PROFESSIONAL LEVEL EXAMINATION

MONDAY 16 MARCH 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 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. One of your clients, Frowzen Ltd (Frowzen), is a small company which is not legally required to have an external audit. Frowzen's managing director owns 75% of the company's share capital.

   Explain the benefits to small companies such as Frowzen and their shareholders of voluntarily undergoing an external audit. **(3 marks)**

2. Your firm has recently been appointed as external auditor of Flayke Ltd (Flayke). Flayke owns a number of luxury hotel resorts throughout Europe. Flayke's finance director has suggested that the planning meeting for the forthcoming audit is held at one of Flayke's resorts. He has also suggested that the members of the audit team and Flayke's finance department stay at the resort for four nights, at Flayke's expense, to get to know each other better.

   Identify and explain the threats to your firm's independence and objectivity presented by the finance director's suggestion and state how your firm should respond. **(3 marks)**

3. Snoe plc (Snoe) has four factories in the UK and one in Poland. It is required to prepare a greenhouse gas (GHG) statement, which discloses information about the company's GHG emissions, in accordance with specific industry regulations. Your firm, which has offices in the UK, has been appointed by Snoe to perform a reasonable assurance engagement, in respect of the GHG statement, and report its findings.

   List the factors your firm should consider when planning how to **resource** this assurance engagement. **(4 marks)**

4. Your subsequent events review, performed during the audit of Ice Ltd for the year ended 31 December 2014, included reading the minutes of board meetings held after the year end. Minutes of the board meeting held on 16 February 2015 identified that the company failed a routine health and safety inspection performed by industry regulators in January 2015.

   Outline the further audit procedures you should perform in respect of this matter. **(3 marks)**

5. List the key differences between the auditor's report issued in respect of an audit conducted under the Companies Act 2006 and an assurance report issued in respect of an engagement to examine prospective financial information. **(4 marks)**

6. During the external audit of Whinter Ltd your firm has identified a material inconsistency between the directors' report and the financial statements.

   State the actions your firm should take and outline any potential implications for the auditor's report. **(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 Weselton plc (Weselton) which is your firm's largest and only listed client. You are the senior responsible for planning the external audit for the year ended 28 February 2015 and the engagement partner has asked you to consider the following key areas of audit risk:

(1) Work in progress
(2) Trade receivables

Weselton provides global relocation services to corporate customers. Services include project management of overseas relocation of offices and employees.

For each relocation project, Weselton estimates the cost of supplying services based on customer requirements and the locations in which the services will be supplied. An indicative price is provided to the customer equal to the estimated cost plus a mark-up of 35%. Actual costs incurred often vary from estimated costs due to changes in customer requirements during the relocation project or unforeseen issues resulting in higher than expected costs. On completion of each project, the customer is invoiced, in sterling, for actual costs incurred plus the 35% mark-up. Credit terms are 30 days.

Weselton employs a small team of project managers who manage multiple projects. However, the majority of costs billed by Weselton arise from the use of external suppliers and other third parties. Costs include payments to local employment agencies for temporary personnel who pack the items to be relocated, fees for overseas legal and HR advice, local visa and immigration costs, shipping and transport fees and insurance costs.

Temporary personnel submit timesheets to local employment agencies which invoice Weselton each month for the total hours worked at rates agreed with Weselton. Invoices may include hours relating to more than one relocation project. Other suppliers invoice Weselton for services at varying points during the relocation and some overseas suppliers invoice in their local currency. All costs incurred, including those of Weselton's own project managers, are recorded in the job costing system against a unique code for each relocation project. Any costs recorded for projects not completed at 28 February are included as work in progress in the year-end financial statements.

Weselton's financial controller, Olaf Cyro, has provided you with the following information:

- In July 2014, the directors decided that the job costing system was outdated. A replacement system was implemented on 21 January 2015 and use of the old system ceased immediately. A delay in training employees on the new system resulted in a backlog of costs to be recorded and some customers were invoiced before all the costs relating to their projects were included on the new system. Additional invoices in respect of the omitted costs, plus the 35% mark-up, were sent to customers in February or are due to be sent by 31 March 2015.

- Bulda GmbH (Bulda), a customer, is refusing to pay its balance outstanding at 28 February 2015 due to a disagreement over the amount invoiced in respect of its relocation project. The disagreement has arisen due to a significant variation between the indicative price and the actual amount invoiced. The balance due from Bulda at 28 February 2015 is £1.8 million. The original indicative price provided was £1.3 million. Olaf believes all of the additional costs arose due to changes in Bulda's requirements during the relocation and that the full amount is recoverable.

- Weselton's previous auditors did not seek reappointment after completing the external audit for the year ended 28 February 2014. During that audit, reliance was placed on the controls over the job costing system. Olaf requested that your firm also relies on those controls as he believes this will ensure the audit is conducted efficiently.

Olaf also provided you with the following extracts from the financial statements of Weselton to use as part of your consideration of the key audit risks:

Statement of profit or loss for the year ended 28 February

	2015 (draft) £'000	**2014 (audited) £'000**
Revenue	45,467	41,339
Cost of sales	(30,795)	(30,622)
Gross profit	14,672	10,717

Statement of financial position as at 28 February

	2015 (draft) £'000	**2014 (audited) £'000**
Work in progress	7,171	5,034
Trade receivables	5,481	3,741

Your discussion with Olaf also revealed the following internal control deficiencies:

(i) Customers are not required to provide written confirmation of changes to their requirements arising during a relocation project.
(ii) Project managers do not monitor actual costs incurred to date compared with the estimated cost of each project.

Requirements

(a) List the matters your firm should have considered and the procedures it should have performed before accepting appointment as external auditor of Weselton. **(10 marks)**

(b) Justify why work in progress and trade receivables have been identified as key areas of audit risk and, for each one, 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. **(18 marks)**

(c) Explain why reliance on controls over the job costing system, requested by Olaf, is unlikely to be appropriate in respect of the audit for the year ended 28 February 2015. **(5 marks)**

(d) For each internal control deficiency listed as (i) and (ii) in the scenario, draft points for inclusion in your firm's report to those charged with governance and management at Weselton. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address it. **(7 marks)**

Total: 40 marks

8. Your firm has been the external auditor of Arendelle Ltd (Arendelle) for a number of years and has recently been engaged to perform a review of Arendelle's interim financial information for the six months to 31 January 2015. Arendelle's bank has requested interim financial information in support of a loan application and requires the information to be reviewed and reported on by Arendelle's auditor. Your firm's review is to be conducted in accordance with ISRE 2410 and will consist of making enquiries and applying analytical and other review procedures.

Arendelle supplies boxes of fruit and vegetables to households and businesses in the east of the UK. Deliveries are spread evenly throughout the year and revenue is collected by direct debit on the day of delivery. Arendelle's delivery vehicles are currently fully utilised. The directors have requested the bank loan to invest in new delivery vehicles so the company can extend its service to other areas of the UK.

You are the senior responsible for the review engagement and you recently met with Arendelle's finance director, Elsa Duke, who provided you with the following information regarding events in the six months since 31 July 2014:

- Arendelle contracted to supply 22 nursing homes. On average, each contract is worth £20,000 pa and supplies commenced on 1 August 2014. Arendelle allowed 30-day credit terms on these specific contracts.

- To meet the increased demand from the nursing home contracts, Arendelle commenced purchasing fruit and vegetables from two new suppliers. The two new suppliers require payment on delivery in contrast to the 30-day credit terms allowed by Arendelle's four existing suppliers.

- On 1 September 2014, Arendelle rented additional space adjacent to its existing storage facility for the purpose of fulfilling the new nursing home catering contracts.

- 20 of Arendelle's 40 delivery vehicles became fully depreciated on 1 August 2014 but are still in use awaiting the outcome of the loan application.

- On 30 October 2014, Arendelle paid Trolls Ltd £100,000 for a marketing campaign due to be launched in April 2015 in the areas of the UK where Arendelle plans to extend its delivery service.

Elsa also provided you with draft interim financial information for the six months to 31 January 2015 from which you have extracted the following key information for further review:

Statement of profit or loss for:	Six months to 31 January 2015 (draft) £'000	Full year to 31 July 2014 (audited) £'000
Revenue	4,720	6,500
Cost of sales*	(3,446)	(5,120)
Gross profit	1,274	1,380
Operating expenses**	(650)	(638)
Profit from operations	624	742
*Cost of sales includes:		
Warehouse rent paid	125	180
Depreciation: delivery vehicles	55	110
**Operating expenses include:		
Marketing expenses	196	192

Statement of financial position as at	31 January 2015 (draft) £'000	31 July 2014 (audited) £'000
Trade receivables	62	-
Trade payables	660	435

Elsa commented she is looking forward to your firm's guidance on how best to present the interim financial information to increase the likelihood of Arendelle's bank agreeing to provide the loan. She also indicated she anticipated Arendelle would be unwilling to pay your firm's fee for this engagement if the loan application was not successful.

You agreed with Elsa to meet with her again on 18 March 2015 to discuss any questions you have arising from your initial review of the draft interim financial information.

Requirements

(a) Explain the ethical issues arising from Elsa's comments in respect of:

(i) providing guidance on the presentation of Arendelle's interim financial information; and

(ii) your firm's fee being contingent on Arendelle successfully receiving the loan from its bank.

(3 marks)

(b) As part of your review of the interim financial information, perform analytical procedures on the information provided and prepare a list of questions which you wish to ask Elsa at your meeting on 18 March 2015. **(17 marks)**

Total: 20 marks

PLEASE TURN OVER

9. Described below are three situations which have arisen at three unrelated audit clients of your firm. The year end in each case is 31 December 2014.

Kristoff Ltd (Kristoff)

Kristoff has made payments to a trust fund set up for the benefit of Anna Oaken, the niece of Hans North, Kristoff's managing director and majority shareholder. Your firm has concluded that the payments should be disclosed as a related party transaction in Kristoff's financial statements. Hans has refused to include the necessary disclosures as he considers the payments to be of a sensitive nature and does not wish the rest of his family to be aware of them. He has threatened your firm with removal from office if it pursues this issue any further.

Reindeer Ltd (Reindeer)

Reindeer has included a note in its financial statements disclosing a possible tax liability of £22 million. HMRC (the UK tax authority) claims Reindeer has evaded taxes on some of its overseas activities. Reindeer plans to appeal against the claim before an appeals tribunal but the outcome of the tribunal will not be determined until after the auditor's report has been signed. The directors have assessed that it is possible, but not probable, that the claim will be upheld by the tribunal and your firm agrees with this assessment. A provision has not been included in Reindeer's financial statements in respect of the claim. Your firm has concluded that a provision is not required and that the note, describing the uncertainty, in Reindeer's financial statements is adequate. The directors of Reindeer have requested that your firm provides a team of tax experts to support them through the appeals tribunal.

The total assets of Reindeer at 31 December 2014 are £450 million and the profit before tax for the year ended 31 December 2014 is £18 million.

Pabbie Group plc (Pabbie)

Pabbie is your firm's largest listed audit client. On 31 October 2014, Pabbie expanded by acquiring a significant overseas subsidiary, Queen SARL (Queen). Your firm is the group auditor, but Queen's financial statements for the year ended 31 December 2014 have been audited by an overseas auditor, Blizzard. Your firm planned to rely on Blizzard's work. However, during the audit Blizzard refused to cooperate. Your firm has no alternative audit procedures it can perform in respect of Queen's financial statements. Queen's results are highly material to a large number of items in Pabbie's group financial statements. The directors of Pabbie have requested that your firm accepts appointment as external auditor of Queen for the year ending 31 December 2015 in order to avoid this issue arising next year. Your firm estimates the total fee for the 2015 audit of the Pabbie group will be £1.4 million and your firm's total annual fee income is likely to be £20 million.

Requirements

For each of the situations outlined above:

(a) Identify and explain the threats to your firm's objectivity and state the steps that your firm should take to address them. **(12 marks)**

(b) State whether you would modify the audit opinion. Give reasons for your conclusions and describe the modification(s), if any, to each auditor's report. **(8 marks)**

Total: 20 marks