

Professional Level – Options Module

# Advanced Audit and Assurance (International)

March/June 2018 – Sample Questions



**Time allowed:** 3 hours 15 minutes

This question 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 question paper until instructed by the supervisor.**

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

Think Ahead



The Association of  
Chartered Certified  
Accountants

Paper P7 (INT)

**Section A – BOTH questions are compulsory and MUST be attempted**

- 1 The Bassett Group (the Group) is a publisher of newspapers and magazines, academic journals, and books. The Group, a listed entity, has a financial year ending 30 April 2018, and your firm, Whippet & Co, was appointed as Group auditor in September 2017. Whippet & Co will audit all Group companies with the exception of Borzoi Co, a foreign subsidiary, which is audited by a local firm of auditors, Saluki Associates. The Group aims to comply fully with relevant corporate governance requirements.

You are the manager responsible for the Group audit, and the audit engagement partner has just sent the following email to you:

**To: Audit manager**

**From: Kerry Dunker, audit engagement partner**

**Subject: Bassett Group audit planning**

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**Hello**

I have provided some information to help you with planning the Bassett Group audit. I met with the Group finance director yesterday to discuss some aspects of the Group's business and related accounting issues. One of the audit team members has already performed limited analytical procedures based on the Group's projected financial statements and comparatives, and I have provided you with the results of this work. I have also provided you with an extract from the communication which we received from Grey & Co, the Group's previous auditor.

Using the information provided, I require you to prepare briefing notes to be used as part of the audit team planning meeting. Your briefing notes should:

**(a) (i)** Evaluate the audit risks to be considered in planning the audit of the Group financial statements, and (14 marks)

**(ii)** Identify and explain the matters which the audit team should approach with a high degree of professional scepticism. (9 marks)

**(b)** To assist the audit assistants' understanding of our audit strategy in respect of Borzoi Co:

**(i)** Explain the term 'significant component' and assess whether Borzoi Co is a significant component of the Group, and

**(ii)** Discuss the nature and extent of involvement which our firm should have with the audit risk assessment to be performed by Saluki Associates. (8 marks)

**Thank you**

**Background information and results of analytical procedures**

The Group operates globally, with sales being made in over 100 countries. The Group has 20 subsidiaries which have been acquired over the last 30 years. All Group companies are located in the same country, with the exception of Borzoi Co, a foreign subsidiary whose operations focus on the translation of published content into a variety of different languages.

The Group's publishing activities can be categorised into three operating segments, each of which are cash generating units for the purpose of impairment reviews: newspapers and magazines, academic journals, and books. The revenue and total assets for 2018 (projected) and 2017 (actual) for the Group in total and for each segment is as follows:

Operating segment	Year to 30 April 2018 Revenue projected \$ million	Year to 30 April 2017 Revenue actual \$ million	% Change in revenue	As at 30 April 2018 Total assets projected \$ million	As at 30 April 2017 Total assets actual \$ million	% Change in total assets
Newspapers and magazines	64	67	(4.5)	45	42	7.1
Academic journals	47	46	2.2	18	15	20
Books	42	45	(6.7)	32	28	14.3
Group total	<u>153</u>	<u>158</u>	(3.2)	<u>95</u>	<u>85</u>	11.8

During the financial year the Group has invested in software which enhances and extends the Group's range of digital publications, across all operating segments. The total investment, which is recognised as an intangible asset, was \$15 million, of which \$5 million relates to purchased software, and \$10 million relates to internally developed software. According to management, the implementation of this software has already led to significant increases in sales of digital publications, and while this accounts for only approximately 20% of Group revenue currently, management is confident that sales of digital publications will quickly grow, and within three years is expected to overtake sales of hard copy publications across all operating segments. Using this justification, management does not consider it necessary to perform impairment reviews on any of the three operating segments this year.

Information on some specific aspects of the Group's operations and the associated Group accounting policies, and information in relation to Borzoi Co, is given below:

#### **Newspapers and magazines – publication rights**

A substantial portion of the Group's newspaper and magazine publications are protected by publication rights which protect the Group's exclusive right to publish the relevant newspaper or magazine for specified periods. The Group owns more than 200 publication rights, which range in period of exclusivity from five years to 30 years. The publication rights are recognised as an intangible asset with a carrying amount of \$7.9 million. The Group's accounting policy is to amortise publication rights over an average period of 25 years.

#### **Books – royalty advances**

The Group commissions authors to write books for which the Group owns the copyright. When a book is commissioned, the author is paid a royalty advance, the amount of which depends on the expected sales of the book. The Group's accounting policy is to defer the cost of the royalty advance within current assets until the book is published, at which point the cost begins to be recognised as an expense, spread over a ten-year period. The Group finance director does not have a justification for this ten-year period other than it being 'industry practice'. The total royalty advance projected to be recognised within current assets at 30 April 2018 is \$3.4 million.

#### **Borzoi Co**

Borzoi Co is located in Farland, a country which has recently experienced political unrest, leading to significant volatility in the local currency, the Oska. At today's date, the management accounts of Borzoi Co recognise total assets of 68 million Oska, and the exchange rate is 4 Oska:1\$. In the last six months, the exchange rate has fluctuated between 10 Oska:1\$ to 3 Oska:1\$.

Farland requires the use of IFRS® Standards and therefore Borzoi Co prepares its financial statements using IFRS Standards as its applicable financial reporting framework.

To help with the company's development of language translation operations, on 1 May 2017, Bassett Co, the parent company of the Group, transferred a piece of translation software to Borzoi Co. The software had been purchased by the parent company for \$1.5 million several years ago and prior to transfer to Borzoi Co, it was held at a carrying amount of \$1 million, this being its cost less amortisation to date. Immediately prior to being transferred to Borzoi Co, the software was revalued in the parent company's financial statements to \$5.4 million, this being its estimated fair value at the time of the transfer. The estimate of fair value was determined by Group management, and this amount is still outstanding for payment by Borzoi Co.

#### **Communication from Grey & Co**

The previous Group auditor, Grey & Co, states the following in their communication to Whippet & Co:

'We have acted as Group auditor for the last four years and our audit opinion has been unmodified each year. However, we would like to bring to your attention a matter relating to the Group's corporate governance arrangements. We found that on several occasions in the last year the Group CFO initially blocked our firm's access to the Group audit committee, making it difficult for us to discuss matters relating to the audit with the committee.'

#### **Required:**

**Respond to the instructions in the audit engagement partner's email.** (31 marks)

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

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

**(35 marks)**

- 2 (a) You are an audit manager in Pointer & Co, a firm of Chartered Certified Accountants which offers a range of assurance services. You are responsible for the audit of Vizsla Co, a company which provides approximately 10% of your firm's practice income each year. The finance director of Vizsla Co has recently contacted you to provide information about another company, Setter Co, which is looking to appoint a provider of assurance services. An extract from the email which the finance director of Vizsla Co has sent to you is shown below:

*'One of my friends, Gordon Potts, is the managing director of Setter Co, a small company which is looking to expand in the next few years. I know that Gordon has approached the company's bank for finance of \$6 million to fund the expansion. To support this loan application, Gordon needs to appoint a firm to provide a limited assurance review on the company's financial statements. He would also want the appointed firm to provide tax planning advice and to prepare both the company's and his personal tax computations for submission to the tax authorities. I have asked Gordon to contact you, and I hope that Pointer & Co will be able to provide these services to Setter Co for a low fee. If the fee you suggest is too high, and unacceptable to Gordon, then I will recommend that Gordon approaches Griffon & Co instead, and I would also consider appointing Griffon & Co to provide the audit of Vizsla Co.'*

Griffon & Co is a firm of Chartered Certified Accountants which has an office in the same town as Pointer & Co.

You have done some research on both Setter Co and Gordon Potts and have confirmed that the company is small enough to be exempt from audit. The company is owner-managed, with the Potts family owning 90% of the share capital. Gordon Potts is a director and majority shareholder of three other companies. An article in a newspaper from several years ago about Gordon Potts indicated that one of his companies was once fined for breach of employment law and that he had used money from one of the company's pension plans to set up a business abroad, appointing his son as the managing director of that business.

**Required:**

**In relation to Pointer & Co's potential acceptance of Setter Co as a client of the firm:**

- (i) Explain the ethical issues and other matters which should be considered; and  
 (ii) Explain the importance of obtaining customer due diligence and recommend the information which should be obtained. (16 marks)

- (b) Pointer & Co has agreed to perform an assurance engagement for Vizsla Co; the engagement will be a review of prospective financial information which is needed to support the company's overdraft facilities. Vizsla Co had a financial year ended 30 September 2017, and an unmodified opinion was issued on these financial statements last month. Pointer & Co's partner responsible for ethics has agreed that any threats to objectivity will be reduced to an acceptable level through the use of a team separate from the audit team to perform the work.

The operating profit forecast for the two years to 31 March 2020 prepared by a member of the accounting team of Vizsla Co is shown below, along with some accompanying notes.

	Note	Six months to 30 September 2018 \$'000	Six months to 31 March 2019 \$'000	Six months to 30 September 2019 \$'000	Six months to 31 March 2020 \$'000
Revenue	1	12,800	16,900	13,700	18,900
Gross profit %		34%	45%	36%	46%
Operating costs:					
Staff costs		(2,800)	(2,900)	(2,800)	(2,900)
Design costs	2	(1,200)	(1,200)	(1,250)	(1,250)
Marketing		(900)	(1,000)	(1,100)	(1,100)
Interest on overdraft	3	(25)	(10)	–	–
Other expenses	4	(3,840)	(5,070)	(4,110)	(5,670)
Operating profit		<u>4,035</u>	<u>6,720</u>	<u>4,440</u>	<u>7,980</u>

**Notes:**

- Vizsla Co is a producer of greetings cards and giftware, the demand for which is seasonal in nature.
- Design costs are mostly payroll costs of the staff working in the company's design team, and the costs relate to the design and development of new product ranges.

3. Vizsla Co has agreed with its bank to clear its overdraft by 1 September 2019, and the management team is confident that after that point the company will not need an overdraft facility.
4. The total 'Other expenses' is calculated based on 30% of the projected revenue for the six-month period.

**Required:**

**Recommend the examination procedures which should be used in the review of the profit forecast.**

(9 marks)

**(25 marks)**

**Section B – TWO questions ONLY to be attempted**

- 3** The audit of Davis Co's financial statements for the year ended 30 November 2017 is nearing completion and the auditor's report is due to be signed next week. Davis Co manufactures parts and components for the aviation industry. You are conducting an engagement quality control review on the audit of Davis Co which is a listed entity and a significant new client of your firm. The draft financial statements recognise revenue of \$8.7 million, assets of \$15.2 million and profit before tax of \$1.8 million.

You have identified the following issues as a result of your review:

- (i) The planned audit approach to trade payables was to place reliance on purchasing controls and keep substantive tests to a minimum. During controls testing on trade payables, from a random statistical sample, the audit team identified three purchase orders which had not been authorised by the procurement manager. On review of the supporting documentation, the audit team concluded that the items were legitimate business purchases and therefore concluded that no additional procedures were required. (4 marks)
- (ii) Following a review of petty cash transactions, the audit assistant identified that the petty cashier paid for taxi fares for personal, non-business journeys with a total value of \$175. Following discussions with the audit assistant, you have ascertained that he did not report the matter further as the amount is immaterial. The audit assistant also commented that the petty cashier is his brother and that he did not want to get him into trouble. (6 marks)
- (iii) Cut-off testing on revenue has identified two goods despatch notes, dated 2 December 2017, for items sent to Chinn Co, with a combined sales value of \$17,880 which had been included in revenue for the year ended 30 November 2017. The client's financial controller, David Mount, has explained that Chinn Co does not order on a regular basis from Davis Co. In the absence of a regular payment history with Chinn Co therefore, and in order to minimise the receivables collection period from this particular customer, the sales invoice is raised and sent to the customer on the same day that the sales order is received. The average time period between the receipt of an order and despatching the goods to the customer is approximately one to two weeks. The audit working papers have concluded that no further investigation is necessary. (6 marks)
- (iv) The finance director, Leslie Gray, has not completed the tax computation for the year ended 30 November 2017. He has recently asked the audit assistant to calculate the company's tax payable for the year on the basis that as a recently qualified chartered certified accountant, the audit assistant was more up to date with recent changes in tax legislation. (4 marks)

**Required:**

**Evaluate the quality control issues and the implications for the completion of the audit including any further actions which should be taken by your audit firm. Your answer should include the matters to be communicated to management and to those charged with governance in relation to the audit of Davis Co.**

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

**(20 marks)**

4 You are an audit manager in Brearley & Co, responsible for the audit of the Hughes Group (the Group). You are reviewing the audit working papers for the consolidated financial statements relating to the year ended 31 March 2018. The Group specialises in the wholesale supply of steel plate and sheet metals. The draft consolidated financial statements recognise revenue of \$7,670 million (2017 – \$7,235 million), profit before taxation of \$55 million (2017 – \$80 million) and total assets of \$1,560 million (2017 – \$1,275 million). Brearley & Co audits all of the individual company financial statements as well as the Group consolidated financial statements. The audit senior has brought the following matters, regarding a number of the Group’s companies, to your attention:

**(a) Dilley Co**

The Group purchased 40% of the share capital and voting rights in Dilley Co on 1 May 2017. Dilley Co is listed on an alternative stock exchange. The Group has also acquired options to purchase the remaining 60% of the issued shares at a 10% discount on the market value of the shares at the time of exercise. The options are exercisable for 18 months from 1 May 2018. Dilley Co’s draft financial statements for the year ended 31 March 2018 recognise revenue of \$90 million and a loss before tax of \$12 million. The Group’s finance director has equity accounted for Dilley Co as an associate in this year’s group accounts and has included a loss before tax of \$4.4 million in the consolidated statement of profit or loss. (7 marks)

**(b) Willis Co**

Willis Co is a foreign subsidiary whose functional and presentational currency is the same as Hughes Co and the remainder of the Group. The subsidiary specialises in the production of stainless steel and holds a significant portfolio of forward commodity options to hedge against fluctuations in raw material prices. The local jurisdiction does not mandate the use of IFRS Standards and the audit senior has noted that Willis Co follows local GAAP, whereby derivatives are disclosed in the notes to the financial statements but are not recognised as assets or liabilities in the statement of financial position. The disclosure note includes details of the maturity and exercise terms of the options and a directors’ valuation stating that they have a total fair value of \$6.1 million as at 31 March 2018. The disclosure note states that all of the derivative contracts were entered into in the last three months of the reporting period and that they required no initial net investment. (6 marks)

**(c) Knott Co**

Knott Co is a long-standing subsidiary in which the Group parent has a direct holding of 80% of the equity and voting rights. Audit work on revenue and receivables at Knott Co has identified sales of aluminium to its parent company in March 2018 with a total sales value of \$77 million which have been recorded in the subsidiary’s financial statements. Audit procedures have identified, however, that the receipt of aluminium was not recorded by the parent company until 2 April 2018. The group has made no adjustment for this transaction in the draft consolidated financial statements. Knott Co makes a 10% profit margin on all of its sales of aluminium. (7 marks)

**Required:**

**Comment on the matters to be considered and explain the audit evidence you should expect to find during your review of the Group audit working papers 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)**

- 5 (a) ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* states 'The purpose of communicating key audit matters is to enhance the communicative value of the auditor's report by providing greater transparency about the audit that was performed.'

**Required:**

**Discuss this statement in relation to the benefits and difficulties of communicating key audit matters to users of the auditor's report and the contribution of ISA 701 in addressing the audit expectation gap.** (8 marks)

- (b) You are the manager responsible for the audit of the Blackmore Group (the Group), a listed manufacturer of high quality musical instruments, for the year ended 31 March 2018. The draft financial statements of the Group recognise a loss before tax of \$2.2 million (2017 – loss of \$1.5 million) and total assets of \$14.1 million (2017 – \$18.3 million). The audit is nearing completion and the audit senior has drafted the auditor's report which contains the following extract:

**Key audit matters**

**1. Valuation of financial instruments**

The Group enters into structured forward contracts to purchase materials used in its manufacturing process. The valuation of these unquoted instruments involves guesswork and is based on internal models developed by the Group's finance director, Thomas Bolin. Mr Bolin joined the Group in January 2018 and there is significant measurement uncertainty involved in his valuations as a result of his inexperience. As a result, the valuation of these contracts was significant to our audit.

**2. Customer liquidation**

Included in receivables shown on the consolidated statement of financial position is an amount of \$287,253 from a customer which has ceased trading. On the basis that the Group has no security for this debt, we believe that the Group should make a full provision for impairment of \$287,253 thereby reducing profit before taxation for the year and total assets as at 31 March 2018 by that amount.

**Qualified opinion arising from disagreement about accounting treatment**

In our opinion, except for the effect on the financial statements of the matter described above, the financial statements have been properly prepared in all material respects in accordance with IFRS Standards.

**Emphasis of matter**

We draw attention to the loss before tax of \$2.2 million for the year ended 31 March 2018 and that the Group is in breach of loan covenants with its key finance providers. A material uncertainty therefore exists which may cast doubt on the Group's ability to continue as a going concern. Our opinion is not modified in respect of this matter.

**Required:**

**Critically appraise the extract from the auditor's report on the consolidated financial statements of the Blackmore Group for the year ended 31 March 2018.**

Note: You are NOT required to re-draft the extract from the auditor's report. (12 marks)

**(20 marks)**

**End of Question Paper**