Strategic Professional – Options

Advanced Audit and Assurance – International

Time allowed 3 hours 15 minutes

ALL THREE questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.

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

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Question 1

You are an audit manager in Potter & Co and your firm has recently been appointed as external auditor of Ronn for the year ending 30 June 2019 following the resignation of the previous auditor. Ronn's draft total assets as at 30 June 2019 are $150 million.

Ronn Ltd (Ronn) is a retailer of photographic equipment operating from 65 stores throughout the country Harmonia. The directors approached your firm to act as auditor because of its reputation in providing professional services to the retail sector.

You are provided with the following exhibits:

1. An email which you have received from the audit engagement partner
2. Information about Ronn
3. Further matters regarding Ronn
4. Extracts from financial statements-Ronn
5. Information about Headford Co

Required:
Respond to the instructions in the email from the audit engagement partner.

(46 marks)

Note: The split of the mark allocation is shown in the partner's email (Exhibit 1).

Professional marks will be awarded for the presentation and logical flow of the briefing notes and the clarity of the explanations **provided.**

(4 marks)

(50 marks)

Exhibit 1 – Email from audit engagement partner

To: **Audit manager**
From: **Audit engagement partner**
Subject: **Two clients; Ronn and Headford.**

Hello

I have provided you with some information in the form of a number of exhibits.
Using the information provided, I require you to prepare briefing notes for my use in which you:

a) Identify the matters that should have been considered by your firm before deciding to accept appointment as Ronn's external auditor.

(6 marks)

b) Evaluate the audit risks to be considered in planning the audit of Ronn.

(13 marks)

c) Identify the parties to whom your firm may be liable for damages if an inappropriate audit opinion is provided on the audited financial statements of Ronn and describe the methods available to your firm to limit its liability to such parties.

(5 marks)

d) Identify the main purpose of including 'findings from the audit' in a report to those charged with governance. From the information provided in exhibit 3, recommend the matters which should be included as 'findings from the audit' in your report to those charged with governance, and explain the reason for their inclusion. (9 marks)

e) Assess the ethical and professional issues raised, and recommend any actions necessary in respect of the contaminated plastic used by Headford Co and the invitation to audit Cong Co.

(13 marks)

Thank you.

Exhibit 2: Information about Ronn

Ronn Ltd (Ronn) is a retailer of photographic equipment operating from 65 stores throughout the country Harmonia.

Recent trading conditions have been difficult for Ronn, because the demand for its cheaper cameras has collapsed as most mobile phones now incorporate a high quality camera. In addition, an earthquake in C-Land, the country where their supplier is based, disrupted Ronn's supply chains early in 2019 and the company sourced inferior quality cameras from elsewhere, which were not popular with customers. All purchases are made on 30-day credit terms and are invoiced in the supplier's local currency.

Ronn's website, which has e-commerce features such as online ordering and payment facilities, experienced technical faults resulting in orders being paid for but customers not receiving their orders or receiving duplicate orders. Following media criticism, the website was closed on 25 April 2019 until further notice.

On 30 April 2019, the directors announced a reorganization involving the closure of 40 unprofitable stores over the next year and a re-launch of the website once improvements are finalized. Approximately half of the workforce will be made redundant over the next year through a voluntary redundancy program. Employees who volunteer for redundancy will be offered an enhanced package with terms in excess of the statutory minimum entitlement. The directors requested that applications for voluntary redundancy were made by 31 May 2019.

The company has standard operating procedures in every store including electronic point of sales (EPOS) systems and maintains a perpetual inventory system, which records the quantities held and the cost price of inventory. Quantities on the perpetual inventory system are updated from goods received records, the EPOS systems, the company website and the results of inventory counts. The cost price of the inventory is updated from purchase invoices. The company carries out inventory counts in the middle of each month at all of its stores.

During each inventory count, all high value items and 5% of the remaining items are counted. The next inventory count is scheduled for 12 June 2019.

At each month end, the inventory system generates an inventory valuation listing and an aged inventory report. The valuation listing includes the cost and quantity on hand for each inventory item. The aged report details the length of time each item has been in the store. The valuation listing at 30 June 2019 will be used as the basis for the inventory value in the financial statements.

The overdraft facility is due for review on 31 August 2019 and the bank has requested audited financial statements by that date together with profit and cash flow forecasts for the two years ending 30 June 2021. The bank loan is repayable in quarterly instalments of $1 million.

The draft statement of financial position also includes PPE with a carrying value of $6.5 million. There was a change in the estimation technique used to determine the depreciation in respect of these assets during the year. Depreciation was previously calculated on a straight line basis over a 10-year useful life, but from 1 July 2018, the useful life has been amended to 15 years. The finance director explained to the audit team that the review of estimated useful life has been made on the basis that the assets are lasting longer than originally anticipated.

The change in depreciation policy has been accounted for as a prior year adjustment, resulting in an increase of $0.2 million to property, plant and equipment and to retained earnings. The depreciation expense recognised for the year to 30 June 2019 is $1.2 million (2018 – $1.5 million).

During the year Ronn took a seven year lease on a suite of offices on the 13th floor of a new development. The lease payments are $130,000 paid annually in advance. The present value of lease payments has been calculated as $770,000. The initial direct costs incurred by Ronn were $7,000. The accountant at Ronn is not sure whether to capitalize these costs or expense them to statement of profit or loss over the lease term.

Ronn also owns a number of prestigious apartments which it leases to famous persons who are under a contract of employment to promote its photographic equipment. The apartments are let at below the market rate. The lease terms are short and are normally for six months. The leases terminate when the contracts for promoting the clothing terminate. Ronn wishes to account for the apartments as investment properties with the difference between the market rate and actual rental charged to be recognised as an employee benefit expense.

Exhibit 3: Further matters regarding Ronn

Assume the audit work has now been completed and you are reviewing the working papers in order to draft a report to those charged with governance.

During the audit of property, plant and equipment it was discovered that controls over capital expenditure transactions had deteriorated during the year. Authorisation had not been gained for the purchase of office equipment with a cost of $225,000.

An internally generated brand name has been included in the statement of financial position at a fair value of $10 million. Audit working papers show that the matter was discussed with the financial controller, who stated that the $10 million represents the present value of future cash flows estimated to be generated by the brand name. The member of the audit team who completed the work programme on intangible assets has noted that this treatment appears to be in breach of IAS 38 *Intangible Assets*, and that the management refuses to derecognise the asset.

Problems were experienced in the audit of inventories. Due to an oversight by the internal auditors of Ronn Co, the external audit team did not receive a copy of inventory counting procedures prior to attending the latest count. This caused a delay at the beginning of the inventory count, when the audit team had to quickly familiarise themselves with the procedures. In addition, on the final audit, when the audit senior requested documentation to support the final inventory valuation, it took two weeks for the information to be received because the accountant who had prepared the schedules had mislaid them.

Exhibit 4 – Extracts from financial statements-Ronn

Extract from Statement of profit or loss

	2019 (Draft)	2018 (audited)
	$000	$000
Revenue	90,100	102,998
Cost of Sales	(52,500)	(48,608)
Gross Profit	**37,600**	**54,390**
Loss before tax	(14,100)	(1.923)

Extract from Statement of financial position

	2019 (Draft)	2018 (audited)
	$000	$000
Current assets		
Inventory	12,300	8,319
Non-current liabilities		
Bank loan	12,000	16,000
Directors' loans	5,749	3,049
Current liabilities		
Trade payables	7,900	4,140
Overdraft (facility $10 million)	9,700	2,206
Bank loan	4,000	4,000
Provision for redundancies	2,400	-

Exhibit 5: Information about Headford Co

You are also responsible for the audit of Headford Co, a manufacturer of plastic toys which are exported all over the world. The following matter has been brought to your attention by the audit senior, who has just completed the planning of the forthcoming audit for the year ending 30 June 2019:

During a discussion with the production manager, it was revealed that there have been some quality control problems with the toys manufactured between March and May 2019. It was discovered that some of the plastic used in the manufacture of the company's products had been contaminated with a dangerous chemical which has the potential to explode if it is exposed to high temperatures. Headford Co did not recall any of the products which had been manufactured during that time from customers, as management felt that the risk of any injury being caused was remote.

Your firm has been invited to tender for the provision of the external audit service to Cong Co. You are aware that Cong Co operates in the same industry as Headford Co, and that the two companies often enter into highly publicised, aggressive advertising campaigns featuring very similar products. Cong Co is a much larger company than Headford Co, and there would be the opportunity to offer some non-audit services as well as the external audit.

Question 2

a) Described below are four situations that have arisen concerning unrelated external audit clients of your firm. The year end in each case is 27 February 2019.

Bran

Bran is a theme park design company. On 18 March 2019 a liquidator was appointed to Varys Ltd (Varys), a customer of Bran. The balance on Bran's receivables ledger at 27 February 2019 in respect of Varys was $229,000. In addition, staff at Bran had commenced work on a number of bespoke design projects exclusively for Varys before the year end, but this work had not been invoiced at 27 February 2019. Bran has recognised work in progress at the yearend of $465,000 in respect of this work. The directors do not believe any adjustments are necessary to the year-end financial statements in respect of this matter as the liquidator was appointed after the year end.

The total assets of Bran at 27 February 2019 are $28,250,000 and the profit before tax for the year ended 27 February 2019 is $6,340,000.

(4 marks)

Theon

Theon Co is a listed client which manufactures machinery for use in the aircraft, defence and marine sectors.

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 Theon 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. The finance director has stated that no adjustments will be made to the financial statements.

For the year ended 27 February 2019, the revenue and profit before tax figures recognised in the draft financial statements are $1,437 million and $139 million, respectively. (5 marks)

Ramsay plc

Ramsay replaced its computerised accounting system on 31 March 2018. During the current year audit multiple errors were discovered affecting a number of material transactions and account balances.

The new accounting system was not run in parallel with the previous system and no records from the previous system have been maintained. No alternative audit procedures were available to establish the level of error that may have arisen in the financial statements as a consequence of the replacement system.

(4 marks)

Jorah

Jorah Co operates supermarkets across the country. It 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. They were classified as held for sale in November 2018. They are recorded at carrying value of $26 million at the year end (fair value less cost to sell was $24 million. No adjustments are planned in this regard.

The draft financial statements recognise total assets of $300 million as at 27 February 2019 and revenue of $620 million and profit before tax of $47·5 million for the year ended 27 February 2019. (5 marks)

Required:

In each of the situations outlined above, discuss the audit option that will be given. Give reasons for your conclusions and also outline the modifications, if any, to each audit report.

(18 arks)

b) You are the manager responsible for the audit of Stannis Co, a company which designs and develops aircraft engines. The audit for the year ended 31 July 2019 is nearing completion and the audit senior has left the following file note for your attention:

'I have just returned from a meeting with the management of Stannis Co, and there is a matter I want to bring to your attention. Stannis Co's statement of financial position recognises an intangible asset of $12·5 million in respect of capitalised research and development costs relating to new aircraft engine designs. However, market research conducted by Stannis Co in relation to these new designs indicated that there would be little demand in the near future for such designs. Management has provided written representation that they agree with the results of the market research.

Currently, Stannis Co has a cash balance of only $125,000 and members of the management team have expressed concerns that the company is finding it difficult to raise additional finance.

The new aircraft designs have been discussed in the chairman's statement which is to be published with the financial statements. The discussion states that 'developments of new engine designs are underway, and we believe that these new designs will become a significant source of income for Stannis Co in the next 12 months.' Stannis Co's draft financial statements include profit before tax of $23 million, and total assets of $210 million. Stannis Co is due to publish its annual report next week, so we need to consider the impact of this matter urgently.'

Required:

Discuss the implications of the audit senior's file note on the completion of the audit and on the auditor's report, recommending any further actions that should be taken by the auditor.

(7 marks)

Question 3

a) You are a manager in the forensic investigation department of your audit firm. The directors of a local manufacturing company, Llama Co, have contacted your department regarding a suspected fraud, which has recently been discovered operating in the company, and you have been asked to look into the matter further. You have held a preliminary discussion with Sansa, the finance director of Llama Co, the notes of this conversation are shown below:

Four months ago Llama Co shut down one of its five factories, in response to deteriorating market conditions, with all staff employed at the factory made redundant on the date of closure.

While monitoring the monthly management accounts, Sansa performed analytical procedures on salary expenses. She found that the monthly total payroll expense had reduced by 3% in the months following the factory closure – not as much as expected, given that 20% of the total staff of the company had been made redundant. Initial investigations performed last week by Sansa revealed that many of the employees who had been made redundant had actually remained on the payroll records, and salary payments in respect of these individuals were still being made every month, with all payments going into the same bank account. As soon as she realised that there may be a fraud being conducted within the company, Sansa stopped any further payments in respect of the redundant employees. She contacted our firm as she is unsure how to proceed, and would like our firm's specialist department to conduct an investigation.

Sansa says that the senior accountant, Miles Rutland, has been absent from work since she conducted her initial investigation last week, and it has been impossible to contact him. Sansa believes that he may have been involved with the suspected fraud.

Sansa has asked whether your department would be able to provide a forensic investigation, but is unsure what this would involve. Llama Co is not an audit client of your firm.

Required:

Describe the objectives of a forensic investigation and explain the steps involved in a forensic investigation into the payroll fraud, including examples of procedures that could be used to gather evidence.

(10 marks)

b) Hangout is a major food retailer which has been expanding rapidly within its own country as well as other international regions. Your firm and have been approached by Raxa, the finance director of Hangout, to advise on a bid that Hangout is proposing to make for the purchase of MAGICP. You have ascertained the following from a briefing note received from Raxa.

MAGICP provides training in management, communications and marketing to a wide range of corporate clients, including multi-nationals. The 'MAGICP' name is well regarded in its areas of expertise. MAGICP is currently wholly-owned by Dawn, an international publisher of textbooks, a listed company. MAGICP has a National and an International business.

The National business comprises 11 training centres. The audited financial statements show revenue of \$12·5 million and profit before taxation of \$1·3 million for this geographic segment for the year to 31 December

2018. Most of the National business's premises are owned or held on long leases. Trainers in the National business are mainly full-time employees.

The International business has five training centres in two continents. For these segments, revenue amounted to $6·3 million and profit before tax $2·4 million for the year to 31 December 2018. Most of the International business's premises are held on operating leases. International trade receivables at 31 December 2018 amounted to $3·7 million. Although the International centres employ some full-time trainers, the majority of trainers provide their services as freelance consultants.

Required:

Explain the matters you should consider before accepting an engagement to conduct a due diligence review of MAGICP and give examples of how inquiry and analytical procedures might appropriately be used in the due diligence review of MAGICP.

(15 marks)