PROFESSIONAL LEVEL EXAMINATION

DECEMBER 2016

Mock Exam 1

(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. You will be given time to sign, date and print your name on the answer booklet, and to enter your candidate number on the question paper. You may not write anything else until the exam starts.
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 each short-form question 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. |				

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1 Jaspers LLP (Jaspers) is the external auditor of Wimper plc (Wimper) which is a listed company. The directors of Wimper have requested that Jaspers undertake an engagement to revalue the company's properties which currently amount to 30% of total assets.

State, with reasons, how Jaspers should respond to this request. **(4 marks)**

2 Bleakhouse LLP (Bleakhouse) has tendered for the external audit of Dickens plc. Bleakhouse has proposed a fee which is less than the market rate in the hope that the firm will subsequently be awarded the more lucrative non-audit services such as tax and advisory work.

Identify the ethical issues posed by Bleakhouse's proposal. **(3 marks)**

3 During the external audit of Indco Ltd (Indco), which provides industrial maintenance services, the audit senior discovered that the operations director, with the approval of the other directors of Indco, had instructed employees to breach statutory health and safety regulations so that the company would benefit from cost savings.

Explain the audit senior's and the audit firm's responsibilities in respect of this matter. **(3 marks)**

4 The managing director of Westco Ltd discovered that staff in the company's buying department do not follow the company's policy of checking for the cheapest supplier when ordering goods. For several years, they have been using one of the most expensive suppliers who periodically treats buying department staff to meals in expensive restaurants. The managing director has expressed surprise that the external auditors did not uncover this irregularity during the external audit and has requested a meeting to discuss this matter.

List the matters the external auditor should discuss with the managing director at the meeting. **(4 marks)**

5 Explain why detection risk cannot be reduced to zero**.** **(2 marks)**

6 During the external audit of Pippin Ltd, the audit senior discovered that the company does not have a formal disaster recovery plan to enable it to recover its data processing capacity as smoothly and as quickly as possible in response to any emergency that could disable a computer system.

List the matters to be included in the auditor's report to those charged with governance and management in respect of the issue outlined above. Describe the possible consequences, and the recommendations that you would make.

(4 marks)

Total: 20 marks

QUESTION 6 COMPLETES THE SHORT FORM QUESTIONS

LONG FORM QUESTIONS (7–9) FOLLOW

7 Your firm has recently been appointed external auditor of Media Ltd (Media) for the year ended 30 November 20X8. The previous auditors were not re-appointed because Charles Smith, the managing director, was dissatisfied with their services. He is particularly unhappy about the amount of tax he and the company have had to pay in recent years.

Charles is keen to expand the business and has suggested that a partner in your firm's corporate finance department join the board of Media as a non-executive director. The appointment would require the partner to attend and participate in monthly board meetings as well as continuing as a partner in your firm.

All of the shares in Media are owned by Charles Smith and his wife Camilla. They are actively involved in running the business together with a finance director and a sales director. All executive directors are entitled to a bonus once profit has reached a specified level. Any bonus is paid 30 days after the auditor's report has been signed. The company is very profitable, has no borrowings and has built up significant retained earnings.

Media is an independent production company which produces films in customers' chosen format (DVDs and other media). Films are commissioned by businesses for staff training purposes or to advertise their products and services. Media agrees a fixed fee at the start of each contract and terms of payment require customers to pay 50% prior to the commencement of any work and the balance on completion. Films can take between a few days and up to two months to complete.

Each film has a project manager who is responsible for monitoring costs against budget. All direct costs relating to each film are recorded in the company's job costing system. These records are used by the finance director to estimate the value of work in progress for the monthly management accounts and the year-end financial statements. For the work in progress valuation, a percentage is added to the direct costs to cover overheads.

Media completed over 150 films for customers based in the United Kingdom and overseas during the year ended 30 November 20X8, the largest of which was for a Spanish company which owns a chain of hotels and golf courses. This contract is now completed and the company is awaiting final payment prior to releasing the DVDs. The final payment was invoiced in euro in September 20X8 and is still outstanding.

Media purchases its own camera and sound equipment which have useful lives of between three and five years. There is an equipment register which is reconciled with the nominal ledger each month. However, there are no periodic physical comparisons of the equipment with the register.

The payroll is processed in-house and all staff are paid monthly by bank transfer. The payroll function was brought in-house in June 20X8 after having been outsourced to a service provider, Paypro Ltd (Paypro). In April 20X6 Media had entered into a five year contract with Paypro, but in June 20X8 the directors of Media withdrew from the contract as they were not satisfied with the service. The company acquired an off-the-shelf payroll package to process payroll and two of the accounts staff have been trained by the supplier to use it.

Media uses self-employed actors who are paid at a daily rate which is negotiated by their agents who invoice Media at the end of each month. These invoices are required to be authorised by project managers prior to posting to the payables ledger. There are often delays in authorising the invoice if the project manager is away on location.

Media operates from premises leased from Realty Ltd, a commercial property company, in which Charles has a majority shareholding.

Requirements

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

7.2 Outline the procedures your firm should have undertaken in order to assess the integrity of the management of Media. For each procedure describe how it would have assisted with your assessment of the integrity of management. **(6 marks)**

7.3 State, with reasons, how your firm should respond to Charles's request for a partner in your firm to join the board of Media as a non-executive director. **(3 marks)**

7.4 Identify, from the information provided in the scenario, the principal areas of audit risk in respect of the financial statements of Media for the year ended 30 November 20X8. For each area of risk:

(a) Justify why it is an audit risk.

(b) Outline the procedures that should be included in the audit plan in order to address the risk.

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

- Justification
- Procedures **(25 marks)**

Total: 40 marks

8 Your firm is the external auditor of Culinary Delights Ltd (Culinary Delights), a company owned by members of the Aspen family, none of whom is involved in running the business. The principal activity is the production of prepared meals which are sold to distributors and retail stores under Culinary Delights' own brand name and, historically, to a national supermarket chain Valco plc (Valco), under the Valco brand name.

Huw Jones is the manager in charge of the external audit of Culinary Delights. He has just received a telephone call from Matt Owen, the finance director, requesting that the audit of the financial statements for the year ended 31 October 20X8 is completed as soon as possible. This is because the company is seeking to increase its overdraft facility and the company's bank requires the audited financial statements prior to reviewing the facility. During the telephone conversation the following matters were discussed.

The draft financial statements show an operating loss for the year ended 31 October 20X8. This is mainly due to:

- Valco failing to renew its contract with Culinary Delights to supply Valco brand products when the contract expired in March 20X8; and
- significant marketing costs incurred in launching a new gourmet range of Culinary Delights' prepared meals and exporting these products to mainland Europe.

Matt is not too concerned about the loss of the Valco contract, which amounted to 28% of revenue, as the company has decided to focus on its own brand products. These products have a higher profit margin and customers are required to pay within 30 days, whereas Valco required 60-day credit terms. Furthermore, sales of the gourmet range have exceeded target.

Matt expects sales of Culinary Delights' own brand products to increase even more following the introduction of a rebate scheme which the company is currently negotiating with its major customers. Under the scheme, customers who purchase a specified volume will get a rebate which will be paid quarterly in arrears.

The company has managed to stay within the current overdraft facility by delaying payments to its suppliers and HMRC. Matt has recently agreed a deferred payments plan with HMRC to pay off the arrears of payroll taxes over the next four months. The extension of the overdraft is just to support the company until it sells some surplus land which is adjacent to its premises. The proceeds will be used to pay a loan instalment falling due in April 20X9 and enable the company to work with a lower overdraft facility.

Matt has prepared profit and cash flow forecasts which indicate a return to profitability and that the company can meet its debts as they fall due in the year ending 31 October 20X9.

Requirements

8.1 Identify and explain the circumstances particular to Culinary Delights which may indicate that it is not a going concern. **(8 marks)**

8.2 Identify the matters to be considered when reviewing the **cash flow** forecast prepared by Matt Owen in order to assess whether the company is a going concern. **(7 marks)**

8.3 Identify the sources of liability to which your firm may be exposed if an inappropriate audit opinion is issued in respect of the financial statements of Culinary Delights for the year ended 31 October 20X8. Outline the steps your firm should take to reduce its exposure to liability. **(5 marks)**

Total: 20 marks

9 You are the senior in charge of the external audit of Turbo Ltd (Turbo), a company which assembles turbines to customer specification. The draft financial statements for the year ended 30 September 20X8 show profit before tax of £1.1 million and total assets of £24.4 million.

The following issues were identified during the course of the audit of the financial statements for the year ended 30 September 20X8.

(1) On 6 October 20X8, the company received an invoice for plant and equipment costing £3.5 million with an estimated useful life of five years which was installed and brought into use on 1 September 20X8. The invoice was dated 5 October 20X8 and had been posted to the ledger accounts as an October 20X8 transaction and as yet not included in the financial statements for the year ended 30 September 20X8.

(2) On 12 November 20X8, a batch of turbines which had been rejected by a customer were sold to another customer for £450,000. The turbines are currently included in work in progress in the financial statements for the year ended 30 September 20X8 at a cost of £350,000. The turbines were completed during the first week of October 20X8 at a further cost of £150,000.

(3) On 25 November 20X8, the company was advised by a tax specialist that because of the complexity of the issues involved in the HMRC enquiry into the company's tax affairs, which was launched in September 20X8, it is not possible to forecast the outcome of that enquiry. However, the specialist has advised that the possible range of outcomes in respect of the additional tax liabilities ranges between a zero liability and a £10 million liability. There is currently no reference to this matter in the draft financial statements.

Requirements

For each of the issues outlined above:

(a) State, with reasons, the action you would take.

(b) Discuss the implications for the auditor's report on the financial statements of Turbo and, where appropriate, describe the modifications you would make to the auditor's report.

Total: 20 marks

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