

Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Tuesday 4 December 2007

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

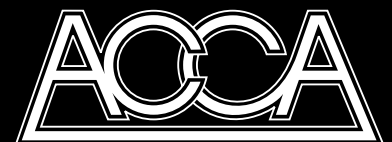
Section B – TWO questions ONLY to be attempted

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)

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The question paper begins on page 3.**

Section A – BOTH questions are compulsory and MUST be attempted

- 1 Your client, Island Co, is a manufacturer of machinery used in the coal extraction industry. You are currently planning the audit of the financial statements for the year ended 30 November 2007. The draft financial statements show revenue of \$125 million (2006 – \$103 million), profit before tax of \$5.6 million (2006 – \$5.1 million) and total assets of \$95 million (2006 – \$90 million). Your firm was appointed as auditor to Island Co for the first time in June 2007.

Island Co designs, constructs and installs machinery for five key customers. Payment is due in three instalments: 50% is due when the order is confirmed (stage one), 25% on delivery of the machinery (stage two), and 25% on successful installation in the customer's coal mine (stage three). Generally it takes six months from the order being finalised until the final installation.

At 30 November, there is an amount outstanding of \$2.85 million from Jacks Mine Co. The amount is a disputed stage three payment. Jacks Mine Co is refusing to pay until the machinery, which was installed in August 2007, is running at 100% efficiency.

One customer, Sawyer Co, communicated in November 2007, via its lawyers with Island Co, claiming damages for injuries suffered by a drilling machine operator whose arm was severely injured when a machine malfunctioned. Kate Shannon, the chief executive officer of Island Co, has told you that the claim is being ignored as it is generally known that Sawyer Co has a poor health and safety record, and thus the accident was their fault. Two orders which were placed by Sawyer Co in October 2007 have been cancelled.

Work in progress is valued at \$8.5 million at 30 November 2007. A physical inventory count was held on 17 November 2007. The chief engineer estimated the stage of completion of each machine at that date. One of the major components included in the coal extracting machinery is now being sourced from overseas. The new supplier, Locke Co, is located in Spain and invoices Island Co in euros. There is a trade payable of \$1.5 million owing to Locke Co recorded within current liabilities.

All machines are supplied carrying a one year warranty. A warranty provision is recognised on the balance sheet at \$2.5 million (2006 – \$2.4 million). Kate Shannon estimates the cost of repairing defective machinery reported by customers, and this estimate forms the basis of the provision.

Kate Shannon owns 60% of the shares in Island Co. She also owns 55% of Pacific Co, which leases a head office to Island Co. Kate is considering selling some of her shares in Island Co in late January 2008, and would like the audit to be finished by that time.

Required:

- (a) **Using the information provided, identify and explain the principal audit risks, and any other matters to be considered when planning the final audit for Island Co for the year ended 30 November 2007.**

Note: your answer should be presented in the format of briefing notes to be used at a planning meeting.
Requirement (a) includes 2 professional marks. (13 marks)

- (b) **Explain the principal audit procedures to be performed during the final audit in respect of the estimated warranty provision in the balance sheet of Island Co as at 30 November 2007.** (5 marks)

- (c) (i) **Identify and describe FOUR quality control procedures that are applicable to the individual audit engagement; and** (8 marks)

(ii) **Discuss TWO problems that may be faced in implementing quality control procedures in a small firm of Certified Public Accountants, and recommend how these problems may be overcome.** (4 marks)

(30 marks)

2 You are the manager responsible for the audit of Sci-Tech Co, a pharmaceutical research company. You are planning the substantive audit procedures to be used in the forthcoming audit of intangible assets and operating expenses. Relevant extracts from the financial statements are as follows:

	30 November 2007 (draft) \$000	30 November 2006 \$000
Balance Sheet		
Intangible assets: Development costs		
Cost	2,750	2,000
Accumulated amortisation	(1,450)	(850)
	1,300	1,150
Total assets	18,500	15,000
Income Statement		
Revenue	4,500	3,800
Operating expenses include:		
Research costs	160	200
Amortisation of development costs	600	450
Salary expenses	380	400
Profit before tax	1,800	1,530

The following is an extract from the notes to the draft financial statements:

‘Expenditure on product development is capitalised as an intangible asset from the point at which it is probable that future economic benefits will result from the product once completed. Any product development costs which do not meet the above criteria are expensed as incurred as research costs. Two products are currently in the development phase: Medex, an antiseptic cream; and Flortex, a medicine to reduce the symptoms of fever.

Amortisation of development costs commences with commercial production, the amortisation period being the estimated life span of the product. Currently two products are being amortised over the following periods:

1. *Plummet Cold Cure* *five years*
2. *Blingo Cough Cure* *three years.*

During the initial planning of the audit, the audit senior made the following note on the working papers:

‘Bio-Cert Co is the main competitor of our client. It appears that Bio-Cert Co is developing a rival product to Flortex. This rival product is expected to be launched in June 2008, six months prior to the expected launch of Flortex.’

Sci-Tech Co decided to outsource its payroll function, commencing in June 2007. The service is being provided by ProPay Co, a small local company. All of the accounting records relating to payroll are maintained and kept by ProPay Co. In previous years the audit of salary expenses was performed using a systems based approach with limited substantive procedures.

Sci-Tech Co receives funding from governmental health departments, as well as several large charitable donations. This funding represents on average 25% of the company’s research and development annual expenditure. The amount of funding received is dependent on three key performance indicator (KPI) targets being met annually. All three of the targets must be met in order to secure the government funding.

Extracts from Sci-Tech Co's operating and financial review are as follows:

KPI target	Draft KPI 2007	Actual KPI 2006
Pharmaceutical products donated free of charge to health care charities: 1% revenue	0.8% revenue	1.2% revenue
Donations to, and cost of involvement with, local community charities: 0.5% revenue	0.6% revenue	0.8% revenue
Accidents in the work place: Less than 5 serious accidents per year	4 serious accidents	2 serious accidents

In addition to performing the financial statement audit, your firm is engaged to provide an assurance opinion on the KPIs disclosed in the operating and financial review.

Required:

- (a) **Define 'outsourcing' and explain the matters to be considered in planning the audit of salary expense.**

Note: requirement (a) includes 2 professional marks. (9 marks)

- (b) (i) **Explain the matters you should consider to determine whether capitalised development costs are appropriately recognised; and** (5 marks)

(ii) **Describe the evidence you would seek to support the assertion that development costs are technically feasible.** (3 marks)

- (c) **Describe the audit procedures you should perform to determine the validity of the amortisation rate of five years being applied to development costs in relation to Plummet.** (5 marks)

- (d) (i) **Discuss why it may not be possible to provide a high level of assurance over the stated key performance indicators; and** (4 marks)

(ii) **Describe the procedures to verify the number of serious accidents in the year ended 30 November 2007.** (4 marks)

(30 marks)

Section B – TWO questions ONLY to be attempted

3 You are an audit manager in Webb & Co, a firm of Certified Public Accountants. Your audit client, Mulligan Co, designs and manufactures wooden tables and chairs. The business has expanded rapidly in the last two years, since the arrival of Patrick Tiler, an experienced sales and marketing manager.

The directors want to secure a loan of \$3 million in order to expand operations, following the design of a completely new range of wooden garden furniture. The directors have approached LCT Bank for the loan. The bank's lending criteria stipulate the following:

'Loan applications must be accompanied by a detailed business plan, including an analysis of how the finance will be used. LCT Bank need to see that the finance requested is adequate for the proposed business purpose. The business plan must be supported by an assurance opinion on the adequacy of the requested finance.'

The \$3 million finance raised will be used as follows:

	\$000
Construction of new factory	1,250
Purchase of new machinery	1,000
Initial supply of timber raw material	250
Advertising and marketing of new product	500

Your firm has agreed to review the business plan and to provide an assurance opinion on the completeness of the finance request. A meeting will be held tomorrow to discuss this assignment.

Required:

- (a) Identify and explain the matters relating to the assurance assignment that should be discussed at the meeting with Mulligan Co.** (8 marks)
- (b) State the enquiries you would make of the directors of Mulligan Co to ascertain the adequacy of the \$3 million finance requested for the new production facility.** (7 marks)

During the year the internal auditor of Mulligan Co discovered several discrepancies in the inventory records. In a statement made to the board of directors, the internal auditor said:

'I think that someone is taking items from the warehouse. A physical inventory count is performed every three months, and it has become apparent that about 200 boxes of flat-packed chairs and tables are disappearing from the warehouse every month. We should get someone to investigate what has happened and quantify the value of the loss.'

Required:

- (c) Define 'forensic accounting' and explain its relevance to the statement made by the internal auditor.** (5 marks)

(20 marks)

- 4 You are an audit manager in Nate & Co, a firm of Certified Public Accountants. You are reviewing three situations, which were recently discussed at the monthly audit managers' meeting:
- (1) Nate & Co has recently been approached by a potential new audit client, Fisher Co. Your firm is keen to take the appointment and is currently carrying out client acceptance procedures. Fisher Co was recently incorporated by Marcellus Fisher, with its main trade being the retailing of wooden storage boxes.
 - (2) Nate & Co provides the audit service to CF Co, a national financial services organisation. Due to a number of errors in the recording of cash deposits from new customers that have been discovered by CF Co's internal audit team, the directors of CF Co have requested that your firm carry out a review of the financial information technology systems. It has come to your attention that while working on the audit planning of CF Co, Jin Sayed, one of the juniors on the audit team, who is a recent information technology graduate, spent three hours providing advice to the internal audit team about how to improve the system. As far as you know, this advice has not been used by the internal audit team.
 - (3) LA Shots Co is a manufacturer of bottled drinks, and has been an audit client of Nate & Co for five years. Two audit juniors attended the annual inventory count last Monday. They reported that Brenda Mangle, the new production manager of LA Shots Co, wanted the inventory count and audit procedures performed as quickly as possible. As an incentive she offered the two juniors ten free bottles of 'Super Juice' from the end of the production line. Brenda also invited them to join the LA Shots Co office party, which commenced at the end of the inventory count. The inventory count and audit procedures were completed within two hours (the previous year's procedures lasted a full day), and the juniors then spent four hours at the office party.

Required:

- (a) **Define 'money laundering' and state the procedures specific to money laundering that should be considered before, and on the acceptance of, the audit appointment of Fisher Co.** (5 marks)
- (b) **With reference to CF Co, explain the ethical and other professional issues raised.** (9 marks)
- (c) **Identify and discuss the ethical and professional matters raised at the inventory count of LA Shots Co.** (6 marks)

(20 marks)

- 5 You are the audit manager for three clients of Bertie & Co, a firm of Certified Public Accountants. The financial year end for each client is 30 September 2007.

You are reviewing the audit senior's proposed audit reports for two clients, Alpha Co and Deema Co.

Alpha Co, a listed company, permanently closed several factories in May 2007, with all costs of closure finalised and paid in August 2007. The factories all produced the same item, which contributed 10% of Alpha Co's total revenue for the year ended 30 September 2007 (2006 – 23%). The closure has been discussed accurately and fully in the chairman's statement and Directors' Report. However, the closure is not mentioned in the notes to the financial statements, nor separately disclosed on the financial statements.

The audit senior has proposed an unmodified audit opinion for Alpha Co as the matter has been fully addressed in the chairman's statement and Directors' Report.

In October 2007 a legal claim was filed against Deema Co, a retailer of toys. The claim is from a customer who slipped on a greasy step outside one of the retail outlets. The matter has been fully disclosed as a material contingent liability in the notes to the financial statements, and audit working papers provide sufficient evidence that no provision is necessary as Deema Co's lawyers have stated in writing that the likelihood of the claim succeeding is only possible. The amount of the claim is fixed and is adequately covered by cash resources.

The audit senior proposes that the audit opinion for Deema Co should not be qualified, but that an emphasis of matter paragraph should be included after the audit opinion to highlight the situation.

Hugh Co was incorporated in October 2006, using a bank loan for finance. Revenue for the first year of trading is \$750,000, and there are hopes of rapid growth in the next few years. The business retails luxury hand made wooden toys, currently in a single retail outlet. The two directors (who also own all of the shares in Hugh Co) are aware that due to the small size of the company, the financial statements do not have to be subject to annual external audit, but they are unsure whether there would be any benefit in a voluntary audit of the first year financial statements. The directors are also aware that a review of the financial statements could be performed as an alternative to a full audit. Hugh Co currently employs a part-time, part-qualified accountant, Monty Parkes, who has prepared a year end balance sheet and income statement, and who produces summary management accounts every three months.

Required:

- (a) **Evaluate whether the audit senior's proposed audit report is appropriate, and where you disagree with the proposed report, recommend the amendment necessary to the audit report of:**
- (i) **Alpha Co;** (6 marks)
 - (ii) **Deema Co.** (4 marks)
- (b) **Describe the potential benefits for Hugh Co in choosing to have a financial statement audit.** (4 marks)
- (c) **With specific reference to Hugh Co, discuss the objective of a review engagement and contrast the level of assurance provided with that provided in an audit of financial statements.** (6 marks)

(20 marks)

End of Question Paper