PROFESSIONAL LEVEL EXAMINATION

MONDAY 8 JUNE 2015

(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 this question paper. You may not write anything else until the exam starts.

2. Answer each question in black ball point 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, a firm of ICAEW Chartered Accountants with over 100 offices throughout Europe, is planning to move to a new office in London. It proposes to lease at the market rate an office block from Run plc (Run), one of the largest property companies in the UK. Your firm is the external auditor of Run.

   State, with reasons, whether or not it is appropriate for your firm to lease the office from Run. **(3 marks)**

2. The risk of management override of internal controls is present in all audited entities.

   State **three** procedures that should be included in external audit plans to address this risk. **(3 marks)**

3. Your firm recently conducted the external audit of the financial statements of Oval Ltd (Oval) for the year ended 28 February 2015. Oval's bank requested the audited financial statements before deciding whether to make a loan to Oval. Oval received the loan from its bank but has defaulted on its first quarterly loan repayment. Your firm's audit opinion was unmodified.

   In respect of the bank having relied on the audited financial statements, explain the possible consequences for your firm if it has provided an inappropriate opinion in the auditor's report on Oval's financial statements. **(4 marks)**

4. Your firm is the external auditor of Googly Ltd (Googly). The directors of Googly have requested that your firm provides a member of staff to assist in the preparation of its annual financial statements.

   Explain the threats to your firm's objectivity arising from the above and describe the safeguards, if any, which should be put in place to mitigate those threats. **(4 marks)**

5. List the factors, for a recurring external audit, that may make it appropriate for an audit firm to revise the terms of an audit engagement or remind the audited entity of existing terms. **(3 marks)**

6. You are the audit junior working on the external audit of Bouncer Ltd (Bouncer). The sales ledger clerk informed you that when he requested the payment of an overdue amount from Mr Wicket, a sole trader, he was told by Mr Wicket that the managing director of Bouncer had personally collected the overdue amount in cash. The managing director subsequently instructed the sales ledger clerk to write off the overdue amount as a bad debt. The amount is not material to the financial statements.

   State, with reasons, the actions that should be taken by you and your firm in relation to this matter. **(3 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 Hutton plc (Hutton), a listed company, for the year ending 30 June 2015. The previous auditors did not seek re-appointment following the conclusion of the previous year's audit.

Hutton sells household products through a chain of retail stores in the UK and its own website. An extensive range of products is offered including the latest electronic equipment such as smart phones and soft furnishings such as curtains and carpets. Hutton has experienced many years of rapid growth but recent trading conditions have been difficult due to competitors offering comparable products at lower prices. In response to the difficult trading conditions, Hutton has developed a new website to replace the old website and is planning a reorganisation involving the closure of 50% of its stores.

You are the senior responsible for planning the external audit for the year ending 30 June 2015 and the engagement partner has asked you to consider the following key areas of audit risk:

(1) Volume-based supplier rebates
(2) Inventory
(3) Intangible assets – website development costs.

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

Statement of profit or loss for the year ending 30 June

	2015 (estimated) £m	**2014 (audited) £m**
Revenue	2,329	2,784
Cost of sales (gross)	(1,434)	(1,489)
Supplier rebates	185	106

Statement of financial position as at 30 June	**2015 (estimated) £m**	**2014 (audited) £m**
Non-current assets		
Intangible assets – website development costs	31	11
Current assets		
Inventories	306	220

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

Hutton has negotiated individual terms for supplier rebates, which range from 1% to 15% of purchases, with each of its 350 principal suppliers. The terms are set out in signed contracts, with each supplier, which typically run from one to three years. Rebates are paid in arrears to Hutton on the conclusion of the contract if Hutton exceeds the volumes of purchases stipulated in the contract. Hutton's sales managers prepare revenue forecasts for each product. The revenue forecasts are used by the accounts department to estimate the volume of purchases that will be placed with each supplier over the contract period. If the volume of estimated purchases exceeds that required in the contract to earn a rebate, a rebate is recognised in the financial statements. Spreadsheets are used to collate the information and calculate the rebate attributable to the current year.

The company has standard operating procedures in every store including electronic point of sales (EPOS) systems and maintains a perpetual inventory system, which records the quantities held and the cost price of inventory. Quantities in the perpetual inventory system are updated from goods received records, the EPOS systems, the company website and the results of inventory counts. The cost price of inventory is updated from purchase invoices. Where there is sufficient certainty that a supplier rebate relating to historical purchases will be received in the future, an adjustment is made to the cost of inventory. Overseas suppliers invoice in their local currency.

At each month end, the inventory system generates an inventory valuation listing and an aged inventory report. The valuation listing includes the cost and quantity on hand for each inventory item. The valuation listing at 30 June 2015 will be used as the basis for the inventory value in the financial statements as no count will take place at the year end. Hutton carries out monthly inventory counts at all of its stores and the next inventory count is planned for 19 June 2015. Your firm has not attended any inventory counts during the year but the internal auditors have attended inventory counts at a sample of stores throughout the year.

Employees from Hutton's IT department commenced work on the replacement website on 1 October 2014 but were unable to resolve a technical issue arising on the interface between the new website and the perpetual inventory system. A contract was signed with Sweepweb, a website development company, to resolve this issue and the IT director has stated that the interface is now working properly. Internal costs are based on the IT director's estimate of time spent by Hutton's staff. The total costs of developing the replacement website are included as an intangible asset in the financial statements for the year ending 30 June 2015 and are being amortised over ten years.

Requirements

(a) Set out the benefits and limitations of using analytical procedures at the planning stage of an external audit. **(5 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 that risk.

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

(i) Justification; and
(ii) Procedures to address the risk. **(30 marks)**

Total: 35 marks

8. The Financial Reporting Council (FRC) has recently undertaken reviews of the quality control procedures at your firm including the inspection of a sample of external audit files. It has reported the following matters to be addressed by your firm.

(1) External audit partners and staff are set targets for selling non-audit services to their audit clients and, as an incentive, are given credit in their annual pay review when the target is met or exceeded.

(2) Shane Smith has been the audit engagement partner for Garfield plc, a listed company, since 2008. No further documentation relating to this issue was available on the files reviewed.

(3) One external audit file did not show any evidence that work performed by junior members of the audit team was reviewed by more senior members.

(4) Kapil LLP (Kapil), a firm of consultants, was verbally instructed to act for your firm as an auditor's expert providing valuations of property included in the financial statements of a number of audited entities. Your firm intends to continue to use Kapil but has not formalised the arrangement.

Requirements

(a) (i) Describe how the FRC promotes improvements in the quality of auditing.

(3 marks)

(ii) Explain why matters (1) to (4) above have been reported to your firm and describe the actions that your firm should take in respect of each matter.

(10 marks)

(b) (i) In respect of quality control procedures undertaken by audit firms, outline the differences between:

- an engagement quality control review (hot review); and
- a review as part of the firm's monitoring procedures (cold review).

(5 marks)

(ii) Set out the attributes required of an individual who is appointed by an audit firm to undertake engagement quality control reviews. **(2 marks)**

Total: 20 marks

9a. You are responsible for the external audit of Yorker plc (Yorker) a firm of management consultants with offices in London, Cardiff and Edinburgh. All consulting services are provided under fixed-price contracts which state that customers will be invoiced on the completion of each contract. Yorker requires that its project managers make a weekly comparison of costs, on each contract with the budgeted costs. During the external audit for the year ended 31 May 2015, you identified the following significant internal control deficiencies:

(1) At the Cardiff office, 25% of the work in progress balance at the year end related to completed projects which were delivered to customers before the year end but had not yet been invoiced.

(2) At the Edinburgh office, project managers had not performed the weekly comparison of actual against budgeted costs in 30% of the contracts examined by the auditors.

Requirement

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

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

(i) Consequences; and
(ii) Recommendations. **(9 marks)**

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9b. Your firm is the external auditor of Spinball plc (Spinball) for the year ended 31 May 2015. Spinball distributes pharmaceutical products and 40% of its revenue comes from Turkey where the government requires Spinball to have a licence to operate. The regulatory situation in Turkey is undergoing considerable change and Spinball expects its licence to operate in Turkey to be withdrawn. However, after carrying out an assessment of the entity's ability to continue as a going concern, the directors have decided that Spinball has sufficient resources to continue operating for the 18 months ending 30 November 2016. Additional funding may be required from that date but Spinball does not currently have this in place.

Spinball is a listed company and is required to apply the UK Corporate Governance Code.

Requirements

(i) Briefly state the **additiona**l disclosure requirements that should be included in the auditor's report on the financial statements of listed companies that are required to apply the UK Corporate Governance Code. Identify and explain the attributes that are required to make these disclosures effective. **(4 marks)**

(ii) State, with reasons, the implications for the auditor's report on Spinball's financial statements for the year ended 31 May 2015 if the directors of Spinball:

(1) adequately disclose; or
(2) do not disclose

the information in respect of the licence to operate in Turkey in the notes to the financial statements. **(7 marks)**

(iii) State, with reasons, the implications for the auditor's report if the directors had based their assessment of the company's ability to continue as a going concern on financial forecasts for the six months ending 30 November 2015, instead of the 18 months ending 30 November 2016. **(5 marks)**

Total: 25 marks