

Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Monday 3 December 2012



Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This 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 paper until instructed by the supervisor.

During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.

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

The Association of Chartered Certified Accountants

Paper P7 (HKG)

ACCA

Section A – BOTH questions are compulsory and MUST be attempted

- 1 (a) You are a manager in Foo & Co, responsible for the audit of Grohl Co, a company which produces circuit boards which are sold to manufacturers of electrical equipment such as computers and mobile phones. It is the first time that you have managed this audit client, taking over from the previous audit manager, Bob Halen, last month. The audit planning for the year ended 30 November 2012 is about to commence, and you have just received an email from Mia Vai, the audit engagement partner.

To: Audit manager

From: Mia Vai, Audit partner, Foo & Co

Subject: Grohl Co – audit planning

Hello

I am meeting with the other audit partners tomorrow to discuss forthcoming audits and related issues. I understand that you recently had a meeting with Mo Satriani, the finance director of Grohl Co. Using the information from your meeting, I would like you to prepare briefing notes for my use in which you:

(i) Evaluate the business risks faced by Grohl Co; (12 marks)

(ii) Identify and explain FOUR risks of material misstatement to be considered in planning the audit; and (8 marks)

(iii) Discuss any ethical issues raised, and recommend the relevant actions to be taken by our firm. (8 marks)

Thank you.

Comments made by Mo Satriani in your meeting

Business overview

Grohl Co's principal business activity remains the production of circuit boards. One of the key materials used in production is copper wiring, all of which is imported. As a cost cutting measure, in April 2012 a contract with a new overseas supplier was signed, and all of the company's copper wiring is now supplied under this contract. Purchases are denominated in a foreign currency, but the company does not use forward exchange contracts in relation to its imports of copper wiring.

Grohl Co has two production facilities, one of which produces goods for the export market, and the other produces goods for the domestic market. About half of its goods are exported, but the export market is suffering due to competition from cheaper producers overseas. Most domestic sales are made under contract with approximately 20 customers.

Recent developments

In early November 2012, production was halted for a week at the production facility which supplies the domestic market. A number of customers had returned goods, claiming faults in the circuit boards supplied. On inspection, it was found that the copper used in the circuit boards was corroded and therefore unsuitable for use. The corrosion is difficult to spot as it cannot be identified by eye, and relies on electrical testing. All customers were contacted immediately and, where necessary, products recalled and replaced. The corroded copper remaining in inventory has been identified and separated from the rest of the copper.

Work has recently started on a new production line which will ensure that Grohl Co meets new regulatory requirements prohibiting the use of certain chemicals, which come into force in March 2013. In July 2012, a loan of \$30 million with an interest rate of 4% was negotiated with Grohl Co's bank, the main purpose of the loan being to fund the capital expenditure necessary for the new production line. \$2.5 million of the loan represents an overdraft which was converted into long-term finance.

Other matters

Several of Grohl Co's executive directors and the financial controller left in October 2012, to set up a company specialising in the recycling of old electronic equipment. This new company is not considered to be in competition with Grohl Co's operations. The directors left on good terms, and replacements for the directors have been

recruited. One of Foo & Co's audit managers, Bob Halen, is being interviewed for the role of financial controller at Grohl Co. Bob is a good candidate for the position, as he developed good knowledge of Grohl Co's business when he was managing the audit.

At Grohl Co's most recent board meeting, the audit fee was discussed. The board members expressed concern over the size of the audit fee, given the company's loss for the year. The board members would like to know whether the audit can be performed on a contingent fee basis.

Financial Information provided by Mo Satriani

Extract from draft statement of comprehensive income

	2012 Draft \$'000	2011 Actual \$'000
Revenue	12,500	13,800
Operating costs	(12,000)	(12,800)
Operating profit	500	1,000
Finance costs	(800)	(800)
Profit/(loss) before tax	(300)	200

The draft statement of financial position has not yet been prepared, but Mo states that the total assets of Grohl Co at 30 November 2012 are \$180 million, and cash at bank is \$130,000. Based on draft figures, the company's current ratio is 1.1, and the quick ratio is 0.8.

Required:

Respond to the email from the audit partner.

(28 marks)

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

Professional marks will be awarded for the presentation, structure, logical flow and clarity of your answer.

(4 marks)

- (b) You have just received a phone call from Mo Satriani, Grohl Co's finance director, in which he made the following comments:

'There is something I forgot to mention in our meeting. Our business insurance covers us for specific occasions when business is interrupted. I put in a claim on 28 November 2012 for \$5 million which I have estimated to cover the period when our production was halted due to the problem with the corroded copper. This is not yet recognised in the financial statements, but I want to make an adjustment to recognise the \$5 million as a receivable as at 30 November.'

Required:

Comment on the matters that should be considered, and recommend the audit procedures to be performed, in respect of the insurance claim.

(8 marks)

(40 marks)

**This is a blank page.
Question 2 begins on page 5.**

- 2 (a) You are a manager in Sambora & Co, responsible for the audit of the Jovi Group (the Group), which is listed. The Group's main activity is steel manufacturing and it comprises a parent company and five subsidiaries. Sambora & Co currently audits all components of the Group.

You are working on the audit of the Group's financial statements for the year ended 30 June 2012. This morning the audit engagement partner left a note for you:

'Hello

The audit senior has provided you with the draft consolidated financial statements and accompanying notes which summarise the key audit findings and some background information.

At the planning stage, materiality was initially determined to be \$900,000, and was calculated based on the assumption that the Jovi Group is a high risk client due to its listed status. During the audit, a number of issues arose which meant that we needed to revise the materiality level for the financial statements as a whole. The revised level of materiality is now determined to be \$700,000. One of the audit juniors was unsure as to why the materiality level had been revised. There are two matters you need to deal with:

- (i) Explain why auditors may need to reassess materiality as the audit progresses. (4 marks)
- (ii) Assess the implications of the key audit findings for the completion of the audit. Your assessment must consider whether the key audit findings indicate a risk of material misstatement. Where the key audit findings refer to audit evidence, you must also consider the adequacy of the audit evidence obtained, but you do not need to recommend further specific procedures. (18 marks)

Thank you'

The Group's draft consolidated financial statements, with notes referenced to key audit findings, are shown below:

Draft consolidated statement of comprehensive income

	Note	30 June 2012 Draft \$'000	30 June 2011 Actual \$'000
Revenue	1	98,795	103,100
Cost of sales		(75,250)	(74,560)
Gross profit		23,545	28,540
Operating expenses	2	(14,900)	(17,500)
Operating profit		8,645	11,040
Share of profit of associate		1,010	900
Finance costs		(380)	(340)
Profit before tax		9,275	11,600
Taxation		(3,200)	(3,500)
Profit for the year		6,075	8,100
Other comprehensive income/expense for the year, net of tax:			
Gains on property revaluation	3	800	–
Actuarial losses on defined benefit plan	4	(1,100)	(200)
Other comprehensive income/expense		(300)	(200)
Total comprehensive income for the year		5,775	7,900

Notes: Key audit findings – statement of comprehensive income

- Revenue has been stable for all components of the Group with the exception of one subsidiary, Copeland Co, which has recognised a 25% decrease in revenue.
- Operating expenses for the year to June 2012 is shown net of a profit on a property disposal of \$2 million. Our evidence includes agreeing the cash receipts to bank statement and sale documentation, and we have confirmed that the property has been removed from the non-current asset register. The audit junior noted

when reviewing the sale document, that there is an option to repurchase the property in five years time, but did not discuss the matter with management.

3. The property revaluation relates to the Group's head office. The audit team have not obtained evidence on the revaluation, as the gain was immaterial based on the initial calculation of materiality.
4. The actuarial loss is attributed to an unexpected stock market crash. The Group's pension plan is managed by Axle Co – a firm of independent fund managers who maintain the necessary accounting records relating to the plan. Axle Co has supplied written representation as to the value of the defined benefit plan's assets and liabilities at 30 June 2012. No other audit work has been performed other than to agree the figure from the financial statements to supporting documentation supplied by Axle Co.

Draft consolidated statement of financial position

	Note	30 June 2012 Draft \$'000	30 June 2011 Actual \$'000
ASSETS			
Non-current assets			
Property, plant and equipment		81,800	76,300
Goodwill	5	5,350	5,350
Investment in associate	6	4,230	4,230
Assets classified as held for sale	7	7,800	–
		<u>99,180</u>	<u>85,880</u>
Current assets			
Inventory		8,600	8,000
Receivables		8,540	7,800
Cash and cash equivalents		2,100	2,420
		<u>19,240</u>	<u>18,220</u>
Total assets		<u>118,420</u>	<u>104,100</u>
EQUITY AND LIABILITIES			
Equity			
Share capital		12,500	12,500
Revaluation reserve		3,300	2,500
Retained earnings		33,600	29,400
Non-controlling interest	8	4,350	4,000
Total equity		<u>53,750</u>	<u>48,400</u>
Non-current liabilities			
Defined benefit pension plan		10,820	9,250
Long-term borrowings	9	43,000	35,000
Deferred tax		1,950	1,350
Total non-current liabilities		<u>55,770</u>	<u>45,600</u>
Current liabilities			
Trade and other payables		6,200	7,300
Provisions		2,700	2,800
Total current liabilities		<u>8,900</u>	<u>10,100</u>
Total liabilities		<u>64,670</u>	<u>55,700</u>
Total equity and liabilities		<u>118,420</u>	<u>104,100</u>

Notes: Key audit findings – statement of financial position

5. The goodwill relates to each of the subsidiaries in the Group. Management has confirmed in writing that goodwill is stated correctly, and our other audit procedure was to arithmetically check the impairment review conducted by management.
6. The associate is a 30% holding in James Co, purchased to provide investment income. The audit team have not obtained evidence regarding the associate as there is no movement in the amount recognised in the statement of financial position.
7. The assets held for sale relate to a trading division of one of the subsidiaries, which represents one third of that subsidiary's net assets. The sale of the division was announced in May 2012, and is expected to be complete by 31 December 2012. Audit evidence obtained includes a review of the sales agreement and confirmation from the buyer, obtained in July 2012, that the sale will take place.
8. Two of the Group's subsidiaries are partly owned by shareholders external to the Group.
9. A loan of \$8 million was taken out in October 2011, carrying an interest rate of 2%, payable annually in arrears. The terms of the loan have been confirmed to documentation provided by the bank.

Required:

Respond to the note from the audit engagement partner.

(22 marks)

Note: The split of the mark allocation is shown within the partner's note.

- (b)** The audit engagement partner now sends a further note regarding the Jovi Group:

'The Group finance director has just informed me that last week the Group purchased 100% of the share capital of May Co, a company located overseas in Farland. The Group audit committee has suggested that due to the distant location of May Co, a joint audit could be performed, starting with the next financial statements for the year ending 30 June 2013. May Co's current auditors are a small local firm called Moore & Co who operate only in Farland.'

Required:

Discuss the advantages and disadvantages of a joint audit being performed on the financial statements of May Co.

(6 marks)

(28 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a)** You are an audit manager in Weller & Co, an audit firm which operates as part of an international network of firms. This morning you received a note from a partner regarding a potential new audit client:

'I have been approached by the audit committee of the Plant Group, which operates in the mobile telecommunications sector. Our firm has been invited to tender for the audit of the individual and group financial statements for the year ending 31 March 2013, and I would like your help in preparing the tender document. This would be a major new client for our firm's telecoms audit department.

The Plant Group comprises a parent company and six subsidiaries, one of which is located overseas. The audit committee is looking for a cost effective audit, and hopes that the strength of the Plant Group's governance and internal control mean that the audit can be conducted quickly, with a proposed deadline of 31 May 2013. The Plant Group has expanded rapidly in the last few years and significant finance was raised in July 2012 through a stock exchange listing.'

Required:

Identify and explain the specific matters to be included in the tender document for the audit of the Plant Group. (8 marks)

- (b)** Weller & Co is facing competition from other audit firms, and the partners have been considering how the firm's revenue could be increased. Two suggestions have been made:
1. Audit partners and managers can be encouraged to sell non-audit services to audit clients by including in their remuneration package a bonus for successful sales.
 2. All audit managers should suggest to their audit clients that as well as providing the external audit service, Weller & Co can provide the internal audit service as part of an 'extended audit' service.

Required:

Comment on the ethical and professional issues raised by the suggestions to increase the firm's revenue. (8 marks)

(16 marks)

- 4 (a) 'Revenue recognition should always be approached as a high risk area of the audit.'

Required:

Discuss this statement.

(6 marks)

- (b) You are a manager in Beck & Co, responsible for the audit of Kobain Co, a new audit client of your firm, with a financial year ended 31 July 2012. Kobain Co's draft financial statements recognise total assets of \$55 million, and profit before tax of \$15 million. The audit is nearing completion and you are reviewing the audit files.

Kobain Co designs and creates high-value items of jewellery. Approximately half of the jewellery is sold in Kobain Co's own retail outlets. The other half is sold by external vendors under a consignment stock arrangement, the terms of which specify that Kobain Co retains the ability to change the selling price of the jewellery, and that the vendor is required to return any unsold jewellery after a period of nine months. When the vendor sells an item of jewellery to a customer, legal title passes from Kobain Co to the customer.

On delivery of the jewellery to the external vendors, Kobain Co recognises revenue and derecognises inventory. At 31 July 2012, jewellery at cost price of \$3 million is held at external vendors. Revenue of \$4 million has been recognised in respect of this jewellery.

Required:

Comment on the matters that should be considered, and explain the audit evidence you should expect to find in your file review in respect of the consignment stock arrangement.

(6 marks)

- (c) Your firm also performs the audit of Jarvis Co, a company which installs windows. Jarvis Co uses sales representatives to make direct sales to customers. The sales representatives earn a small salary, and also earn a sales commission of 20% of the sales they generate.

Jarvis Co's sales manager has discovered that one of the sales representatives has been operating a fraud, in which he was submitting false claims for sales commission based on non-existent sales. The sales representative started to work at Jarvis Co in January 2012. The forensic investigation department of your firm has been engaged to quantify the amount of the fraud.

Required:

Recommend the procedures that should be used in the forensic investigation to quantify the amount of the fraud.

(4 marks)

(16 marks)

- 5 (a) You are the manager responsible for the audit of Dylan Co, a listed company, and you are reviewing the working papers of the audit file for the year ended 30 September 2012. The audit senior has left a note for your attention:
- 'Dylan Co outsources its entire payroll, invoicing and credit control functions to Hendrix Co. In August 2012, Hendrix Co suffered a computer virus attack on its operating system, resulting in the destruction of its accounting records, including those relating to Dylan Co. We have therefore been unable to perform the planned audit procedures on payroll, revenue and receivables, all of which are material to the financial statements. Hendrix Co has manually reconstructed the relevant figures as far as possible, and has supplied a written statement to confirm that they are as accurate as possible, given the loss of accounting records.'

Required:

- (i) **Comment on the actions that should be taken by the auditor, and the implications for the auditor's report;** (7 marks)
 - (ii) **Discuss the quality control procedures that should be carried out by the audit firm prior to the audit report being issued.** (3 marks)
- (b) You are also responsible for the audit of Squire Co, a listed company, and you are completing the review of its interim financial information for the six months ended 31 October 2012. Squire Co is a car manufacturer, and historically has offered a three-year warranty on cars sold. The financial statements for the year ended 30 April 2012 included a warranty provision of \$1.5 million and recognised total assets of \$27.5 million. You are aware that on 1 July 2012, due to cost cutting measures, Squire Co stopped offering warranties on cars sold. The financial statements for the six months ended 31 October 2012 do not recognise any warranty provision. Total assets are \$30 million at 31 October 2012.

Required:

Assess the matters that should be considered in forming a conclusion on Squire Co's interim financial statements, and the implications for the review report. (6 marks)

(16 marks)

End of Question Paper