and have refused to disclose further information about the activities of Pampas.

Letterbox's draft financial statements show consolidated profit before tax for the year ended 30 November 2014 of £19.2 million. Included within this figure is profit before tax of £2.4 million in respect of one month's trading for Pampas.

Requirements

(i) Discuss the implications of the above for the auditor's report on the consolidated financial statements of Letterbox for the year ended 30 November 2014.

(ii) Discuss whether or not it is appropriate for your firm to continue to act as Letterbox's external auditor. **(6 marks)**

Total: (20 marks)