



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 this 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. Your firm has decided to resign as external auditor of Tahoe plc (Tahoe), a listed company, during the firm's term of office, due to a disagreement with the directors of Tahoe over an accounting policy.

List your firm's rights and responsibilities, under the Companies Act 2006, in relation to its resignation. **(2 marks)**

2. The ICAEW Code of Ethics identifies circumstances where an auditor is or may be required to disclose, to third parties, confidential information obtained during the course of an external audit.

List, with examples, the circumstances in which the disclosure of confidential information, without the client's permission, is or may be required. **(4 marks)**

3. Coniston LLP (Coniston) has tendered for the external audit of Windermere plc. Coniston has proposed a fee below the market rate in the hope that the firm will subsequently be awarded more lucrative advisory work.

Identify and explain the ethical issues posed by Coniston's proposal. **(4 marks)**

4. Your audit firm, which has several listed clients in its portfolio, has a policy prohibiting partners and staff from owning shares in client companies.

Outline the procedures that your firm should have in place to ensure that partners and staff comply with this policy. **(3 marks)**

5. During the year ending 30 November 2016, the audit committee of Baikal plc (Baikal) is scheduled to meet three times. One of the terms of reference of the audit committee of Baikal is to monitor the effectiveness of the outsourced internal audit function.

List the matters that should be considered by the audit committee at its meetings during the year ending 30 November 2016 that will assist it to meet this term of reference. **(3 marks)**

6. External auditor's reports on the financial statements of companies that are required to apply the UK Corporate Governance Code have to provide additional information about the audit work performed.

List the additional information required to be included in the auditor's report and state the benefits to the users of the financial statements of having this information. **(4 marks)**

QUESTION 6 COMPLETES THE SHORT-FORM QUESTIONS

LONG-FORM QUESTIONS (7 – 9) FOLLOW

7. Your firm is the external auditor of Whistler Consultants Ltd (Whistler). You have succeeded Tom Turner as audit manager. Tom was the audit manager for the previous three years until he joined Whistler as finance director in July 2015. You have not previously worked on the Whistler audit. Lisa Lowry is the engagement partner and has been responsible for the audit of Whistler since it became a client of your firm ten years ago.

You are planning the external audit for the year ended 30 November 2015 and Lisa has asked you to consider the following key areas of audit risk:

- (1) Fee income
- (2) Work in progress
- (3) Trade receivables
- (4) Provision for claims.

Tom has provided you with the following extracts from the financial statements:

Statement of profit or loss for the year ended 30 November

	2015 (draft) £'000	2014 (actual) £'000
Fee income	501,320	470,903
Cost of sales	240,556	233,014

Statement of financial position as at 30 November

	2015 (draft) £'000	2014 (actual) £'000
Work in progress	84,251	67,425
Trade receivables (net of allowance for bad debts)	71,671	52,335
Provisions for claims	9,991	15,521

Whistler provides management consultancy services to clients across Europe. All work is performed under fixed-price contracts and clients are invoiced in either sterling or euro. Total fee incomes in the industry as a whole have declined by 2% on average over the year ended 30 November 2015. Whistler has submitted a loan application to its bank to finance expansion in India and China where a number of government consultancy contracts are to be awarded in 2016 and 2017.

The scope of the work is agreed with each client at the start of the assignment. Fee income from fixed-price contracts is recognised once the assignment is complete and the final consultancy report is issued. Customers are required to pay Whistler an initial payment of 30% of the contract value prior to the commencement of any work and the balance on completion of the work. Whistler's terms of trade require payment within 30 days of invoice date for both initial payments and final instalments.

Whistler maintains a project costing system, an earlier version of which was replaced in September 2015. Costs relating to each assignment are recorded against a unique project code. At the end of each day, Whistler's consultants record their time spent on each

assignment, together with any expenses incurred, directly into the project costing system. Whistler's consultants have standard charge-out rates dependent on their level of seniority. These charge-out rates are recorded in the project costing system which is used to value work in progress in the financial statements. Provision is made for expected losses on contracts.

Whistler sometimes becomes involved in disputes with clients which could potentially lead to claims for damages by the client. Insurance cover is maintained against the payment of damages in respect of such claims. Where management considers that there is a reasonable basis for a claim against Whistler, a provision is made in the financial statements for the uninsured costs in respect of that claim. Because of Whistler's high volume of claims in previous years, the insurer has reduced the scope of Whistler's insurance cover for new claims arising from work completed during the year ended 30 November 2015.

A discussion with Tom has revealed the following internal control deficiencies:

- (i) On several occasions throughout the year, consultants ordered IT equipment directly from suppliers. Company policy requires all IT equipment to be purchased by the buying department.
- (ii) Whistler does not have any bribery prevention policies in place.

Requirements

- (a) Explain what is meant by the familiarity threat in the context of the external audit of Whistler and discuss the safeguards available to your firm in order to mitigate this threat. **(6 marks)**
- (b) Justify why the items listed as (1) to (4) 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:

- Justification; and
- Procedures to address each risk. **(24 marks)**

- (c) For each internal control deficiency listed as (i) and (ii), draft points for inclusion in your firm's report to those charged with governance and management at Whistler. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address it. **(10 marks)**

Total: 40 marks

8. Tasty Sauces Ltd (TSL) was incorporated three years ago. TSL produces a range of branded sauces which are exceptionally popular, especially in the warmer months when they are bought for barbeques. The directors are planning to reorganise the business as a result of a forecast rapid growth in revenue. This will involve outsourcing all manufacturing, relocation of the business premises and development of new products.

The growth will be funded by equity finance from Denzil Dragon (Denzil), proceeds from the disposal of TSL's manufacturing unit and an increase in the bank overdraft facility. Denzil is a wealthy individual who specialises in providing finance for rapidly expanding businesses in return for a minority shareholding in the business. The directors have prepared profit and cash flow forecasts for the three years ending 31 December 2018 in support of the request for the overdraft facility. The company's bank requires the cash flow forecasts to be examined and reported on by independent accountants and the directors have requested that your firm performs this examination.

The directors have provided the following additional information:

- The significant growth experienced since incorporation was due to a two-year contract with Terose, a supermarket with stores across the South of England. The contract specifies that TSL cannot supply any other supermarket during the period of the contract. The contract is due to expire in June 2016. Credit terms are 75 days after delivery. The contract specifies that if Terose purchases a specified volume of sauces over the period of the contract, TSL has to pay Terose a rebate at the end of the contract.
- TSL is in negotiations with five other large supermarkets, with stores across the UK and Europe, which want to purchase TSL's sauces when the contract with Terose expires in June 2016. The directors are seeking four-year contracts with each supermarket with credit terms of 30 days.
- TSL will cease its own production and has agreed with Mixit Ltd (Mixit), a specialist manufacturer, that Mixit will manufacture TSL's sauces from July 2016 onwards. Mixit has requested payment in advance each month, for 12 months, until a trading relationship is established after which it will give 30 days credit.
- TSL will sell its manufacturing unit, which it owns, as it will then be surplus to requirements. The manufacturing unit will take six months to decommission and all equipment will be scrapped. A property developer has expressed interest in the site and TSL is currently applying for permission to change the use of the site from industrial to residential.
- TSL proposes to rent a new combined warehouse, office and research facility from July 2016. Rent is payable quarterly in advance with a rent-free period for the first six months. TSL plans to develop new products such as soups and curries at this facility. It is expected that soups will take one year to develop and curries two years before they can be sold to supermarkets.
- Denzil will provide equity funding in equal tranches in March 2016 and June 2016. Half of Denzil's investment will be repurchased by TSL once TSL achieves a specified level of profit. TSL has a policy of paying cash dividends equivalent to one quarter of its annual profits.

You are the senior responsible for planning the examination of the cash flow forecasts and the engagement partner has identified the following items included in the cash flow forecasts as being significant:

- (1) Receipts from and payments to supermarkets for the sale of products
- (2) Payments to Mixit
- (3) Proceeds from the disposal of the manufacturing unit
- (4) Payments for the rented warehouse, office and research facility
- (5) Receipts from and payments to Denzil Dragon.

Requirements

- (a) (i) Identify the matters to be included in your firm's engagement letter for the examination of the cash flow forecasts in respect of:
- management's responsibilities;
 - the purpose and scope of your firm's work; and
 - limiting your firm's liability.
- (ii) Explain why these matters should be included. **(8 marks)**
- (b) For the items listed (1) to (5), identify the specific matters you would consider when reviewing the reasonableness of the assumptions underlying each receipt or payment. **(10 marks)**
- (c) State **four** key differences you would expect to see between the items included in the profit forecasts and the receipts and payments included in the cash flow forecasts prepared by the directors of TSL. **(4 marks)**

Total: 22 marks

9. Described below are three situations that have arisen at unrelated external audit clients of your firm, a firm of ICAEW chartered accountants. The year end in each case is 31 October 2015.

Mint Ltd (Mint)

Your audit work concluded that the accounting records relating to cash sales were inadequate. Cash sales comprise 7% of Mint's recorded revenue.

Coriander Ltd (Coriander)

The financial statements of Coriander include inventory at cost of £1.3 million. The inventory was purchased on 1 October 2015 in anticipation of fulfilling a large order for a customer. However, the customer went into liquidation on 5 November 2015 and was unable to complete any part of the transaction with Coriander. On 30 November 2015 Coriander sold the inventory for £1 million. The draft financial statements show that Coriander's profit before tax is £12.9 million and total assets are £39.1 million.

Basil Ltd (Basil)

The financial statements of Basil show the purchase of a motor vehicle from Saffron Ltd (Saffron), for £19,000, which has been appropriately included in non-current assets. Whilst reviewing Basil's board minutes you discovered that Saffron is owned and managed by the husband of Basil's managing director. The directors of Basil refuse to disclose the transaction in the notes to the financial statements as they claim that the amount is too small to warrant disclosure. The draft financial statements of Basil show total assets of £7.5 million.

Requirements

- (a) For each of the situations outlined above, state whether or not you would modify the audit opinion. Give reasons for your conclusions and describe the modifications, if any, to each audit report. **(11 marks)**
- (b) Describe the possible consequences for your firm if an inappropriate audit opinion on financial statements is issued and outline the quality control procedures your firm should implement to reduce the risk of issuing an inappropriate audit opinion. **(7 marks)**

Total: 18 marks