ACCA INTERIM ASSESSMENT

Advanced Audit & Assurance

December 2011

Time allowed
Reading and planning: 15 minutes
Writing: 3 hours

This paper is divided into two sections:

Section A – BOTH questions are compulsory and MUST be attempted

Section B – TWO questions ONLY to be attempted

Do NOT open this paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

This question paper must not be removed from the examination hall.

Kaplan Publishing/Kaplan Financial

Paper P7 (INT/UK)

KAPLAN PUBLISHING

Section A – BOTH questions are compulsory and MUST be attempted

1 You have recently been appointed to audit manager at Gilbert LLP, a medium sized firm of chartered certified accountants, where you began as a trainee seven years ago. Your first assignment in your new role is the audit of Moonstone Co, a client of Gilbert LLP for the last five years, for the year ending 30 November 2010.

Moonstone are specialists in the quarrying of aggregate materials for use in the various building trades. Their turnover for the year ended 30 November 2010 was \$31.5mn (2009: \$37.3mn); profit before tax was \$2.4mn (2009: \$3.2mn); and total assets were \$23.0mn (2009: \$22.1mn).

On 1 December 2009 Moonstone were granted a five year licence by a local council to quarry gravel at a remote site in the Peak District. The gravel is being sold exclusively for use in the construction of a new motorway, the M99, which is due to open in the winter of 2012. Although the licence did not cost Moonstone anything the directors have capitalised the licence on the balance sheet at an estimated fair value of \$750k. They argue that the licence is an asset because they control it and it will produce economic benefits over a number of years.

The licence was granted with one concession: that Moonstone converts the quarry into a lake and nature reserve at the end of the licence period. In the spirit of prudence the directors are providing \$75k a year to cover the total estimated cost of restoration works.

Due to high unemployment, after the closure of a large car plant, local government has awarded Moonstone a \$200k grant to recruit and train a local workforce and to employ them for the duration of the project. According to a note on the previous year's audit file the FD, Trevor Cramphorn, does not want to record the grant in 'turnover' because this does not accurately reflect the activity of the business. He proposes instead to record the \$200k in 'other income' in the 2010 accounts.

In order to facilitate this new project Moonstone have purchased some new digging machinery, at a cost of \$1,000,000, and some new vehicles to transport the aggregate, at a cost of \$250,000. Both are to be depreciated on a straight line basis over their estimated useful lives, which have been assessed as ten years, at which point the directors feel assets of this nature would be scrapped. During a recent telephone conversation with Mr Cramphorn you discovered that the new vehicles will be redeployed at the end of the M99 project. However, it is considered likely that the digging machinery will be surplus to requirements and sold off when digging is complete for a quarter of their original value.

As part of your initial planning for the assignment you have done some research on the internet and have found two interesting articles. The first article, from June 2010, relates to a fatal accident at one of Moonstone's quarries involving an explosives engineer, a faulty light bulb and a poorly placed detonator next to a lavatory flush handle. The second article relates to environmental protests at the Peak District site following the discovery, and consequent relocation of, a rare species of ground nesting bird called the Lesser Spotted Warbling Turtle Dove. The latter appears to have attracted quite a lot of attention as it appeared multiple times on your search. A more recent article suggested that the environmentalists are planning a legal case to close the site down.

In response to the articles you held a conversation with the Managing Director, Mr Alfie Moon. He stated that a provision of $100k has been recorded. This is the amount Moonstone offered the engineer's widow as a goodwill gesture. Apparently she refused the money, threatening instead to sue Moonstone for millions. Mr Moon laughed this off as ridiculous given that the accident was solely the engineer's fault for not following the company's operating manual. He also added that there is no concern over the environmentalists' law suit because Moonstone consulted the local council and various experts from the local zoo about the best way to safely relocate the Turtle Doves. He added that Moonstone was "a caring company" and that they do "everything possible to ensure that the local wildlife is affected as little as possible." It was a little difficult to hear the rest of Mr Moon's response due to a detonation in the background drowning out the MD's voice.

Required:

(a) Using the information provided, prepare a report for the engagement partner that identifies and explains the audit risks to be addressed at the planning meeting for the final audit of Moonstone Co for the year ended 30 November 2010.

Three professional marks are available for part (a). **(16 marks)**

(b) Describe the principle audit work to be performed in respect of the useful economic life of the licence. **(6 marks)**

In some jurisdictions companies with revenue below a certain threshold are exempt from statutory year-end audit. It has been suggested that for those small companies an independent review might replace the annual audit.

Required:

(c) Set out the arguments for and against proposals to exempt smaller companies from statutory audit and to introduce an independent professional review for certain companies. **(10 marks)**

(Total: 32 marks)

2 You are a manager working for Vitality & Sons, a medium sized firm of chartered certified accountants. You have been charged with finding prospective new clients in the wake of a significant reduction in trade due to the imposition of thresholds for statutory audits. As part of this new role you visited a computer hardware manufacturer and wholesaler, Macrohard Co. The managing director and majority shareholder, Mr Fence, has asked your firm to make a proposal for its audit and the provision of financial advice with a view to obtaining a stock exchange listing.

You make the following notes from your initial meeting.

Turnover for the year ended 31 December 2010 was $5mn (2009: $3mn), profit before tax was $1mn (2009: $0.5mn) and total assets were $3mn (2009: $2mn). Despite the apparent improvement in profits Macrohard requires finance to:

(a) Establish a nationwide customer base by making some of the company's products available to the public through high street retail outlets, and

(b) Set up a division in Germany to purchase supplies; no sales would be made there as the company faces strong competition.

Mr Fence takes personal charge of buying, selling and inventory. He is the main contact with suppliers and customers, and negotiates prices directly with both. He has recently appointed a senior bookkeeper (not a qualified accountant) to help with credit control and to set up more formal accounting systems and procedures.

A recently installed computer system provides basic payroll, sales, receivables and inventory information. The software was specifically written to Mr Fence's requirements by his former brother-in-law, who is an IT graduate but joined the police force after finishing university.

Purchasing is recorded manually because of the complexity of foreign currency conversion (many purchases of materials are from European suppliers). The purchase costs and quantities are fed into the inventory system by the bookkeeper. The system can then generate a current listing of PC parts in inventory. At the end of the year inventory totalled $230k (2009: $135k).

The annual budget set at the start of the period has always significantly understated actual sales and expenses because of higher than expected growth. Management accounts are produced infrequently. The cost of sales used for the management accounts is computed as a percentage of sales value for different product groups. In the past, this method has proved reasonably reliable when compared with the results which incorporate the annual physical inventory count. However, margins on product lines have recently become much more varied because of negotiations with individual customers and suppliers.

The company is also experiencing a high level of returns because of faulty products. In 2010 these totalled $65k (2009: $40k). These are put back into inventory if they cannot be sold at a discount for cash over the trade counter. There are also small unreconciled amounts (which vary each month) on the sales and purchase ledger control accounts. At 31 December 2010 unreconciled receivables totalled $30k and unreconciled payables totalled $17k (31 December 2009: $11k and $6k respectively).

The growth of the business has resulted in the company outgrowing its premises. Mr Fence is negotiating a loan from his bank to cover the cost of new premises to be built to his specification, and contracts for these were recently signed. The design stage is complete and building work has commenced. His bank is waiting for a profit forecast before giving final approval to a $0.8 million loan to finance the building work.

Growth has made the company short of cash. It has an overdraft which has increasingly tended to exceed the agreed overdraft limit – hence the employment of the senior bookkeeper to improve credit control. Mr Fence indicates that a large receipt from a major customer, expected at the beginning of next month, is to be used to clear some of the tax payment arrears as well as repaying his loan account of $80,000.

Mr Fence is recently divorced. The settlement with his former wife has left him without a home and he needs to increase his emoluments to provide himself with new accommodation. Mr Fence is dissatisfied with his existing firm of accountants which prepares and audits the annual financial statements. His dissatisfaction is partly because of the unreconciled amounts on the ledgers and partly because his accountants have failed to suggest how he can take increased emoluments to meet his personal needs.

Required:

(a) **Using the information provided, write a report to the intended audit partner that identifies and explains the principal business risks facing Macrohard. Your explanation should consider the financial statements consequences of the identified risks.**

Note: there are 2 professional marks available for the report **(14 marks)**

(b) **Discuss the factors that the engagement partner should consider before deciding whether or not the firm should make a proposal for this engagement.** **(8 marks)**

Consequent to discussions with Mr Fence, Vitality & Sons made a proposal for the audit of Macrohard Co. Given the strong reaction to your proposal and the lack of competitive proposals you consider it likely that you will be offered the role of auditor.

(c) **Define 'money laundering' and state the procedures that should be considered before, and on the acceptance of, the audit appointment of Macrohard Co.** **(5 marks)**

(d) **The initial fee estimate quoted in the proposal was $20k. This was based upon an assessment of the total amount of time required to complete the audit. What other factors should be considered when deciding the basis of fees?** **(5 marks)**

(Total: 32 marks)

Section B – TWO questions ONLY to be attempted

3 You are the manager responsible for the audit of Madison Co. The company's principal activity is wholesaling frozen food. The draft consolidated financial statements for the year ended 31 December 2010 show revenue of $33.5 million (2009 – $31.15 million), profit before taxation of $5.95 million (2009 – $7.1 million) and total assets of $24.0 million (2009 – $18.2 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention:

(a) In early 2010 a chemical leakage from refrigeration units owned by Madison caused contamination of some of its property. Madison has incurred $150,000 in clean up costs, $300,000 in modernisation of the units to prevent future leakage and a $15,000 fine to a regulatory agency. Apart from the fine, which has been expensed, these costs have been capitalised as improvements. **(6 marks)**

(b) While the refrigeration units were undergoing modernisation Madison outsourced all its cold storage requirements to Elric Warehousing Services. At 31 December 2010 it was not possible to physically inspect Madison's inventory held by Elric due to health and safety requirements preventing unauthorised access to cold storage areas.

Madison's management has provided written representation that inventory held at 31 December 2010 was $5.05 million (2009 – $3.35 million). This amount has been agreed to a costing of Elric's monthly return of quantities held at 31 December 2010. **(6 marks)**

(c) Madison owns a residential apartment above its head office. Until 31 December 2009 it was let for $1,500 a month. Since 1 January 2010 it has been occupied rent-free by the senior sales executive. **(6 marks)**

Required:

For each of the above issues:

(i) comment on the matters that you should consider; and

(ii) state the audit evidence that you should expect to find,

in undertaking your review of the audit working papers and financial statements of Madison Co for the year ended 31 December 2010.

NOTE: *The mark allocation is shown against each of the three issues.*

(Total: 18 marks)

4 You are an audit manager at Bartolome, a firm of Chartered Certified Accountants. You have specific responsibility for undertaking annual reviews of existing clients and advising whether an engagement can be properly continued. The following matters have arisen in connection with recent assignments:

(a) Leon Dormido is the senior in charge of the audit of the financial statements of Moreno Co for the year ending 31 October 2010, which is currently approaching completion. Moreno's Chief Executive Officer, James Bay, has just sent you an e-mail to advise you that Leon has been short-listed for the position of Finance Director. You were not previously aware that Leon had applied for the position. **(6 marks)**

(b) Chatam Inc is a long-standing client. One of its subsidiaries, Ayora, has made losses for several years. At your firm's request, Chatam's management has made a written representation that goodwill arising on the acquisition of Ayora is not impaired. Your firm's auditors' report on the consolidated financial statements of Chatam for the year ended 30 June 2010 is unmodified. Your firm's auditors' report on the financial statements of Ayora is similarly unmodified. Chatam's Chief Executive, Charles Barrington, is due to retire in 2011 when his share options mature. **(7 marks)**

(c) An audit client, Pinzon Inc, is threatening to sue your firm in respect of audit fees charged for the year ended 31 December 2009. Pinzon is alleging that Bartolome billed the full rate on air fares for audit staff when substantial discounts had been obtained by Bartolome. **(5 marks)**

Assess the ethical and professional issues raised and recommend any actions necessary in response to the above matters.

Note: *The mark allocation is shown against each of the three issues.*

(Total: 18 marks)

5 You are a manager in the quality assurance team of an audit firm and are conducting a cold review of the audit file for Beevor Inc. The audit team for Beevor Inc included Nick Rose the audit manager; Kamrun Khanom the audit senior; and Stephen Bishop an audit junior.

Beevor Inc provides freight services between seven major cities in one country, Ator. The cities are located at significant distances from each other meaning that deliveries can take several days. There were a number of protests by lorry drivers in Ator last year, who were angry about the increased taxes on fuel in Ator. The lorry drivers protested using rolling road blocks on the major roads in Ator. This caused significant delays to Beevor Inc in reaching its customers.

The company made an annual profit of $2m last year, and total assets were $9m.

You are reviewing the irrecoverable debt provision working paper, completed by Kamrun Khanom during the audit (although it has not been signed by Kamrun). The working paper was reviewed and evidenced as reviewed by Stephen Bishop.

The working paper includes the following note: "The irrecoverable debt provision of $425,000 includes an amount of $150,000 relating to a debt from one customer, Feret Co. Feret Co is refusing to settle the latest invoice of $300,000 issued to it by Beevor, because of the extent of recent delays. Feret Co says it lost out on a contract because of the delays caused, and the goods delivered, which were bespoke, were rendered obsolete as a result. Having discussed this issue with management, they have been offering customers a standard 50% discount where such delays have been incurred and have therefore provided for half of the debt owed by Feret Co. This appears reasonable.

An after date cash review of other debts was carried out, but as there were no issues identified this has not been retained on file."

Required:

(a) Explain "management bias" and discuss why management bias may be difficult for the auditor to identify and take any action on. (5 marks)

(b) In relation to the above situation:

(i) Comment on the matters that should have been considered, and

(ii) Recommend further audit procedures that should have been carried out

(5 marks)

(c) Explain the engagement performance quality control measures the auditor should have in place and critically evaluate the engagement performance of the Beevor Inc audit, making any recommendations you think appropriate.

(8 marks)

(Total: 18 marks)

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