Section A – BOTH questions are compulsory and MUST be attempted

1 You are an audit manager in Hound & Co, responsible for the audit of Parker Co, a new audit client of your firm. You are planning the audit of Parker Co's financial statements for the year ending 30 June 2013, and you have just attended a meeting with Ruth Collie, the finance director of Parker Co, where she gave you the projected results for the year. Parker Co designs and manufactures health and beauty products including cosmetics.

You have just received an email from Harry Shepherd, the audit engagement partner:

To: Audit manager

From: Harry Shepherd, Partner

Subject: Parker Co

Hello

I understand you met with Ruth Collie at Parker Co recently and that you are planning the forthcoming audit. To bring me up to date on this new client, I would like you to use the information obtained in your meeting to prepare briefing notes for my use in which you:

(a) Perform preliminary analytical procedures and evaluate the audit risks to be considered in planning the audit of the financial statements, and identify and explain any additional information that would be relevant to your evaluation; and (24 marks)

(b) Discuss any ethical issues raised and recommend the relevant actions to be taken by our firm. (7 marks)

Thank you.

Parker Co – Statement of profit or loss and other comprehensive income

	Notes	30 June 2013 Projected $'000	30 June 2012 Actual $'000
Revenue		7,800	8,500
Cost of sales	1	(5,680)	(5,800)
Gross profit		2,120	2,700
Operating expenses		(1,230)	(1,378)
Operating profit		890	1,322
Finance costs		(155)	(125)
Profit before tax		735	1,197
Taxation		(70)	(300)
Profit for the year		665	897

Note 1: Cost of sales includes $250,000 relating to a provision for a potential fine payable. The advertising regulatory authority has issued a notice of a $450,000 fine payable by Parker Co due to alleged inappropriate claims made in an advertising campaign. The fine is being disputed and the matter should be resolved in August 2013.

Parker Co – Statement of financial position

	Notes	30 June 2013 Projected $'000	30 June 2012 Actual $'000
Non-current assets			
Property, plant and equipment		21,500	19,400
Intangible asset – development costs	2	2,250	–
		23,750	19,400
Current assets			
Inventory		2,600	2,165
Trade receivables		900	800
Cash		–	1,000
		3,500	3,965
Total assets		27,250	23,365
Equity			
Share capital		8,000	8,000
Revaluation reserve	3	2,500	2,000
Retained earnings		1,275	1,455
		11,775	11,455
Non-current liabilities			
2% preference shares		3,125	3,125
Bank loan		3,800	2,600
Obligations under finance leases		4,900	4,000
		11,825	9,725
Current liabilities			
Trade payables		1,340	1,000
Taxation		50	300
Obligations under finance leases		860	685
Provisions		500	200
Overdraft		900	–
		3,650	2,185
Total equity and liabilities		27,250	23,365

Note 2: The development costs relate to a new range of organic cosmetics.

Note 3: All of the company's properties were revalued on 1 January 2013 by an independent, professionally qualified expert.

Notes from your meeting with Ruth Collie

Business review

Parker Co is facing difficult trading conditions. Consumer spending is depressed due to recession in the economy. The health and beauty market remains very competitive and a major competitor launched a very successful new cosmetics range during the year, which led to a significant decline in sales of one of Parker Co's most successful brands. It has been necessary to cut prices on some of the company's product ranges in an attempt to maintain market share. However, a new brand using organic ingredients is being developed and is due to launch in September 2013.

Financial matters

Cash flow has been a problem this year, largely due to the cash spent on developing the new product range. Cash was also needed to pay dividends to both equity and preference shareholders. To help to reduce cash outflows, some new assets were acquired under finance leases and an extension to the company's bank loan was negotiated in December 2012.

Human resources

In December 2012 Parker Co's internal audit team performed a review of the operation of controls over the processing of overtime payments in the human resources department. The review found that the company's specified internal controls procedures in relation to the processing of overtime payments and associated tax payments were not always being followed. Until December 2012 this processing was split between the human resources and finance departments. Since then, the processing has been entirely carried out by the finance department.

Expansion plans

Management is planning to expand Parker Co's operations into a new market relating to beauty salons. This is a growing market, and there is synergy because Parker Co's products can be sold and used in the salons. Expansion would be through the acquisition of an existing company which operates beauty salons. A potential target, Beauty Boost Co, has been identified and preliminary discussions have taken place between the management of the two companies. Parker Co's managing director has asked for our firm's advice about the potential acquisition, and specifically regarding the financing of the transaction. Beauty Boost Co is an audit client of our firm, so we have considerable knowledge of its business.

Required:

Respond to the email from the audit partner. (31 marks)

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

Professional marks will be awarded for the presentation, logical flow and clarity of explanation of the briefing notes. (4 marks)

(35 marks)

2 (a) Kennel & Co, a firm of Chartered Certified Accountants, is the external audit provider for the Retriever Group (the Group), a manufacturer of mobile phones and laptop computers. The Group obtained a stock exchange listing in July 2012. The audit of the consolidated financial statements for the year ended 28 February 2013 is nearing completion.

You are a manager in the audit department of Kennel & Co, responsible for conducting engagement quality control reviews on listed audit clients. You have discussed the Group audit with some of the junior members of the audit team, one of whom made the following comments about how it was planned and carried out:

'The audit has been quite time-pressured. The audit manager told the juniors not to perform some of the planned audit procedures on items such as directors' emoluments and share capital as they are considered to be low risk. He also instructed us not to use the firm's statistical sampling methods in selecting trade receivables balances for testing, as it would be quicker to pick the sample based on our own judgement.

'Two of the juniors were given the tasks of auditing trade payables and going concern. The audit manager asked us to review each other's work as it would be good training for us, and he didn't have time to review everything.

'I was discussing the Group's tax position with the financial controller, when she said that she was struggling to calculate the deferred tax asset that should be recognised. The deferred tax asset has arisen because several of the Group's subsidiaries have been loss making this year, creating unutilised tax losses. As I had just studied deferred tax at college I did the calculation of the Group's deferred tax position for her. The audit manager said this saved time as we now would not have to audit the deferred tax figure.

'The financial controller also asked for my advice as to how the tax losses could be utilised by the Group in the future. I provided her with some tax planning recommendations, for which she was very grateful.'

Required:

In relation to the audit of the Retriever Group, evaluate the quality control, ethical and other professional matters arising in respect of the planning and performance of the Group audit. (13 marks)

(b) The audit committee of the Group has contacted Kennel & Co to discuss an incident that took place on 1 June 2013. On that date, there was a burglary at the Group's warehouse where inventory is stored prior to despatch to customers. CCTV filmed the thieves loading a lorry belonging to the Group with boxes containing finished goods. The last inventory count took place on 30 April 2013.

The Group has insurance cover in place and Kennel & Co's forensic accounting department has been asked to provide a forensic accounting service to determine the amount to be claimed in respect of the burglary. The insurance covers the cost of assets lost as a result of thefts.

It is thought that the amount of the claim will be immaterial to the Group's financial statements, and there is no ethical threat in Kennel & Co's forensic accounting department providing the forensic accounting service.

Required:

In respect of the theft and the associated insurance claim:

(i) Identify and explain the matters to be considered, and the steps to be taken in planning the forensic accounting service; and

(ii) Recommend the procedures to be performed in determining the amount of the claim.

Note: The total marks will be split equally between each part. (12 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 You are the manager responsible for the audit of Setter Stores Co, a company which operates supermarkets across the country. The final audit for the year ended 31 January 2013 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of $300 million, revenue of $620 million and profit before tax of $47·5 million.

Three issues from the audit working papers are summarised below:

(a) Assets held for sale

Setter Stores Co owns a number of properties which have been classified as assets held for sale in the statement of financial position. The notes to the financial statements state that the properties are all due to be sold within one year. On classification as held for sale, in October 2012, the properties were re-measured from carrying value of $26 million to fair value less cost to sell of $24 million, which is the amount recognised in the statement of financial position at the year end. (8 marks)

(b) Sale and leaseback arrangement

A sale and leaseback arrangement involving a large property complex was entered into on 31 January 2013. The property complex is a large warehousing facility, which was sold for $37 million, its fair value at the date of the disposal. The facility had a carrying value at that date of $27 million. The only accounting entry recognised in respect of the proceeds raised was to record the cash received and recognise a non-current liability classified as 'Obligations under finance lease'. The lease term is for 20 years, the same as the remaining useful life of the property complex, and Setter Stores Co retains the risks and rewards associated with the asset. (7 marks)

(c) Distribution licence

The statement of financial position includes an intangible asset of $15 million, which is the cost of a distribution licence acquired on 1 September 2012. The licence gives Setter Stores Co the exclusive right to distribute a popular branded soft drink in its stores for a period of five years. (5 marks)

Required:

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of each of the issues described above.

Note: The split of the mark allocation is shown against each of the issues above.

(20 marks)

4 You are a manager in Groom & Co, a firm of Chartered Certified Accountants. You have just attended a monthly meeting of audit partners and managers at which client-related matters were discussed. Information in relation to two clients, which were discussed at the meeting, is given below:

(a) Spaniel Co

The audit report on the financial statements of Spaniel Co, a long-standing audit client, for the year ended 31 December 2012 was issued in April 2013, and was unmodified. In May 2013, Spaniel Co's audit committee contacted the audit engagement partner to discuss a fraud that had been discovered. The company's internal auditors estimate that $4·5 million has been stolen in a payroll fraud, which has been operating since May 2012.

The audit engagement partner commented that neither tests of controls nor substantive audit procedures were conducted on payroll in the audit of the latest financial statements as in previous years' audits there were no deficiencies found in controls over payroll. The total assets recognised in Spaniel Co's financial statements at 31 December 2012 were $80 million. Spaniel Co is considering suing Groom & Co for the total amount of cash stolen from the company, claiming that the audit firm was negligent in conducting the audit.

Required:

Explain the matters that should be considered in determining whether Groom & Co is liable to Spaniel Co in respect of the fraud. (12 marks)

(b) Bulldog Co

Bulldog Co is a clothing manufacturer, which has recently expanded its operations overseas. To manage exposure to cash flows denominated in foreign currencies, the company has set up a treasury management function, which is responsible for entering into hedge transactions such as forward exchange contracts. These transactions are likely to be material to the financial statements. The audit partner is about to commence planning the audit for the year ending 31 July 2013.

Required:

Discuss why the audit of financial instruments is particularly challenging, and explain the matters to be considered in planning the audit of Bulldog Co's forward exchange contracts. (8 marks)

(20 marks)

5 You are the manager responsible for the audit of the Poodle Group (the Group) and you are completing the audit of the consolidated financial statements for the year ended 31 March 2013. The draft consolidated financial statements recognise revenue of $18 million (2012 – $17 million), profit before tax of $2 million (2012 – $3 million) and total assets of $58 million (2012 – $59 million). Your firm audits all of the components of the Group, apart from an overseas subsidiary, Toy Co, which is audited by a small local firm of accountants and auditors.

The audit senior has left a file note for your attention. You are aware that the Group's annual report and financial statements are due to be released next week, and the Group is very reluctant to make any adjustments in respect of the matters described.

(a) Toy Co

The component auditors of Toy Co, the overseas subsidiary, have been instructed to provide the Group audit team with details of a court case which is ongoing. An ex-employee is suing Toy Co for unfair dismissal and has claimed $500,000 damages against the company. To comply with local legislation, Toy Co's individual financial statements are prepared using a local financial reporting framework. Under that local financial reporting framework, a provision is only recognised if a cash outflow is virtually certain to arise. The component auditors obtained verbal confirmation from Toy Co's legal advisors that the damages are probable, but not virtually certain to be paid, and no provision has been recognised in either the individual or consolidated financial statements. No other audit evidence has been obtained by the component auditors. (7 marks)

(b) Trade receivable

On 1 June 2013, a notice was received from administrators dealing with the winding up of Terrier Co, following its insolvency. The notice stated that the company should be in a position to pay approximately 10% of the amounts owed to its trade payables. Poodle Co, the parent company of the Group, includes a balance of $1·6 million owed by Terrier Co in its trade receivables. (7 marks)

(c) Chairman's statement

The draft chairman's statement, to be included in the Group's annual report, was received yesterday. The chairman comments on the performance of the Group, stating that he is pleased that revenue has increased by 20% in the year. (6 marks)

Required:

In respect of each of the matters described:

(i) Assess the implications for the completion of the Group audit, explaining any adjustments that may be necessary to the consolidated financial statements, and recommending any further procedures necessary; and

(ii) Describe the impact on the Group audit report if these adjustments are not made.

Note: The split of the mark allocation is shown above against each of the parts.

(20 marks)

End of Question Paper