

Section A – BOTH questions are compulsory and MUST be attempted

- 1 You are a manager in Holly & Co, a firm of Chartered Certified Accountants, and you are responsible for the audit of the Laurel Group (the Group), with a financial year ending 31 May 2017. The Group produces cosmetics and beauty products sold under various brand names which are globally recognised and which are sold in more than 100 countries.

You have received the following email from the Group audit engagement partner:

To: Audit manager
From: Brigitte Sanders, Audit Engagement Partner
Subject: Audit planning – the Laurel Group

Hello

It is time for you to begin planning the audit of the Laurel Group. I have provided you with some information – a summary of relevant points from the permanent audit file, notes from a meeting with the Group finance director and some extracts from the latest forecast financial statements with comparative figures. Using this information you are required to:

(a) Evaluate the risks of material misstatement to be considered in planning the Group audit. Your evaluation should utilise analytical procedures as a method for identifying relevant risks. (16 marks)

(b) Recommend any additional information which should be requested from the Group which would allow a more detailed preliminary analytical review to be performed. (5 marks)

(c) Recommend the principal audit procedures to be performed on:

(i) The impairment of the Chico brand; and (5 marks)

(ii) The planned acquisition of Azalea Co. (5 marks)

Please present your findings in briefing notes for my use in discussion with the rest of the audit team.

Thank you.

Points from the permanent audit file

Holly & Co was appointed as Group auditor three years ago, and the firm audits all components of the Group, which is a listed entity.

The Group sells its products under well-known brand names, most of which have been acquired with subsidiary companies. The Group is highly acquisitive, and there are more than 40 subsidiaries and 15 associates within the Group.

Products include cosmetics, hair care products and perfumes for men and women. Research into new products is a significant activity, and the Group aims to bring new products to market on a regular basis.

Extract from projected and actual financial statements and associated notes from meeting with Group finance director

Consolidated statement of financial position

	Note	Projected 31 May 2017 \$m	Actual 31 May 2016 \$m
Assets			
Non-current assets			
Property, plant and equipment	1	92	78
Intangible assets – goodwill		18	18
Intangible assets – acquired brand names	2	80	115
Intangible assets – development costs		25	10
Total non-current assets		<u>215</u>	<u>221</u>
Current assets		143	107
Total assets		<u>358</u>	<u>328</u>
Equity and liabilities			
Equity			
Equity share capital		100	100
Retained earnings		106	98
Non-controlling interest		23	23
Total equity		<u>229</u>	<u>221</u>
Non-current liabilities			
Debenture loans	3	100	80
Deferred tax	4	10	2
Total non-current liabilities		<u>110</u>	<u>82</u>
Current liabilities		19	25
Total liabilities		<u>129</u>	<u>107</u>
Total equity and liabilities		<u>358</u>	<u>328</u>

Consolidated statement of profit or loss for the year to 31 May

	Projected 2017 \$m	Actual 2016 \$m
Revenue	220	195
Operating expenses	(185)	(158)
Operating profit	35	37
Finance costs	(7)	(7)
Profit before tax	28	30
Tax expense	(3)	(3)
Profit for the year	<u>25</u>	<u>27</u>

Notes:

- Capital expenditure of \$20 million has been recorded so far during the year. The Group's accounting policy is to recognise assets at cost less depreciation. During the year, a review of assets' estimated useful lives concluded that many were too short, and as a result, the projected depreciation charge for the year is \$5 million less than the comparative figure.

2. Acquired brand names are held at cost and not amortised on the grounds that the assets have an indefinite life. Annual impairment reviews are conducted on all brand names. In December 2016, the Chico brand name was determined to be impaired by \$30 million due to allegations made in the press and by customers that some ingredients used in the Chico perfume range can cause skin irritations and more serious health problems. The Chico products have been withdrawn from sale.
3. A \$20 million loan was taken out in January 2017, the cash being used to finance a specific new product development project.
4. The deferred tax liability relates to timing differences in respect of accelerated tax depreciation (capital allowances) on the Group's property, plant and equipment. The liability has increased following changes to the estimated useful lives of assets discussed in note 1.

Planned acquisition of Azalea Co

Group management is currently negotiating the acquisition of Azalea Co, a large company which develops and sells a range of fine fragrances. It is planned that the acquisition will take place in early June 2017, and the Group is hopeful that Azalea Co's products will replace the revenue stream lost from the withdrawal of its Chico perfume range. Due diligence is taking place currently, and Group management is hopeful that this will support the consideration of \$130 million offered for 100% of Azalea Co's share capital. The Group's bank has agreed to provide a loan for this amount.

Required:

Respond to the instructions in the partner's email.

(31 marks)

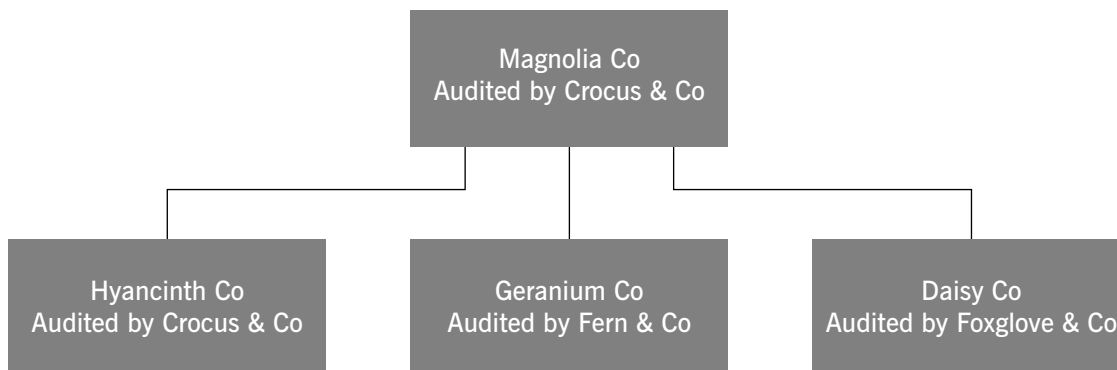
Note: The split of the mark allocation is shown within the email.

Professional marks will be awarded for presentation, logical flow, and clarity of explanations provided. (4 marks)

(35 marks)

- 2 You are responsible for performing Engagement Quality Control Reviews on selected audit clients of Crocus & Co, and you are currently performing a review on the audit of the Magnolia Group (the Group). The Group manufactures chemicals which are used in a range of industries, with one of the subsidiaries, Daisy Co, specialising in chemical engineering and developing products to be sold by the other Group companies. The Group's products sell in over 50 countries.

A group structure is shown below, each of the subsidiaries is wholly owned by Magnolia Co, the parent company of the Group:



Crocus & Co is engaged to provide the audit of the Group financial statements and also the audit of Hyacinth Co and Magnolia Co. Geranium Co, a new subsidiary, is audited by a local firm of auditors based near the company's head office. Daisy Co is audited by an unconnected audit firm which specialises in the audit of companies involved with chemical engineering.

The Group's financial year ended on 31 December 2016 and the audit is in the completion stage, with the auditor's report due to be issued in three weeks' time. The Group's draft consolidated financial statements recognise profit before tax of \$7.5 million and total assets of \$130 million.

The notes from your review of the audit working papers are shown below, summarising the issues relevant to each subsidiary.

(a) Hyacinth Co – internal controls and results of controls testing

The Group companies supply each other with various chemical products to be used in the manufacture of chemicals. Audit work performed at the interim stage at Hyacinth Co, including walk through procedures and internal control evaluations, concluded that internal controls over intra-group transactions were not effective, and this was documented in the audit file. At the final audit, tests of controls were performed to confirm this to be the case. The tests of controls confirmed that intra-group transactions are not being separately identified in the Group's accounting system and reconciliations of amounts owed between the subsidiaries are not performed.

The group audit manager has concluded on the audit working papers that 'as intra-group balances are cancelled on consolidation, this issue has no impact on the Group audit and no further work is necessary'.

As part of the audit approach it was determined that extensive testing would be performed over the internal controls for capital expenditure at Hyacinth Co as it was identified during planning that the company had made significant acquisitions of plant and equipment during the year. Following controls testing the internal controls over capital expenditure were evaluated to be effective in Hyacinth Co.

The working papers conclude that 'based on the results of controls testing at Hyacinth Co, it is reasonable to assume that controls are effective across the Group' and substantive procedures on property, plant and equipment in each Group company have been planned and performed in response to this assessment. (9 marks)

(b) Geranium Co – new subsidiary

This subsidiary was acquired on 30 September 2016 and is audited by Fern & Co. The Group audit strategy contains the following statement in relation to the audit of Geranium Co: 'Geranium Co will only be consolidated for three months and the post-acquisition profit for that period to be included in the Group financial statements is \$150,000. On that basis, Geranium Co is immaterial to the Group financial statements and therefore our audit procedures are based on analytical procedures only.'

Other than the analytical procedures performed, there is no documentation in respect of Geranium Co or its audit firm Fern & Co included in the Group audit working papers.

The draft statement of financial position of Geranium Co recognises total assets of \$30 million. (7 marks)

(c) Daisy Co – restriction on international trade

As well as being involved in chemical engineering and supplying chemicals for use by the other Group companies, Daisy Co specialises in producing chemicals which are used in the agricultural sector, and around half of its sales are made internationally.

Daisy Co is audited by Foxglove & Co, and the Group audit working papers contain the necessary evaluations to conclude that an appropriate level of understanding has been obtained in respect of the audit firm.

Foxglove & Co has provided your firm with a summary of key audit findings which includes the following statement: 'During the year new government environmental regulations have imposed restrictions on international trade in chemicals, with sales to many countries now prohibited. Our audit work concludes that this does not create a significant going concern risk to Daisy Co, and we have confirmed that all inventories are measured at the lower of cost and net realisable value.'

The Group audit manager has concluded that 'I am happy that no further work is needed in this area – we can rely on the unmodified audit opinion to be issued by Foxglove & Co. This issue was not identified until it was raised by Foxglove & Co, it has not been mentioned to me by the Group board members, and it has no implications for the consolidated financial statements.'

The draft statement of financial position of Daisy Co recognises total assets of \$8 million and the statement of profit or loss recognises profit before tax of \$50,000.

The draft consolidated financial statements recognises goodwill in respect of Daisy Co of \$3 million (2015 – \$3 million). (9 marks)

Required:

In respect of each of the matters described above:

- (i) Comment on the quality of the planning and performance of the Group audit discussing the quality control and other professional issues raised; and**
- (ii) Recommend any further actions, including relevant audit procedures, to be taken by your firm, prior to finalising the Group auditor's report.**

Note: the split of the mark allocation is shown next to each of the issues above.

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3** You are a manager working in the public sector audit department of Fern & Co. You are responsible for the audit of Moosewood Hospital, for the year ended 31 March 2017. You have recently visited the audit team, who are currently on site performing the fieldwork, to review the work performed to date and to discuss their progress. During your visit the audit senior informed you of the following matter:

During a review of the valuation of medical inventories, including medicines used in a variety of treatments at the hospital, it was noted that a number of items had passed their recommended use by dates. These were recorded on an inventory spreadsheet maintained by the financial controller and were easy to spot because they were highlighted in red. One of the audit team inspected a sample of the inventories in question and confirmed that their use by dates had expired. When asked about this, the financial controller stated that the audit team must be mistaken. The audit team requested to look at the spreadsheet again but he refused. The next day the finance director confronted the audit team accusing them of extending their investigations 'beyond their remit'. He also threatened to remove them from the premises if they continued to ask questions which were not relevant to the audit of the hospital's financial statements. Since then the audit team have been unable to complete their audit of medical inventories. They have also noted that the room where the inventories were previously kept has been emptied.

Required:

- (a) Identify and explain the ethical and professional issues raised and recommend any actions which should be taken in respect of the matter described by the audit senior.** (10 marks)

In addition to the audit of the financial statements your firm is also required to conduct an audit of the performance information of Moosewood Hospital. You are required to provide assurance with regard to both the accuracy and completeness of three key performance measures which are used to monitor the hospital's efficiency and effectiveness. The performance measures, all of which the Hospital claims to have met, are:

1. To maintain an average patient to nurse ratio of no more than 6:1.
2. To achieve a minimum 75% annual usage of surgical rooms.
3. To ensure that the rate of admissions within 28 days for previously treated conditions does not exceed 3%.

Required:

- (b) Explain the difference between a 'performance audit' and an 'audit of performance information.'** (3 marks)
- (c) Recommend the examination procedures which should be used in auditing the performance information of Moosewood Hospital.** (7 marks)

(20 marks)

4 You are the manager responsible for the audit of Osier Co, a jewellery manufacturer and retailer. The final audit for the year ended 31 March 2017 is nearing completion and you are reviewing the audit working papers. The draft financial statements recognise total assets of \$1,919 million (2016 – \$1,889 million), revenue of \$1,052 million (2016 – \$997 million) and profit before tax of \$107 million (2016 – \$110 million). Three issues from the audit working papers are summarised below:

(a) Cost of inventory

Inventory costs include all purchase costs and the costs of conversion of raw materials into finished goods. Conversion costs include direct labour costs and an allocation of production overheads. Direct labour costs are calculated based on the average production time per unit of inventory, which is estimated by the production manager, multiplied by the estimated labour cost per hour, which is calculated using the forecast annual wages of production staff divided by the annual scheduled hours of production. Production overheads are all fixed and are allocated based upon the forecast annual units of production. At the year end inventory was valued at \$21 million (2016 – \$20 million). (7 marks)

(b) Impairment

At the year end management performed an impairment review on its retail outlets, which are a cash generating unit for the purpose of conducting an impairment review. While internet sales grew rapidly during the year, sales from retail outlets declined, prompting the review. At 31 March 2017 the carrying amount of the assets directly attributable to the retail outlets totalled \$137 million, this includes both tangible assets and goodwill.

During the year management received a number of offers from parties interested in purchasing the retail outlets for an average of \$125 million. They also estimated the disposal costs to be \$1.5 million, based upon their experience of corporate acquisitions and disposals. Management estimated the value in use to be \$128 million. This was based upon the historic cash flows attributable to retail outlets inflated at a general rate of 1% per annum. This, they argued, reflects the poor performance of the retail outlets.

Consequently the retail outlets were impaired by \$9 million to restate them to their estimated recoverable amount of \$128 million. The impairment was allocated against the tangible assets of the outlets on a pro rata basis, based upon the original carrying amount of each asset in the unit. (7 marks)

(c) Warranty provision

Each year management makes a provision for jewellery returned under warranty. It is based upon an estimate of returns levels for each product type (rings, bracelets, necklaces, watches, earrings, etc) and is calculated on an annual basis by the sales director. The breakdown for the current provision, as extracted from the notes to the financial statements, is as follows:

	\$million	
At 1 April 2016	11.5	
Provisions charged during the year	0.5	
Provisions utilised during the year	(1.9)	
Unutilised provisions reversed	(3.1)	
At 31 March 2017	7.0	(6 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. You are not required to discuss any potential implications for the auditor’s report.

(20 marks)

5 You are a manager at Thyme & Co, a firm of Chartered Certified Accountants. You are currently involved in the completion stage of two engagements relating to different clients. Both engagements have raised issues that require your attention.

- (a) Rocket Co is a listed client operating in the engineering industry. The company manufactures machinery for use in the aircraft, defence and marine sectors. The audit for the year ended 30 April 2017 is almost complete. The revenue and profit before tax figures recognised in the draft financial statements are \$1,437 million and \$139 million, respectively (2016 – \$1,489 million and \$175 million respectively).

Audit procedures identified two sales transactions in the final quarter of the year that related to two different customers but where the goods were delivered to the same location. Further investigations revealed that the goods were delivered to a third party, who agreed to store them until the customers were ready to receive delivery. The goods have yet to be delivered to the customers because they are both building new facilities and neither is sufficiently progressed to receive the new machinery. The contract terms explicitly state that Rocket Co is obliged to deliver the goods to the customers for final inspection and acceptance and the client has not agreed to any consequent amendments to these terms. The sales invoices were raised and the revenue recognised upon despatch of the goods to the storage facility. During discussions with the audit team, the finance director stated that the company had fulfilled its contractual obligations to provide the goods by a specified date. The revenue attributable to the two transactions totalled \$17 million.

Required:

- (i) **Comment upon the matter described above and explain the further actions necessary before the auditor's report can be signed.** (7 marks)
- (ii) **Discuss the implications for the auditor's report if no adjustments are made to the financial statements.** (5 marks)
- (b) You are reviewing the draft assurance report in relation to the examination of a forecast for Tulip Co. The forecast is included in a proposal due to be sent to Tulip Co's lenders as part of an effort to secure a new loan. Audit procedures concluded that there is no reason to believe that the forecast is unrealistic or that it has not been properly prepared. You are currently reviewing the draft assurance report, which is provided below:

Independent auditor's report on the forecast of Tulip Co

To the shareholders of Tulip Co:

We have examined the forecast information of Tulip Co contained in the loan proposal in accordance with the relevant standards on assurance engagements applicable to the examination of prospective financial information. Thyme & Co is not responsible for the forecast, including the assumptions on which it is based.

Based on our examination of the evidence supporting the assumptions, we believe that these assumptions provide a reasonable basis for the forecast. Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with IFRS.

Actual results are likely to be different from the forecast since the assumptions on which the forecast is based are unlikely to be accurate.

Signed by assurance engagement partner, Thyme & Co

Required:

Critically appraise the proposed assurance report extract of Tulip Co.

Note: You are NOT required to re-draft the assurance report.

(8 marks)

(20 marks)

End of Question Paper