Audit and Assurance Services (International Stream)

PART 3
TUESDAY 7 DECEMBER 2004

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
1 Azure, a limited liability company, was incorporated in Sepiana on 1 April 2004. In May, the company exercised an exclusive right granted by the government of Pewta to provide twice weekly direct flights between Lyme, the capital of Pewta, and Darke, the capital of Sepiana.

The introduction of this service has been well advertised as ‘efficient and timely’ in national newspapers. The journey time between Sepiana and Pewta is expected to be significantly reduced, so encouraging tourism and business development opportunities in Sepiana.

Azure operates a refurbished 35-year-old aircraft which is leased from an international airline and registered with the Pewtan Aviation Administration (the PAA). The PAA requires that engines be overhauled every two years. Engine overhauls are expected to put the aircraft out of commission for several weeks.

The aircraft is configured to carry 15 First Class, 50 Business Class and 76 Economy Class passengers. The aircraft has a generous hold capacity for Sepiana’s numerous horticultural growers (e.g. of cocoa, tea and fruit) and general cargo.

The six hour journey offers an in-flight movie, a meal, hot and cold drinks and tax-free shopping. All meals are prepared in Lyme under a contract with an airport catering company. Passengers are invited to complete a ‘satisfaction’ questionnaire which is included with the in-flight entertainment and shopping guide. Responses received show that passengers are generally least satisfied with the quality of the food – especially on the Darke to Lyme flight.

Azure employs 10 full-time cabin crew attendants who are trained in air-stewardship including passenger safety in the event of accident and illness. Flight personnel (the captain and co-pilots) are provided under a contract with the international airline from which the aircraft is leased. At the end of each flight the captain completes a timesheet detailing the crew and actual flight time.

Ticket sales are made by Azure and travel agents in Sepiana and Pewta. On a number of occasions Economy seating has been over-booked. Customers who have been affected by this have been accommodated in Business Class as there is much less demand for this, and even less for First Class. Ticket prices for each class depend on many factors, for example, whether the tickets are refundable/non-refundable, exchangeable/non-exchangeable, single or return, mid-week or weekend, and the time of booking.

Azure’s insurance cover includes passenger liability, freight/baggage and compensation insurance. Premiums for passenger liability insurance are determined on the basis of passenger miles flown.

Required:

(a) Identify and explain the business risks facing Azure. (9 marks)

(b) Describe how the risks identified in (a) could be managed and maintained at an acceptable level by Azure. (9 marks)

(c) Suggest FOUR measures of operational performance and the evidence that should be available to provide assurance on their accuracy. (6 marks)

(24 marks)
Cerise, a limited liability company, manufactures computer-controlled equipment for production-line industries such as cars, washing machines, cookers, etc. On 1 September 2004 the shareholder-managers decided, unanimously, to accept a lucrative offer from a multi-national corporation to buy the company's patented technology and manufacturing equipment.

By 10 September 2004 management had notified all the employees, suppliers and customers that Cerise would cease all manufacturing activities on 31 October 2004. The 200-strong factory workforce and the majority of the accounts department and support staff were made redundant with effect from that date, when the sale was duly completed.

The marketing, human resources and production managers will cease to be employed by the company at 31 December 2004. However, the chief executive, sales manager, finance manager, accountant and a small number of accounting and other support staff expect to be employed until the company is wound down completely.

Cerise's operations extend to fourteen premises, nine of which were put on the market on 1 November 2004. Cerise accounts for all tangible, non-current assets under the cost model (i.e. at depreciated cost). Four premises are held on leases that expire in the next two to seven years and cannot be sold or sub-let under the lease terms. The small head office premises will continue to be occupied until the lease expires in 2007. No new lease agreements were entered into during 2004.

All Cerise's computer-controlled products carry a one-year warranty. Extended warranties of three and five years, previously available at the time of purchase, have not been offered on sales of remaining inventory from 1 November onwards.

Cerise has three-year agreements with its national and international distributors for the sale of equipment. It also has annual contracts with its major suppliers for the purchase of components. So far, none of these parties have lodged any legal claim against Cerise. However, the distributors are withholding payment of their account balances pending settlement of the significant penalties which are now due to them.

Required:
You are required to answer the following in the context of the final audit of the financial statements of Cerise for the year ending 31 December 2004:

(a) Using the information provided, identify and explain the financial statement risks to be taken into account in planning the audit. (12 marks)

(b) Explain how the extent of the reliance to be placed on:
   (i) analytical procedures; and (4 marks)
   (ii) management representations, (4 marks)

should compare with that for the prior year audit.

(c) Describe the principal audit work to be performed in respect of the carrying amount of the following items in the balance sheet:
   (i) amounts due from distributors; and (3 marks)
   (ii) lease liabilities. (3 marks)

(26 marks)
You are the manager responsible for the audit of Verdi, a long-established limited liability company. Verdi manufactures, distributes and installs heavy engineering equipment (e.g. turbines) for the oil and gas industry. The draft financial statements for the year ended 30 September 2004 show revenue of $330 million (2003 – $228 million), profit before taxation of $15·9 million (2003 – $13·7 million) and total assets of $187 million (2003 – $159 million).

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

(a) During the year technological advancement of the manufacturing process resulted in an increase in production capacity in three of the company's factory buildings. The remaining factory building became surplus to Verdi’s production requirements. On 29 September 2004, Verdi contracted to sell this building for $11·5 million. The building had last been revalued in September 2001 and had a carrying amount of $9·2 million at the date of sale. The gain on disposal has been credited to revenue and the balance of the revaluation surplus relating to the building, $3·7 million, has been credited against other operating expenses in the income statement.  

(b) $7 million was lent to Verdi on 1 July 2003 for five years at 5 3/4%, to finance investment in manufacturing equipment. The loan became repayable on demand on 1 July 2004 when Verdi failed to pay the annual interest charge for the first year. On 17 October 2004 the lender agreed to 'roll over' the overdue interest by adding it to the principal amount due. The draft financial statements classify the loan as a non-current financial liability and the first year's interest charge is accrued in 'trade and other payables'.

(c) Verdi’s scale of charges for installing equipment was increased by 40% with effect from 1 January 2004. This increase takes into account Verdi now giving a warranty to reinstall any item which fails to perform to specification, through an installation defect, for a period of up to three years. The notes to the financial statements disclose the following:

‘The company guarantees all installations of equipment sold since 1 January 2004. No provision has been recognised as the amount of the obligation cannot be measured with sufficient reliability.’

Installation fees for the year to 30 September 2004 amounted to $5·2 million of which $1 million related to the three months to 31 December 2003.

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 Verdi for the year ended 30 September 2004.

NOTE: The mark allocation is shown against each of the three issues.
Section B – TWO questions ONLY to be attempted

4  (a) Compare and contrast the auditor’s considerations of materiality at the planning stage and the overall review stage of an audit.  

(b) You are the manager in charge of the audit of Beige Interiors, a limited liability company. Your auditor’s report for the year to 30 September 2003 was signed, without modification, in January 2004.

The scope of the audit for the year to 30 September 2004 has however been limited as the former chief executive fled the country in early February 2004, taking the accounting records with him. As a training exercise you have asked one of the trainees assigned to the audit, Jade, to draft the extracts for the basis of opinion and opinion paragraphs that would not be standard wording in an unmodified auditor’s report. Jade has drafted the following:

‘Basis of opinion (extract)’
‘However, the evidence available to us was limited because accounting records were missing at the beginning of the period and it was not possible to completely reconstruct them.’

‘Opinion (extract)’
‘Because of the possible effect of the limitation in evidence available to us, we do not express an opinion on the financial statements.’

Required:

Discuss the suitability of Jade’s draft. Your answer should identify and comment on the principal matters relevant to forming an appropriate opinion on the financial statements of Beige Interiors for the year ended 30 September 2004. 

NOTE: You are NOT required to redraft the extracts.
You are an audit manager in Ebony, a firm of Chartered Certified Accountants. Your specific responsibilities include planning the allocation of professional staff to audit assignments. The following matters have arisen in connection with the audits of three client companies:

(a) The Finance Director of Almond, a private limited company, has requested that only certain staff are to be included on the audit team to prevent unnecessary disruption to Almond’s accounting department during the conduct of the audit. In particular, that Xavier be assigned as accountant in charge (AIC) of the audit and that no new trainees be included in the audit team. Xavier has been the AIC for this client for the last two years. (5 marks)

(b) Alex was one of the audit trainees assigned to the audit of Phantom, a private limited company, for the year ended 31 March 2004. Alex resigned from Ebony with effect from 30 November 2004 to pursue a career in medicine. Kurt, another AIC, has just told you that on the day Alex left he told Kurt that he had ticked schedules of audit work as having been performed when he had not actually carried out the tests. (5 marks)

(c) During the recent interim audit of Magenta, a private limited company, the AIC, Jamie, has discovered a material error in the prior year financial statements for the year ended 31 December 2003. These financial statements had disclosed an unquantifiable contingent liability for pending litigation. However, the matter was settled out of court for $4·5 million on 14 March 2004. The auditor’s report on the financial statements for the year ended 31 December 2003 was signed on 19 March 2004. Jamie believes that Magenta’s management is not aware of the error and has not drawn it to their attention. (5 marks)

Required:

Comment on the ethical, quality control and other professional issues raised by each of the above matters and their implications, if any, for Ebony’s staff planning.

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

(15 marks)

ISA 600 ‘Using the Work of Another Auditor’ establishes standards and provides guidance when an auditor, reporting on the financial statements of an entity, uses the work of another auditor on the financial information of one or more components included in the financial statements of that entity.

Required:

Comment on the extent to which ISA 600 provides guidance on the following issues in the context of a group audit:

(a) co-operation between auditors;

(b) multi-location audits;

(c) ‘business empires’;

(d) joint audits; and

(e) division of responsibility.

Your answer should identify and discuss specific issues that require additional guidance.

(15 marks)