PROFESSIONAL LEVEL EXAMINATION

MONDAY 3 DECEMBER 2018

(2½ HOURS)

AUDIT AND ASSURANCE

This exam consists of **four** questions (100 marks).

Marks breakdown

Question 1	20 marks
Question 2	30 marks
Question 3	28 marks
Question 4	22 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.

2. Please alert the invigilator immediately if you encounter any issues during the delivery of the exam. The invigilator cannot advise you on how to use the software. If you believe that your performance has been affected by any issues which occurred, you must request and complete a candidate incident report form at the end of the exam; this form must be submitted as part of any subsequent special consideration application.

3. 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.

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

5 Answer question one, consisting of **six** short-form questions, in note form only. Complete sentences are not required.

6. The examiner will take account of the way in which answers are structured. Respond directly to the exam question requirements. Do not include any content or opinion of a personal nature. A student survey is provided post-exam for feedback purposes.

7. 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.

Question 1

1.1 As part of your analytical procedures on the financial statements of Kraken Ltd (Kraken), a retailer, you note an improvement in the current ratio. The financial controller explains that this is due to the factors listed below:

(a) A restructuring of Kraken's finances with short-term borrowings consolidated into a 10-year loan with annual repayments.

(b) The sale of one of Kraken's freehold stores to a developer for cash.

For each of the above factors, briefly explain whether it is a plausible explanation for the improvement in the current ratio. **(2 marks)**

1.2 Your firm is the external auditor of Nessie Ltd (Nessie). Nessie and Klingon Ltd (Klingon) are competitors engaged in the manufacture of mobile phones. On 1 December 2018, Nessie received notification of legal proceedings against it by Klingon for an alleged infringement by Nessie of a number of patents granted to Klingon.

Explain why your firm should consider this matter during the audit of the financial statements of Nessie for the year ended 31 October 2018. **(4 marks)**

1.3 Outline the differences between the conclusion expressed following an engagement to examine prospective financial information and the opinion expressed in an external auditor's report on financial statements. Give reasons for these differences. **(4 marks)**

1.4 Your firm is the external auditor of Hydra Ltd (Hydra) for the year ended 31 October 2018. Trade receivables at 31 October 2018 included £750,000 due from Orc plc (Orc). The chief executive of Hydra refused to provide any information about the contract with Orc and refused permission for your firm to contact Orc to confirm the outstanding balance. The chief executive claimed that the contract involved the military and that Hydra had signed a confidentiality agreement with Orc. No alternative audit procedures are available to establish the existence of the debt. Hydra's total assets at 31 October 2018 were £29.0 million and profit before tax for the year then ended was £5.0 million.

Explain the implications for the auditor's report on Hydra's financial statements for the year ended 31 October 2018. **(4 marks)**

1.5 Describe the responsibilities of the ethics partner within an external audit firm. **(3 marks)**

1.6 You are an audit senior on the external audit of Vampire Ltd (Vampire) for the year ended 31 October 2018. Whilst planning the external audit you read the following comment on the 'points forward for next year' working paper included in last year's audit file:

'During the course of our audit we discovered that Vampire had underpaid payroll taxes of £25,755. We notified Vampire in writing, of the need to pay this amount as soon as possible. The statement of financial position has been adjusted to include this sum within current liabilities as 'Amounts payable – unpaid taxes'.

Included in the company's unaudited financial statements for the year ended 31 October 2018 is a credit entry of £25,755 in the statement of profit or loss described as ''payroll difference''. Revenue and profit before tax for the year ended 31 October 2018 are £27 million and £2.2 million respectively.

State, with reasons, the actions that you and your firm should take in respect of this matter. **(3 marks)**

Total: 20 marks

Question 2

Your firm has recently been appointed as the external auditor of Dragon plc (Dragon), a listed company, for the year ended 30 November 2018, following the resignation of the previous auditor. Dragon is an online retailer offering customers a choice of over 1,000 items of groceries and household goods.

Customers place their orders online and their orders are hand-picked and delivered to customers by Dragon using its own delivery vehicles. Dragon operates from 10 freehold distribution centres throughout the UK.

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

- Volume-based supplier rebates
- Non-current assets - delivery vehicles
- Non-current assets - freehold distribution centres.

The engagement partner provided you with the following extracts from the draft financial statements:

Draft statement of profit or loss for the year ended 30 November (extract)

	2018 (unaudited) £m	**2017 (audited) £m**
Revenue	2,885	2,352
Cost of sales (gross of supplier rebates)	(1,194)	(987)
Volume-based supplier rebates	110	65
Loss on sale of delivery vehicles	(45)	(25)
Depreciation charge for delivery vehicles	(47)	(55)

Draft statement of financial position as at 30 November (extract)

	2018 (unaudited)	**2017 (audited)**
Non-current assets	**£m**	**£m**
Delivery vehicles (carrying value)	664	558

In addition, the engagement partner has provided you with the following information:

- Dragon has negotiated individual terms for supplier rebates with each of its 100 principal suppliers. Rebates range from 1% to 10% of purchases. The terms are set out in signed annual contracts with each supplier. The contracts end at different times of the year. Rebates are paid in arrears to Dragon on the conclusion of the contract if Dragon exceeds the volumes of purchases stipulated in the contract. Dragon's operations managers prepare revenue forecasts for each product. The revenue forecasts are then used to estimate the annual volume of purchases that will be placed with each supplier. If the volume of estimated purchases exceeds that required in the contract to earn a rebate, a rebate is recognised in the financial statements. Dragon maintains a rebate management system that was developed by its IT department to collate the necessary information and calculate the rebates. An earlier version of this system was replaced in September 2018.

- The delivery vehicles are serviced and repaired in Dragon's workshops. It is company policy to replace delivery vehicles every six years. Delivery vehicles are purchased from a UK dealer. Employees in Dragon’s workshops modify the delivery vehicles to make them suitable for transporting frozen food and to brand the delivery vehicles with Dragon’s corporate identity. All costs associated with both purchasing and modifying the delivery vehicles, including time spent by Dragon’s workshop employees, is included in the cost of delivery vehicles in the non-current asset register. The cost less any estimated residual value is depreciated on a straight-line basis over six years.

- Five of the 10 freehold distribution centres were valued by an external valuer in October 2018. The distribution centres are currently included in the accounting records at cost less accumulated depreciation which is lower than the valuation figure. The directors wish to recognise the new valuation in the financial statements for the year ended 30 November 2018.

- Dragon has applied for a bank loan to finance the modernisation of some of its distribution centres. The bank has requested the audited financial statements by 31 December 2018 in support of the loan application.

Requirements

2.1 Identify and explain the matters that your firm should have considered before accepting appointment as external auditor of Dragon. **(7 marks)**

2.2 Justify why volume-based supplier rebates and non-current assets have been identified as key areas of audit risk and, for each key area, describe the procedures that should be included in the audit plan to address those risks. You should present your answer using the following subheadings:

- Volume-based supplier rebates
- Non-current assets - delivery vehicles
- Non-current assets - freehold distribution centres. **(23 marks)**

Total: 30 marks

Question 3

Your firm is the external auditor of Gremlins plc (Gremlins), a listed company. Gremlins is a building contractor with operations throughout Europe. The engagement partner signed an unmodified audit report on 31 August 2018 in respect of the financial statements of Gremlins for the year ended 30 June 2018. On 30 September 2018, a liquidator was appointed at Gremlins following breaches in loan covenants and the bank's refusal to renew the overdraft facility.

The senior partner of your firm is considering whether to notify the firm's professional indemnity insurers as he believes that an inappropriate audit opinion may have been issued. He has instructed an independent partner to undertake a cold review of the audit files, prior to making that decision.

The independent partner's review identified the following four issues:

Issue 1

There was no evidence that a briefing meeting involving members of the audit team took place before or during the audit fieldwork.

Issue 2

An extract from the working paper summarising the audit work in respect of the direct confirmation of the trade receivables balances is shown below:

Summary of work on direct confirmation of the trade receivables balance

Materiality for the financial statements - £2.0 million
Trade receivables balance - £300.0 million
Sample selected for direct confirmation - £20.0 million (90 balances)

Results of confirmations

	Number	**£m**
Confirmed directly	25	10.5
For non-replies, alternative procedures were used as follows:		
• Balances confirmed by cash after date testing	35	6.5
• Balances confirmed by agreeing to sales invoices	20	2.5
• No further work on balances that individually are not material	10	0.5
Total	**90**	**20.0**

Findings
One error of £150,000 identified which is below materiality.

Conclusion
Trade receivables are therefore not materially misstated.

Issue 3
An engagement quality control reviewer had not been appointed.

Issue 4
Planned audit work in respect of the going concern status was not completed.

Requirements

3.1 Explain why issue (1) above was identified by the independent partner and outline the matters that should have been discussed with the audit team at a briefing meeting.
(5 marks)

3.2 Explain why issues (2) and (3) above were identified by the independent partner and for each item, list the additional procedures that should have been undertaken by your firm.
(7 marks)

3.3 In respect of issue (4), describe the audit procedures that should have been undertaken to address the going concern risk. **(6 marks)**

3.4 Assuming that your firm should have concluded that Gremlins was not a going concern, state whether you would have modified the audit opinion if the financial statements of Gremlins for the year ended 30 June 2018 were prepared:

(a) on a break-up basis with adequate disclosure included in the notes to the financial statements; or

(b) on a going concern basis.

Give reasons for each conclusion and describe the modifications, if any, to the auditor's report.
(6 marks)

3.5 List the possible consequences for your firm if an inappropriate auditor's report had been issued. **(4 marks)**

Total: 28 marks

Question 4

Your firm Griffin LLP (Griffin), an ICAEW firm of chartered accountants, is the external auditor of Yeti plc (Yeti), a listed company. Yeti employs 2,500 consultants and provides management consultancy services to clients throughout the world. All consultancy services are provided under fixed-price contracts.

You are the audit manager responsible for the audit of Yeti. You will be attending Yeti's forthcoming audit committee meeting with Nicola Canvey, the audit engagement partner. Nicola has provided you with a copy of the audit committee's agenda and has requested that you research each agenda item so that you are in a position to answer any questions. An extract from the agenda is given below.

Extract from the audit committee's agenda

(1) External auditor's report to those charged with governance following the audit for the year ended 31 October 2018.

Griffin will present to the audit committee, a report to those charged with governance which highlighted the following internal control deficiencies:

(a) The company's policy requires that each month, contract managers compare the costs incurred to date and the expected costs to complete each contract with the total budgeted costs. This comparison was not made in 50% of the contracts examined by the auditors.

(b) Yeti has signed a contract with Zombie Ltd (Zombie) to manage all of the consultants' transport arrangements. The contract requires that all airfares and hotels must be booked through the website recently developed by Zombie for this purpose.

However, some consultants claim that the website is often unreliable and is not user friendly. Consequently, consultants frequently book airline tickets and hotel rooms directly with the airline and hotel. They subsequently reclaim the cost from Yeti by submitting their receipts along with manual expense claim forms.

(2) Rotation of the audit engagement partner

A letter has been received from Griffin advising that Nicola Canvey is due to be rotated off the audit team as she has been the audit engagement partner for five years. The audit committee will discuss the chief executive's proposal that Nicola continues in her role to help future audits run smoothly. Yeti's current chief executive has recently announced his retirement.

(3) Griffin's response to the invitation to provide non-audit services

Griffin has stated that there is capacity to undertake non-audit services for Yeti and will present to the audit committee, their response to the following invitations:

Invitation (a)

To assist with, and take responsibility for, the recruitment of a new chief executive.

Invitation (b)

To provide payroll services for Yeti, on an outsourced basis, as the audit committee is unhappy with the performance of the company currently providing these services.

(4) Potential conflict of interest
Griffin has advised that they have been approached by Gorgon Ltd (Gorgon) to act as external auditor. Gorgon is one of Yeti's major competitors. Griffin has indicated that they will only accept appointment at Gorgon if they have Yeti's informed consent to act. Griffin has stated that they will implement a number of procedures to address any conflict of interest.

Requirements

4.1 For each internal control deficiency listed as (a) and (b) in agenda item (1), outline what should have been included in the report to those charged with governance regarding the possible consequence(s) of the deficiency and the recommendations to address the deficiency. **(8 marks)**

4.2 In respect of agenda item (2), identify and explain the threats to Griffin's objectivity and state, with reasons, how Griffin should respond to the proposal that Nicola Canvey continues as audit engagement partner. **(4 marks)**

4.3 For each invitation to provide non-audit services listed as (a) and (b) in agenda item (3), draft notes that identify and explain the threats to Griffin's objectivity. State, with reasons, how Griffin should address those threats. **(7 marks)**

4.4 In respect of agenda item (4), outline the procedures that Griffin should implement to address the potential conflict of interest. **(3 marks)**

Total: 22 marks