PROFESSIONAL LEVEL EXAMINATION

WEDNESDAY 6 DECEMBER 2017

(2½ HOURS)

AUDIT AND ASSURANCE

This exam consists of **six** short-form questions (20 marks) and **three** long-form questions (80 marks).

1. Please read the instructions on this page carefully before you begin your exam. If you have any questions, raise your hand and speak with the invigilator before you begin. The invigilator cannot advise you on how to use the software.

2. Click on the **Start Exam** button to begin the exam. The exam timer will begin to count down. A warning is given five minutes before the exam ends. When the exam timer reaches zero, the exam will end. To end the exam early, press the **Finish** button.

3. You may use a pen and paper for draft workings. Any information you write on paper will not be read or marked.

4. Answer the short-form questions in note form only. Complete sentences are not required.

5. The examiner will take account of the way in which answers are structured. Do not include anything which is not in direct response to the exam questions.

6. Ensure that all of your responses are visible on screen and are not hidden within cells. Your answers will be presented to the examiner exactly as they appear on screen.

1. External audit firms handle large volumes of client data and have a responsibility to put internal controls in place to protect that data.

   List the consequences that could arise if an audit firm failed to meet this responsibility and outline the internal controls that should be in place to mitigate the risk of failing to protect client data. **(4 marks)**

2. Wharfe Golf Club (Wharfe) is unincorporated and is not legally required to have an external audit. Wharfe's main sources of income are membership fees and sales of food and golf equipment.

   List the benefits for Wharfe of voluntarily undergoing an external audit. **(3 marks)**

3. The risk of management override of internal controls is present in all organisations.

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

4. Swale Ltd's (Swale) external auditor is proposing to express an adverse opinion on the company's financial statements for the year ended 30 September 2017. This is due to disagreement over a number of accounting policies applied in the preparation of the financial statements. Swale has approached your firm and requested a second opinion on the auditor's report

   Identify and explain the ethical issues that may arise for your firm from this request and state how your firm should deal with this request. **(3 marks)**

5. Your firm is the external auditor of Aire Ltd (Aire) which operates a chain of retail stores selling household goods. Aire is wholly-owned by Sunwac Ltd (Sunwac) and is dependent on Sunwac to provide finance to continue operating.

   The directors of Aire have provided your firm with an email from Sunwac's directors stating that Sunwac will continue to provide Aire with ongoing financial support. No audit work has been performed in respect of the email. The directors of Aire have prepared the financial statements on the going concern basis.

   Comment on the reliability of the email as audit evidence and outline any audit work that should be undertaken in respect of the email confirmation. **(4 marks)**

6. Sue Ure is the engagement partner responsible for the external audit of Nidd plc (Nidd), a listed company. Sue is due to be removed from the audit team as she has been the engagement partner for the last five years. However, because of a recent major change in the structure of Nidd's business following the acquisition of a competitor, the audit committee has requested that Sue continues as engagement partner.

   State, with reasons, how Sue's firm should respond to the audit committee's request. **(3 marks)**

7. Your firm has recently been appointed as the external auditor of Lab Equipment Ltd (LEL) for the year ending 31 December 2017. The previous auditors did not seek reappointment following the conclusion of the 2016 audit.

You are the audit senior and the engagement partner asked you to consider the following two key areas of audit risk:

(1) Trade receivables
(2) Inventories.

You have been provided with the following extracts from the financial statements:

Statement of profit or loss for the year ending 31 December

	2017 (estimated) £'000	**2016 (audited) £'000**
Revenue	125,500	108,137
Cost of sales	(68,500)	(64,007)
Gross profit	57,000	44,130

Statement of financial position as at 31 December

	2017 (estimated) £'000	**2016 (audited) £'000**
Current assets		
Inventories	14,200	8,307
Trade receivables	15,500	9,222

In addition, the following information has been provided:

- LEL is a UK-based producer of scientific instruments, for use in hospitals and universities, which sells its instruments around the world. Each year, the range of instruments is updated and presented in an online catalogue which includes the selling prices. Customers either order directly from the catalogue or agree a contract with LEL. In some countries the use of commercial intermediaries (agents) to facilitate negotiations is standard practice.

- LEL invoices customers in Sterling and requires payment within 30 days of the invoice date. One overseas customer, Ruritania Education Consortium, is withholding payment of £1.3 million as it claims that the instruments it purchased are defective.

- Instruments are assembled, from bought-in components, to a standard specification produced by the in-house design team. Components are purchased from suppliers based in the UK and overseas who invoice LEL in their local currency. LEL operates a perpetual inventory system for components and finished instruments. Quantities recorded in the perpetual inventory system are checked by periodic counting throughout the year by the company's employees. The company does not undertake a full inventory count at the year end.

- The inventory system is fully integrated with the cost accounting system. The cost accounting system records the cost of components, labour and production overheads for each instrument.

- Each week, the inventory system generates an inventory valuation listing and an aged inventory report. The inventory valuation listing includes the cost and quantity on hand for each component and each instrument.

- During 2017, LEL experienced quality problems with components purchased from one of its major suppliers, Partco Ltd (Partco). LEL terminated its contract with Partco on 30 September 2017 and switched to a new supplier which charges higher prices for higher quality components. LEL has not passed on these costs to its customers.

- During 2017, the chief buyer exceeded reorder limits in respect of a number of components.

The recent interim audit revealed the following internal control deficiencies:

(a) The sales staff amend the prices in the online catalogue on the oral authority of the sales director. No check is made on the amendments.

(b) LEL does not have any bribery prevention policies in place.

During the interim audit, the managing director of LEL requested that the audit team completes the audit by 28 February 2018. The company requires the audited financial statements to support an application for a bank loan to finance the purchase of equipment. As an incentive to complete the audit to this deadline, the managing director offered the audit team and their close family free use of LEL's private box for a premier league football match. He also offered to pay for the costs of travelling and overnight accommodation at a luxury hotel following the football match.

Requirements

7.1 Outline the process set out by the ICAEW Code of Ethics that your firm should have undertaken to obtain professional clearance from LEL's previous auditors. List the reasons for this process. **(6 marks)**

7.2 Justify why the items listed as (1) and (2) 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 to address those risks. Your answer should include examples of specific data analytics routines that can be applied to the items listed as (1) and (2).

Present your answer in a two-column format using the headings:

- Justification; and
- Procedures to address each risk. **(21 marks)**

7.3 For each internal control deficiency listed as (a) and (b) in the scenario, draft points for inclusion in your firm's report to those charged with governance and management at LEL. For each deficiency, you should outline the possible consequence(s) of the deficiency and provide recommendations to address it. **(9 marks)**

7.4 Explain the ethical issues arising in respect of the offer of the free use of a private box at a premier league football match and paid travel and hotel costs. **(4 marks)**

Total: 40 marks

8. Crystal Diamond Screens Ltd (CDS) is a cinema operator with 22 cinemas in large cities across the UK. The main source of income is ticket sales for admission to watch the films. The directors want to attract more customers by offering a greater choice of films. Each cinema currently has only one screen but CDS is planning to convert 20 of the 22 cinemas to multiplexes (ie. a cinema with at least five screens).

Arnie Flynn, CDS's finance director, has prepared profit and cash flow forecasts for the four years ending 31 December 2021, which are to be submitted to CDS's bank in support of a loan to finance the conversions. CDS has requested that your firm examines and provides an assurance report on the cash flow forecasts.

Arnie has provided the following additional information:

- Ten cinemas will be converted to multiplexes each year. During the conversions, which will each take one year to complete, the cinema being converted will not show any films. The first ten conversions are planned to start on 1 January 2019.

- There will be a 10% increase in ticket price once conversions are completed to reflect the improved facilities. Because the conversions allow more efficient use of space, the seating capacity of each cinema will increase by 5%.

- Three construction firms have submitted tenders for the conversion work and these are awaiting evaluation by CDS.

- New seating will be installed in the cinemas during the conversions. Tenders have not yet been invited for the seating but costs have been estimated, by the directors, at £150 per seat.

- The conversions will be managed on behalf of CDS by Monroe and Co, a firm of project managers.

- To help finance the conversions, two cinemas which are too small to be converted will be closed on 30 June 2018 and sold. A property developer has expressed interest in both sites and CDS is currently applying for permission to change the use of the sites from a cinema to residential.

- CDS pays the film distribution company a rental fee, monthly in arrears, for each film shown. The fee is a percentage of the ticket sales for each film. CDS has negotiated a rent-free period for the first three months following the cinema conversions.

- Following each conversion, the directors plan to recruit six additional employees for each cinema who will be paid the minimum hourly wage. All employees are eligible for annual bonuses linked to profits made by the company as a whole.

Your firm is currently finalising its terms of engagement with CDS for the review of the cash flow forecasts. Arnie has asked for an explanation of the following phrases used in your firm's draft engagement letter:

- "We will request from management written confirmation concerning representations made to us in connection with the examination of the forecasts."

- "Our report will provide a moderate level of assurance as to whether the assumptions provide a reasonable basis for the preparation of the forecasts."

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

(1) Receipts from ticket sales
(2) Payments for the conversion of cinemas, new seating and project management fees
(3) Proceeds from the sale of the two cinemas
(4) Payments to the film distribution company
(5) Payments to employees
(6) Receipts from and payments to the bank.

Requirements

8.1 Draft a response to Arnie which:

(a) lists the general representations that should be obtained from management as part of the assurance work on the cash flow forecasts and explains why such representations are required; and

(b) explains the term moderate assurance and why a higher level of assurance cannot be provided as to whether the assumptions provide a reasonable basis for the preparation of the cash flow forecasts. **(8 marks)**

8.2 For the items listed (1) to (6) in the scenario, identify the specific matters you would consider when reviewing the reasonableness of the assumptions underlying each receipt or payment. **(12 marks)**

Total: 20 marks

9. Described below are situations which have arisen at four unrelated external audit clients of your firm. The year end in each case is 30 September 2017.

Foyle Ltd (Foyle)
In June 2016, Foyle entered into a fixed-price contract with Mersey plc. The contract is due to be completed in January 2018. Due to increases in the cost of the materials purchased by Foyle for the contract, the directors of Foyle estimate that the contract will make a total loss of £0.2 million. The directors of Foyle have refused to provide for this loss in the financial statements as they maintain that the loss on this contract will be offset by profits on other contracts in the year ending 30 September 2018.

The draft financial statements show that Foyle's profit before tax is £9.7 million and total assets are £84.7 million.

Ogmore Ltd (Ogmore)
Your firm's evaluation of the directors' assessment of Ogmore's ability to continue as a going concern included an examination of the company's financial forecasts prepared by its directors for the two years ending 30 September 2019. Your firm has concluded that there are significant doubts as to whether Ogmore can continue as a going concern. The directors of Ogmore prepared the financial statements on the going concern basis. The notes to the financial statements include adequate disclosures in respect of the uncertainty related to the going concern assumption.

Pattack plc (Pattack)
The brother of the managing director of Pattack owns Clyde Ltd (Clyde) a haulage business which Pattack uses for some of its distribution requirements. The total amount paid by Pattack to Clyde during the year was £0.4 million. The directors of Pattack have refused to disclose this transaction in the notes to the financial statements as they claim that the amount is too small to warrant disclosure.

The draft financial statements show that Pattack's profit before tax is £11.3 million and total assets are £88.0 million.

Tyne Ltd (Tyne)
The former engagement partner responsible for the audit of Tyne left your firm and joined Tyne on 1 September 2017 as finance director. Your firm has determined that there is no significant threat to the audit team's integrity, objectivity and independence arising from this move and has decided to continue as external auditor. Tyne is a small entity as defined by the Companies Act 2006 and the firm has taken advantage of the exemptions of the FRC's Provisions Available for Small Entities.

Requirements

9.1 For each of the situations described above, explain the implications, if any, for the auditor's report. **(12 marks)**

9.2 (a) Identify the parties to whom your firm may be liable for damages if an inappropriate audit opinion is issued.

(b) Outline the methods available to your firm to limit its liability to such parties.

(c) Outline the quality control procedures your firm should implement to reduce the risk of issuing an inappropriate audit opinion.

(8 marks)

Total: 20 marks

