AUDIT AND ASSURANCE

This paper is made up of SIX short-form questions (20 marks) and THREE written test questions (80 marks).

1. Ensure your candidate details are on the front of your answer booklet.

2. Answer each question in black ballpoint 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 short-form questions must begin on a new page and should be submitted in numerical order.

Written Test Questions (7 – 9)

5. Answers to each written test 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.

IMPORTANT

Question papers contain confidential information and must NOT be removed from the examination hall.

Please check that the information above relates to you and is correct. You MUST enter your candidate number in this box.
1 Your client, Motorco Ltd, runs a garage. Since its formation in 1982 its main activities have been those of vehicle repair and selling fuel. However, in the last two years, the company has begun buying and selling second hand cars. You are the audit senior on this assignment and, as part of your audit, you have been testing the company’s vehicle inventory records which show cars bought (their source and cost) and sold (their price and purchaser). You notice some large round sum receipts and payments that don’t appear to tie up with the vehicle inventory movements. What action should you and your firm take? (4 marks)

2 You have recently been employed as a senior manager in a firm of accountants which has 50 partners and staff (5 partners, 30 other professional staff including qualified staff and trainees, and 15 support staff). The senior partner has asked you to cast a fresh eye over the firm’s quality control procedures and suggest improvements. Explain, with examples, what elements of a quality control system you would expect to find. (4 marks)

3 Briefly outline why, in spite of companies instituting systems of internal control, there will always be an element of control risk. (3 marks)

4 Your audit firm has two unconnected clients whose main activity is property development. They both use experts to value their portfolios of properties. Intrahouse Ltd employs its own experts while Extrahouse Ltd outsources this service to a professional firm of valuers. Compare and contrast this situation in relation to audit risk and the implications for your audits of the companies. (4 marks)

5 Your firm’s client portfolio includes two listed companies. What action should your firm take annually in relation to your independence? (2 marks)

6 While auditing your firm’s client, Trent Ltd, a member of your team has spotted a transaction involving the sale of some property to Soar Ltd, a company in which you believe Trent Ltd’s managing director is a major shareholder. This transaction has been brought to your attention as audit senior. How should you proceed? (3 marks) (20 marks)

QUESTION 6 COMPLETES THE SHORT FORM QUESTIONS

WRITTEN TEST QUESTIONS (7 – 9) FOLLOW
Hamptons Ltd (Hamptons) is a private company that manufactures shoes. 55% of its shares are owned by its managing director, John Hampton, with the remaining shares being equally owned by two of John's brothers and his sister, all of whom are also directors.

John does not wish to reappoint the existing auditors as he does not believe that they are responsive enough to his requests for advice, and he feels that their audit fees are too high. He has approached your firm to act as auditors and also provide additional services. Your firm acts for several companies in the same shoe manufacturing industry sector as Hamptons.

As well as company and personal tax advice (for himself and fellow directors) he is particularly interested in your firm assisting the company with its plans to expand. This may involve producing reports on the suitability of other businesses to take over, and providing general business advice.

Requirements

(a) State the matters you would consider and the procedures you would perform in order to decide whether Hamptons would be a suitable audit client for your firm. (12 marks)

(b) Explain the ethical threats that could arise in respect of the non-audit services requested by Mr Hampton and describe the safeguards that might mitigate such threats. (8 marks)
Your firm has recently been appointed external auditor of Goodnight Ltd (Goodnight) for the year ending 31 March 20X2. The previous auditor did not seek reappointment.

All of the shares in Goodnight are owned by the Derby brothers, John and Henry. They are the only directors and spend on average three days a week managing Goodnight as they have other business interests. The company employs a full-time qualified accountant and a finance director. The accountant is currently on sick leave and the directors have requested that a member of your firm’s staff assist with the preparation of the financial statements for the year ending 31 March 20X2.

Goodnight’s principal activity is the manufacture and sale of high quality beds and sofa beds which are sold to the public, hotels and guest houses. Items are produced by hand in the company’s workshop which is located in central England. Customers place their orders by telephone or over the internet and pay by credit or debit card. All sales are transacted in UK sterling.

The company’s terms of trade require a 50% deposit with the order. Once the order is completed, the balance must be paid five days prior to delivery. Typical production time is three to four weeks. Customers are required to check the items on delivery and have seven working days to return the items if not completely satisfied. All items are sold with a one-year guarantee. At peak times the company uses subcontractors to assist with the manufacture of the beds. These subcontractors are required to invoice Goodnight at the end of each month.

The company does not supply goods from inventory as all items are made to customer order. Finished goods in the workshop relate to items awaiting despatch to customers. The company does not have continuous records for raw materials inventory and undertakes a full count of raw materials at each month end including at the year end. The quantities are recorded on inventory sheets and are subsequently costed by the company accountant. John Derby estimates the value of work in progress and finished goods awaiting despatch.

Raw materials are sourced from a number of suppliers based in the UK and overseas. All of the timber used in the frames for the beds is purchased from Ramos Ltd which is owned by John and Henry’s mother, Sharon Derby.

There has been steady growth in sales in recent years and, in February 20X2, Goodnight acquired the premises adjacent to its existing workshop to allow expansion of its manufacturing capacity. The new premises are not yet in use as they are currently undergoing extensive refurbishment in order to make them fit for purpose.

The acquisition was funded by a bank loan repayable in quarterly instalments over ten years. The existing workshop, which is owned by the company and included in the financial statements at cost less accumulated depreciation, was revalued by an external valuer in January 20X2. The directors wish to incorporate the revalued amount in the financial statements for the year ending 31 March 2011.

Requirements

(a) In respect of the assistance with the preparation of the financial statements explain the threats to objectivity which may arise from the provision of this service and state how your firm might respond to these threats.  

(b) Identify, from the information provided in the scenario, the principal areas of audit risk in respect of the financial statements of Goodnight for the year ending 31 March 20X2. For each risk:

(i) list the factors which have led you to identify that risk; and

(ii) outline the procedures that should be included in the audit plan in order to address the risk.

You should present your answer in a two-columnar format using the headings (i) audit risk and factors; and (ii) procedures to address the risk.
There are several key communications with clients, both at the beginning of an audit (for example, the engagement letter) and at the end (for example, the report to management). Empire Ltd is a new client of your firm that owns and operates a chain of hotels. The directors believe that your engagement letter is a means of absolving yourselves from any responsibility for the audit but have reluctantly signed it.

At the start of the audit the finance director provided the following information about the company’s systems:

- The systems are maintained on a network of computers with the main accounting functions centralised at head office.
- The business critical files are held on servers at one location.
- Consumables (food, cleaning supplies), bathroom and guestroom consumables (tea, coffee, soap etc) and linen (sheets, towels etc) are purchased from approved suppliers even though the goods are ordered at hotel level.
- Payroll data is entered locally although the payroll itself is run centrally.
- Capital items are purchased centrally on the provision of a requisition (with justifications) from individual hotels. Items over £10,000 require three quotes to be obtained.
- The company has a number of major corporate customers who have centrally negotiated discounts that should be applied at local level.
- Access to computer systems at local level is password protected.

During the audit the following issues were identified:

- The location where the business critical servers are held was not secure. Also, backup copies of data were held at the same location.
- At some hotels consumables were being ordered from local, non-approved suppliers. While large amounts were not involved, these are being disguised as ‘sundries’.
- At some locations there was no evidence of approval of starters, leavers, overtime and pay rates.
- On several occasions capital requisitions were found with inappropriate and insufficient justification.
- Four purchases of capital items of over £10,000 were found not to have received three quotes.
- It appeared that, at local level, company policy regarding discounts given to corporate customers was being ignored, with greater than the centrally specified discounts being given.
- You established that changing passwords was at the discretion of staff members.

Requirements

(a) State the purpose of an audit engagement letter and list eight items that you would expect to be included in its contents. (You are not required to draft the letter.) (5 marks)

(b) Set out in a manner suitable for inclusion in a report to management the consequences of the issues identified during the audit of Empire. For each consequence, describe the recommendations that would mitigate the consequences. You are not required to draft a covering letter. (20 marks)

(25 marks)