



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.

--	--	--	--

BLANK PAGE

1. 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)**

2. You are the audit senior responsible for the external audit of Krill Ltd (Krill). The engagement partner has requested that you undertake a review of the work recently performed by the audit junior during the audit of Krill's financial statements.

List the purposes of the review requested by the engagement partner. **(3 marks)**

3. Your firm has recently accepted appointment as external auditor of Herring Ltd (Herring), a competitor of Hake Ltd (Hake). Your firm has acted as external auditor of Hake for a number of years. Both companies have provided your firm with informed consent to act.

Outline the procedures that your firm should implement to address any potential conflicts of interest arising out of this appointment. **(3 marks)**

4. You are responsible for planning the external audit of Squid Ltd (Squid) for the year ending 30 September 2015. Today, you read a newspaper article stating that Squid, a manufacturer of dried food products, has recalled its leading baby milk powder from supermarkets due to a number of batches being contaminated with substances that may be harmful to babies.

Briefly explain the matters you should consider, as part of your audit planning, as a result of reading the newspaper article. **(4 marks)**

5. Your firm is concluding its audit of the financial statements of Turtle Ltd (Turtle) for the year ended 31 March 2015. The audit work has identified a number of misstatements, which are individually immaterial, in transactions and account balances recorded in the statement of profit or loss and statement of financial position.

State the actions your firm should take in relation to the misstatements before reaching its audit opinion on the financial statements of Turtle. **(3 marks)**

6. Outline the differences between the conclusion expressed following an engagement to review financial statements and the opinion expressed in an external audit report on financial statements. Give reasons for these differences. **(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 Haskett Ltd (Haskett), a wholly-owned subsidiary of McCarthy Travel Group Ltd (MT Group). Your firm has been the external auditor of MT Group for a number of years. The group audit is performed by an audit team based in your firm's London office.

MT Group owns a number of subsidiaries that operate bus services in five regions of the UK. In July 2014, MT Group was awarded a new contract, by a government body, to provide bus services in the east of England. On 1 August 2014, MT Group created a new company, Haskett, to supply the bus services under the new contract. All revenue and costs relating to fulfilment of the contract are recorded in Haskett's own accounting records.

You are the audit senior responsible for the audit of Haskett's financial statements for the year ended 31 July 2015 and you are based in your firm's office located in the east of England. Your responsibilities include preparing the audit plan and communicating with the group auditor in your firm's London office. The engagement partner for the Haskett audit, Mandy Winter, has asked you to consider the following key areas of audit risk:

- (1) Revenue
- (2) Property, plant and equipment – buses
- (3) Legal claim against Haskett

Passengers can pay for journeys taken on Haskett's buses in the following ways:

- purchase of a ticket using cash when boarding a bus
- electronic contactless card which the customer has pre-loaded with funds. Customers touch their contactless card on a card reader when boarding a bus and a single fare is deducted from the funds available on the card
- purchase of a season ticket, through Haskett's website, which allows unlimited travel on Haskett's bus routes for a period of three, six or twelve months

The contactless card system is operated by Dolphin Systems Ltd (Dolphin). Dolphin was formed in June 2014 by Clay McCarthy who was appointed as managing director of Haskett in August 2014. Clay owns 100% of the share capital of Dolphin.

Revenue from season ticket sales is recognised evenly over the relevant season ticket period. All other revenue is recognised on the day of travel. Haskett's customers load funds onto a contactless card through Dolphin's own website, payment is taken and the funds held by Dolphin until the customer makes a bus journey. Data from the Dolphin card reader on each bus is electronically transmitted to Dolphin's central computer at the end of each day. The central computer software calculates the amount due to Haskett and the funds are electronically transferred, on a daily basis, to Haskett's bank account, after deducting a 12% commission charge. No checks are made by Haskett regarding the amounts calculated and transferred by Dolphin. This is the first time any MT Group subsidiary has used a contactless card system on its buses.

Haskett operates a fleet of buses half of which consists of buses purchased at market value from other MT Group subsidiaries and refurbished by Haskett's own employees. The rest of the fleet consists of new buses purchased from EchoBus Ltd (EchoBus), a UK bus manufacturer. All costs associated with both purchasing and refurbishing the fleet have been recognised as property, plant and equipment in Haskett's financial statements. All buses are being depreciated over ten years.

The east of England bus service contract runs for eight years and required Haskett to commence bus services on 1 February 2015. However, due to delays in the manufacture of the new buses by EchoBus, a significantly reduced service commenced on 1 February 2015 and the full service commenced on 1 April 2015. The government body that awarded the contract has made a claim for damages against Haskett of £250,000 for breach of contract. The outcome of the claim will not be known until after the audit report on Haskett's financial statements is due to be signed. Haskett's directors do not wish to include a provision or make any disclosure in respect of the claim as they intend to make their own claim of £250,000 against EchoBus.

Mandy has provided you with the following draft extracts from the financial statements of Haskett and budget information, prepared by MT Group when tendering for the new contract, to be used as part of your consideration of the key audit risks. Mandy also informed you that Haskett's draft profit before tax for the year ended 31 July 2015 is £538,000.

Statement of profit or loss for the year ended 31 July 2015 (extract)

	Actual (draft) £'000	Budgeted £'000
Revenue	8,975	7,450
Cost of sales	<u>(7,180)</u>	<u>(6,183)</u>
Gross profit	<u>1,795</u>	<u>1,267</u>

Statement of financial position as at 31 July 2015 (extract)

	Actual (draft) £'000	Budgeted £'000
Property, plant and equipment – buses	<u>4,900</u>	<u>3,500</u>

Requirements

- (a) 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 **(25 marks)**

- (b) Set out the matters you should consider, as part of your audit planning, arising from:

- (i) the ownership of Dolphin by Clay McCarthy; and
(ii) Haskett being a component of MT Group. **(10 marks)**

Total: 35 marks

8. Your firm is considering whether to accept the following four unrelated prospective engagements:

Clymene Ltd (Clymene)

Your firm has been the external auditor of Clymene for a number of years. Clymene has recently reduced the number of employees working in its accounts department to save costs. The directors have asked your firm to accept reappointment as external auditor for the year ending 31 December 2015 and have requested that your firm prepares the year-end financial statements in addition to the audit. Your firm has not prepared the financial statements in previous years. The engagement partner has estimated that your firm's current fee from Clymene, of £600,000, would increase by 25% as a result of providing the additional service. Your firm's gross annual fee income, **excluding** amounts received from Clymene, is £6.4 million.

Dusky Ltd (Dusky)

Your firm's report to management and those charged with governance, prepared during the external audit of Dusky for the year ended 30 September 2014, identified a number of significant internal control deficiencies in Dusky's inventory system. In March 2015, the company modified its inventory system to address the deficiencies identified in your firm's report. The directors of Dusky have requested that your firm accept an engagement to evaluate the design and operation of the system and confirm in an assurance report that the system is now free from any control deficiencies.

Risso Ltd (Risso)

Risso is a marine biology research and development company. The directors of Risso have approached your firm to provide a second opinion on the application of an accounting standard to Risso's financial statements. The audit opinion on Risso's financial statements for the year ended 31 March 2015 was modified by Risso's external auditors due to a disagreement over the application of the accounting standard.

Irrawaddy Ltd (Irrawaddy)

The directors of Irrawaddy have requested that your firm accepts an engagement to examine and report on prospective financial information for the three years ending 30 June 2018, prepared by the company in support of a loan application. The independent examination and report has been requested by Irrawaddy's bank. Irrawaddy's external auditor is currently performing audit work on the financial statements for the year ended 30 June 2015 but has not been offered the engagement to examine the prospective financial information.

Requirement

For each of the four prospective engagements, identify the matters that your firm should consider, including any professional and ethical issues arising, and any steps it should take **before** deciding whether to accept the engagement.

Total: 25 marks

9. Rescue24 is a UK not-for-profit charity whose activities involve the rescue and veterinary treatment of injured wild animals. The charity is required to undergo an external audit in accordance with the constitution in its governing document and you are the audit senior responsible for the audit for the year ended 30 June 2015.

Due to a reduction in government spending, Rescue24 has experienced a decline in the level of government grants available for its activities. It has also found it increasingly difficult to obtain financial donations through its traditional fundraising activities of street collections and telephone campaigns. In December 2014, the trustees decided to meet a shortfall in Rescue24's funding using crowdfunding which is the practice of obtaining funding by raising monetary contributions via the internet. Rescue24 chose to raise funds through the crowdfunding website, crowdcause.com, and launched a campaign on the website in January 2015. However, the trustees had no experience of this type of fundraising activity and failed to put in place any promotional or marketing support for the campaign. The lack of public awareness meant the campaign failed and no funds were received by Rescue24.

In March 2015, the trustees negotiated an increase in Rescue24's overdraft facility and obtained a bank loan, secured on Rescue24's only premises, to meet the shortfall in funds and enable Rescue24 to continue its activities. However, the draft statement of financial activities for the year ended 30 June 2015 shows that expenditure exceeded income for the year and the draft balance sheet at 30 June 2015 shows a net liability position. As a result of the financial issues arising in the year, three of Rescue24's five trustees and its fundraising manager resigned from their positions.

During the audit, you identified the following internal control deficiencies:

- (1) Collection boxes used during street collections were not sealed or numbered and collectors were responsible for counting and recording proceeds from their own collection boxes.
- (2) Certain veterinary drugs were not stored in a secure lockable container, in contravention of the requirements of the Veterinary Medicines Directorate.

Requirements

- (a) For each internal control deficiency identified in (1) and (2) above, draft points for inclusion in your firm's report to the trustees. For each deficiency, outline the possible consequence(s) of the deficiency and provide recommendations to address it. **(7 marks)**
- (b) Identify and explain the factors which give rise to an uncertainty about the going concern status of Rescue24. **(7 marks)**
- (c) Assuming your firm concludes there is an uncertainty about the going concern status of Rescue24, explain the potential implications for the audit opinion on the financial statements of Rescue24 for the year ended 30 June 2015 if the trustees:
 - (i) make appropriate disclosures; or
 - (ii) do not make any disclosures.

Your answer should describe the effects, if any, on your firm's audit report in each situation. **(6 marks)**

Total: 20 marks