Audit and Assurance Services

(International Stream)

Paper 3.1(INT)

PART 3

TUESDAY 6 JUNE 2006

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into two sections

Section A	ALL THREE questions are compulsory and MUST be answered
Section B	TWO questions ONLY to be answered

Do not open this paper until instructed by the supervisor

This question paper must not be removed from the examination hall

The Association of Chartered Certified Accountants

Section A – ALL THREE questions are compulsory and MUST be attempted

1 Your firm has successfully tendered for the audit of Yates Co, a private national haulage and distribution company with over 2,000 employees. This long-established company provides refrigerated, bulk and heavy haulage transport services to time-sensitive delivery schedules.

You have obtained the following financial information from Yates:

	For the year to 30 June	
	2006	2005
	Draft	Actual
Income statement	$m	$m
Revenue (Note 1)	161·5	144·4
Materials expense (Note 2)	88·0	74·7
Staff costs	40·6	35·6
Depreciation and amortisation	8·5	9·5
Other expenses	19·6	23·2
Finance costs	2·9	2·2
Total expenses	159·6	145·2
Profit/(loss) before taxation	1·9	(0·8)
Balance sheet		
Intangible assets (Note 3)	7·2	6·2
Tangible assets (Note 4)		
Property	55·1	57·8
Vehicles and transport equipment	16·4	16·0
Other equipment	7·4	9·3
Inventories	0·6	0·5
Trade receivables (Note 5)	13·7	13·4
Cash and cash equivalents	3·4	2·8
Total assets	103·8	106·0
Provisions		
Restructuring (Note 6)	9·7	10·8
Tax provision	3·0	3·3
Liabilities		
Finance lease liabilities (Note 7)	5·4	4·4
Trade payables	13·8	13·1
Other liabilities (Note 8)	8·5	7·9
Total liabilities	40·4	39·5

Notes

(1) Revenue is net of rebates to major customers that increase with the volume of consignments transported. Rebates are calculated on cumulative sales for the financial year and awarded quarterly in arrears.

(2) Materials expense includes fuel, repair materials, transportation and vehicle maintenance costs.

(3) Purchased intangible assets, including software and industrial licences, are accounted for using the cost model. Internally generated intangible assets, mainly software developed for customers to generate consignment documents, are initially recognised at cost if the asset recognition criteria are satisfied.

(4) Movements on tangible non-current assets have been drafted as follows:

	Property	Vehicles and transport equipment	Other equipment	Total
Historical cost	$m	$m	$m	$m
Opening balance at 1 July 2005	75·7	25·6	17·8	119·1
Additions	1·4	2·7	1·1	5·2
Disposals	(2·5)	(2·6)	(1·4)	(6·5)
Closing balance at 30 June 2006	74·6	25·7	17·5	117·8
Depreciation and impairment losses				
Opening balance at 1 July 2005	17·9	9·6	8·5	36·0
Depreciation and impairment loss	2·4	1·9	2·5	6·8
Disposals	(0·8)	(2·2)	(0·9)	(3·9)
Closing balance at 30 June 2006	19·5	9·3	10·1	38·9
Carrying amount at 30 June 2006	55·1	16·4	7·4	78·9
Carrying amount at 30 June 2005	57·8	16·0	9·3	83·1

Depreciation is charged using the straight-line method assuming the following useful lives:

	Years
Property	6 to 60
Vehicles and transport equipment	3 to 8
Other equipment	3 to 15

(5) Trade receivables are carried at their principal amount, less allowances for impairment.

(6) The restructuring provision relates to employee termination and other obligations arising on the closure and relocation of distribution depots in December 2004.

(7) Finance leases are capitalised at the date of inception of the lease at fair value or the present value of the minimum lease payments, if less.

(8) Other liabilities include amounts due to employees for accrued wages and salaries, overtime, sick leave, maternity pay and bonuses.

Required:

In respect of the financial statements audit of Yates Co for the year ending 30 June 2006:

(a) Calculate preliminary materiality and justify the suitability of your assessment. (6 marks)

(b) Identify and explain the financial statement risks to be taken into account in planning the final audit. (12 marks)

(c) Explain the extent to which you should plan to place reliance on analytical procedures as audit evidence. (6 marks)

(d) Briefly describe the principal audit work to be performed in respect of the carrying amount of the following items in the balance sheet:

(i) trade receivables; and (3 marks)

(ii) vehicles. (3 marks)

(30 marks)

2 Your audit client, Prescott Co, is a national hotel group with substantial cash resources. Its accounting functions are well managed and the group accounting policies are rigorously applied. The company's financial year end is 31 December.

Prescott has been seeking to acquire a construction company for some time in order to bring in-house the building and refurbishment of hotels and related leisure facilities (e.g. swimming pools, squash courts and restaurants). Prescott's management has recently identified Robson Construction Co as a potential target and has urgently requested that you undertake a limited due diligence review lasting two days next week.

Further to their preliminary talks with Robson's management, Prescott has provided you with the following brief on Robson Construction Co:

> The chief executive, managing director and finance director are all family members and major shareholders. The company name has an established reputation for quality constructions.
>
> Due to a recession in the building trade the company has been operating at its overdraft limit for the last 18 months and has been close to breaching debt covenants on several occasions.
>
> Robson's accounting policies are generally less prudent than those of Prescott (e.g. assets are depreciated over longer estimated useful lives).
>
> Contract revenue is recognised on the percentage of completion method, measured by reference to costs incurred to date. Provisions are made for loss-making contracts.
>
> The company's management team includes a qualified and experienced quantity surveyor. His main responsibilities include:
>
> (1) supervising quarterly physical counts at major construction sites;
> (2) comparing costs to date against quarterly rolling budgets; and
> (3) determining profits and losses by contract at each financial year end.
>
> Although much of the labour is provided under subcontracts all construction work is supervised by full-time site managers.
>
> In August 2005, Robson received a claim that a site on which it built a housing development in 2002 was not properly drained and is now subsiding. Residents are demanding rectification and claiming damages. Robson has referred the matter to its lawyers and denied all liability, as the site preparation was subcontracted to Sarwar Services Co. No provisions have been made in respect of the claims, nor has any disclosure been made.
>
> The auditor's report on Robson's financial statements for the year to 30 June 2005 was signed, without modification, in March 2006.

Required:

(a) Identify and explain the specific matters to be clarified in the terms of engagement for this due diligence review of Robson Construction Co. (6 marks)

(b) State, with reasons, the principal additional information that should be made available for your review of Robson Construction Co. (8 marks)

(c) State the specific inquiries you should make of Robson Construction Co's management relevant to its accounting for construction contracts. (6 marks)

(20 marks)

3 You are the manager responsible for the audit of Keffler Co, a private limited company engaged in the manufacture of plastic products. The draft financial statements for the year ended 31 March 2006 show revenue of $47·4 million (2005 – $43·9 million), profit before taxation of $2 million (2005 – $2·4 million) and total assets of $33·8 million (2005 – $25·7 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention:

(a) In April 2005, Keffler bought the right to use a landfill site for a period of 15 years for $1·1 million. Keffler expects that the amount of waste that it will need to dump will increase annually and that the site will be completely filled after just ten years. Keffler has charged the following amounts to the income statement for the year to 31 March 2006:

– $20,000 licence amortisation calculated on a sum-of-digits basis to increase the charge over the useful life of the site; and

– $100,000 annual provision for restoring the land in 15 years' time. (9 marks)

(b) A sale of industrial equipment to Deakin Co in May 2005 resulted in a loss on disposal of $0·3 million that has been separately disclosed on the face of the income statement. The equipment cost $1·2 million when it was purchased in April 1996 and was being depreciated on a straight-line basis over 20 years. (6 marks)

(c) In April 2006, Keffler was banned by the local government from emptying waste water into a river because the water did not meet minimum standards of cleanliness. Keffler has made a provision of $0·9 million for the technological upgrading of its water purifying process and included $45,000 for the penalties imposed in 'other provisions'. (5 marks)

Required:

For each of the above issues:

(i) comment on the matters that you should consider; and
(ii) state the audit evidence that you should expect to find,

in undertaking your review of the audit working papers and financial statements of Keffler Co for the year ended 31 March 2006.

NOTE: The mark allocation is shown against each of the three issues.

(20 marks)

Section B – TWO questions ONLY to be attempted

4 **(a)** The purpose of ISA 510 'Initial Engagements – Opening Balances' is to establish standards and provide guidance regarding opening balances when the financial statements are audited for the first time or when the financial statements for the prior period were audited by another auditor.

Required:

Explain the auditor's reporting responsibilities that are specific to initial engagements. (5 marks)

(b) You are the audit manager of Johnston Co, a private company. The draft consolidated financial statements for the year ended 31 March 2006 show profit before taxation of \$10·5 million (2005 – \$9·4 million) and total assets of \$55·2 million (2005 – \$50·7 million).

Your firm was appointed auditor of Tiltman Co when Johnston Co acquired all the shares of Tiltman Co in March 2006. Tiltman's draft financial statements for the year ended 31 March 2006 show profit before taxation of \$0·7 million (2005 – \$1·7 million) and total assets of \$16·1 million (2005 – \$16·6 million). The auditor's report on the financial statements for the year ended 31 March 2005 was unmodified.

You are currently reviewing two matters that have been left for your attention on the audit working paper files for the year ended 31 March 2006:

(i) In December 2004 Tiltman installed a new computer system that properly quantified an overvaluation of inventory amounting to \$2·7 million. This is being written off over three years.

(ii) In May 2006, Tiltman's head office was relocated to Johnston's premises as part of a restructuring. Provisions for the resulting redundancies and non-cancellable lease payments amounting to \$2·3 million have been made in the financial statements of Tiltman for the year ended 31 March 2006.

Required:

Identify and comment on the implications of these two matters for your auditor's reports on the financial statements of Johnston Co and Tiltman Co for the year ended 31 March 2006. (10 marks)

(15 marks)

5 You are an audit manager in Fox & Steeple, a firm of Chartered Certified Accountants, responsible for allocating staff to the following three audits of financial statements for the year ending 31 December 2006:

(a) Blythe Co is a new audit client. This private company is a local manufacturer and distributor of sportswear. The company's finance director, Peter, sees little value in the audit and put it out to tender last year as a cost-cutting exercise. In accordance with the requirements of the invitation to tender your firm indicated that there would not be an interim audit.

(b) Huggins Co, a long-standing client, operates a national supermarket chain. Your firm provided Huggins Co with corporate financial advice on obtaining a listing on a recognised stock exchange in 2005. Senior management expects a thorough examination of the company's computerised systems, and are also seeking assurance that the annual report will not attract adverse criticism.

(c) Gray Co has been an audit client since 1999 after your firm advised management on a successful buyout. Gray provides communication services and software solutions. Your firm provides Gray with technical advice on financial reporting and tax services. Most recently you have been asked to conduct due diligence reviews on potential acquisitions.

Required:

For these assignments, compare and contrast:

(i) the threats to independence;
(ii) the other professional and practical matters that arise; and
(iii) the implications for allocating staff.

(15 marks)

6 The explosive growth of investing and raising capital in the global markets has put new emphasis on the development of international accounting, auditing and ethical standards. The International Federation of Accountants (IFAC) has been at the forefront of the development of the worldwide accountancy profession through its activities in ethics, auditing and education.

Required:

Explain the developments in each of the following areas and indicate how they affect Chartered Certified Accountants:

(a) IFAC's 'Code of Ethics for Professional Accountants'; (5 marks)

(b) International Standards on Auditing (ISAs); and (5 marks)

(c) mandatory continuing professional development (CPD) requirements. (5 marks)

(15 marks)

End of Question Paper