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ACCA – Paper P7 Advanced Audit and Assurance December 2014 to June 2015 Interim Assessment

Instructions

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Marking Report

Notice to Markers

- 1 When commenting about the script performance, please ensure on individual questions and on overall assessment your comments cover areas of examination technique including:

• Time management	• Handwriting	• Presentation and layout	• Use of English
• Points clearly and concisely made	• Relevance of answers to question	• Coverage and depth of answer	• Accuracy of calculations
• Calculations cross-referenced to workings	• All parts of the requirement attempted	• Length of answers equates to marks available	• Read the question carefully

- 2 For each question, please provide suitable constructive comments

Question Number	General Comments	Exam Technique Comments

ACCA INTERIM ASSESSMENT

Advanced Audit and Assurance

December 2014 to June 2015

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.

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Paper P7

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Section A – BOTH questions are compulsory and MUST be attempted

- 1 You have recently been appointed to audit manager at Gilbert & Co, 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 & Co for the last five years, for the year ending 30 June 2015.

Moonstone is a specialist in the quarrying of aggregate materials for use in the various building trades. Revenue for the year ended 30 June 2015 is expected to be \$31.5mn (2014: \$37.3mn); profit before tax was \$2.4mn (2014: \$3.2mn); and total assets were \$23.0mn (2014: \$22.1mn).

- (a) You have received the following email from the audit partner for Moonstone:

To: M. Anager
From: E. Partner
Subject: Moonstone Co Audit Planning

Hello

I have just been to a meeting with Trevor Cramphorn and Alfie Moon, the Managing Director and Finance Director of Moonstone Co. We were discussing recent events which will have a bearing on our forthcoming audit, and my notes from the meeting are attached to this email. We need to start planning the audit as soon as possible, and I would like to have the planning meeting early next week.

In preparation for this, I would like you to prepare a report for me in which you:

(i) Evaluate the audit risks to be addressed at the planning meeting for the final audit of Moonstone Co for the year ended 30 June 2015. **(14 marks)**

(ii) Recommend the principal audit procedures to be performed in respect of the useful economic life of the licence. **(7 marks)**

Thank you.

Attachment: Notes from meeting with Moonstone Co

On 1 July 2014 Moonstone was 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 four years. Although the licence did not cost Moonstone anything the directors have capitalised the licence on the statement of financial position at an estimated fair value of \$750k. They argue that the licence is an asset because they control it and it will produce economic benefit 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 'revenue' because this does not accurately reflect the activity of the business. He proposes instead to record the \$200k in 'other income' in the financial statements.

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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, with no expected residual value. 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 relates to a recent 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 recognised. 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:

Respond to the partner's email. (21 marks)

Note: the split of the mark allocation is shown within the partner's email.

Professional marks will be awarded in part (a) for the presentation and clarity of your answer. (4 marks)

- (b) In some jurisdictions companies with revenue below a certain threshold are exempt from statutory year-end audit. It has been suggested that the threshold be increased to exempt more companies from the statutory year-end audit.

Required:

Set out the arguments for and against proposals to increase the threshold for statutory year-end audit. (10 marks)

(Total: 35 marks)

- 2 You are a manager working for Vitality & Sons, a medium sized firm of chartered certified accountants. You have been asked to find prospective new clients. 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.
- (a) You have received the following email from the engagement partner.

<p>To: A Manager</p> <p>From: An Audit Partner</p> <p>Subject: Audit and Financial Advice – Macrohard Co</p> <p>Hello</p> <p>Congratulations on securing an invitation from Macrohard Co to make a proposal for its audit and the provision of financial advice with a view to obtaining a stock exchange listing.</p> <p>In preparation for this you are required to:</p> <p>(i) Evaluate the business risks facing Macrohard Co based on the information you obtained during your initial meeting with the company. (12 marks)</p> <p>(ii) Discuss the factors that I should consider before deciding whether or not the firm should make a proposal for this engagement. (8 marks)</p> <p>Thank you</p>

You made the following notes from your initial meeting.

Revenue for the year ended 31 December 2014 was \$5mn (2013: \$3mn), profit before tax was \$1mn (2013: \$0.5mn) and total assets were \$3mn (2013: \$2mn). Despite the apparent improvement in profits Macrohard requires finance to:

- (1) Establish a nationwide customer base by making some of the company's products available to the public through high street retail outlets, and
- (2) Set up a division in Germany to purchase supplies. No sales would be made in Germany as there is strong competition in that market.

Mr Fence takes personal charge of buying, selling and inventory management. 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 (2013: \$135k).

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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 calculated 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 2014 these totalled \$65k (2013: \$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 2014 unreconciled receivables totalled \$30k and unreconciled payables totalled \$17k (2013: \$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 remuneration 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 remuneration to meet his personal needs.

Respond to the partner's email. (20 marks)

Note: the split of the mark allocation is shown within the partner's email.

(b) **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)

(Total: 25 marks)

Section B – TWO questions ONLY to be attempted

3 You are the partner responsible for performing an engagement quality control review on the audit of Henley Co. You are currently reviewing the working papers on the financial statements of Henley Co for the year ended 31 July. This is the first year your firm has audited Henley Co. The draft financial statements show revenue of \$7m, profit before tax of \$0.5m, and total assets of \$4.6m. Henley Co commenced trading three years ago. This is the first year that Henley Co has made a profit.

- (a) Henley Co has a deferred tax asset of \$60,000 relating to unutilised tax losses which accumulated during the loss making period. They are confident that future taxable trading profits will be generated in order for the tax losses to be utilised.

Required:

Comment on the matters that you should consider and state the audit evidence that you should expect to find in your review of the audit working papers for the year ended 31 July. (6 marks)

- (b) During the audit one of the audit juniors raised concerns about the performance of the audit. The main issues raised were:
- (i) No audit team briefing was held at the start of the audit.
 - (ii) The manager in charge only visited the client once a week. The remainder of the time the team consisted of two audit juniors and a senior who was busy in client meetings for much of the time.
 - (iii) The audit junior was assigned the audit of the warranty provision. This is the first year such a provision has been included in the financial statements and as a result is based solely on the judgement of management.
 - (iv) The client has also changed their accounting systems during the year and the system therefore needed to be fully documented and tested. None of the audit team were sure exactly how to do this having always worked on clients where the systems had been documented in a previous year.

Required:

Evaluate the audit junior's concerns regarding the performance of the audit. (8 marks)

- (c) **Discuss the reasons why entities change their auditors/professional accountants. (6 marks)**

(Total: 20 marks)

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4 You are a senior manager in the firm Gold Partners, chartered certified accountants, which has 18 offices throughout the country of Olympia. You are reviewing a number of situations which were discussed recently at the monthly manager's meeting.

- (i) Gold Partners is planning to open a new office. An audit client, Sprinters Co has suggested that Gold Partners leases one of their vacant properties at the market rate. Sprinters Co is a property management company, with a large number of properties throughout Olympia. **(4 marks)**
- (ii) Velodrome Co, an audit client, is a listed company. The audit engagement partner of Velodrome Co, Bradley Hoy, has been in place for nearly seven years, and is due to be rotated at the end of the audit. However, Bradley has agreed with the managing partners at Gold Partners to use the one year extension permitted by the IFAC and ACCA Code of Ethics and remain in place for a further year.

This extension is permitted for key audit partners whose continuity is especially important to audit quality, as long as the threat to independence can be reduced to an acceptable level. The audit is to be put out for tender in one year's time, and Bradley is concerned that continuity is maintained in order to increase the chances of retaining the audit.

Bradley believes that the audit committee at Velodrome Co is inexperienced, and therefore it would not be appropriate to draw their attention to this decision as it may 'overload them with unnecessary information'. Bradley does not believe any additional safeguards are necessary as 'nothing is changing'. **(8 marks)**

- (iii) A letter has been received from the solicitors representing Pent & Athlon Co, an audit client. The letter states that Pent & Athlon Co intend to take legal action against Gold Partners after the share price of Pent & Athlon Co dropped by more than 60% following the settlement of a large claim by one of Pent & Athlon Co's customers. The claim was disclosed as a contingent liability in the prior year financial statements and the shareholders are stating that this accounting treatment is inappropriate, as the claim has been settled within 12 months of the year end, it should have been provided for. **(8 marks)**

Required:

Identify and discuss the ethical and professional issues raised, and recommend any actions that should be taken.

Note: the mark allocations are shown above. (Total: 20 marks)

5 (a) Discuss the role and function of an audit committee. (8 marks)

(b) 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 2014 show revenue of \$33.5 million (2013 – \$31.15 million), profit before taxation of \$5.95 million (2013 – \$7.1 million) and total assets of \$24.0 million (2013 – \$18.2 million).

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

In early 2014 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.

Required:

Comment on the matters that you should consider and state the audit evidence that you should expect to find in your review of the audit working papers for the year ended 31 December 2014. (7 marks)

Note: You do not need to consider the impact on the audit report.

(c) **Compare and contrast the responsibilities of management, and of auditors, in relation to accounting estimates. You should include a description of the procedures used in the assessment of estimates where relevant. (5 marks)**

(Total: 20 marks)

