

Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Tuesday 2 December 2008

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 (HKKG)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black rectangular background.

Section A – BOTH questions are compulsory and MUST be attempted

- 1 Bluebell Co operates a chain of 95 luxury hotels. This year’s results show a return to profitability for the company, following several years of losses. Hotel trade journals show that on average, revenue in the industry has increased by around 20% this year. Despite improved profitability, Bluebell Co has poor liquidity, and is currently trying to secure further long-term finance.

You have been the manager responsible for the audit of Bluebell Co for the last four years. Extracts from the draft financial statements for the year ended 30 November 2008 are shown below:

Extracts from the Statement of Comprehensive Income	2008	2007
	\$m	\$m
Revenue (note 1)	890	713
Operating expenses (note 2)	(835)	(690)
Other operating income (note 3)	135	10
Operating profit	190	33
Finance costs	(45)	(43)
Profit/(loss) before tax	145	(10)

Note 1: Revenue recognition

Revenue comprises sales of hotel rooms, conference and meeting rooms. Revenue is recognised when a room is occupied. A 20% deposit is taken when the room is booked.

Note 2: Significant items included in operating expenses:	2008	2007
	\$m	\$m
Share-based payment expense (i)	138	–
Damaged property repair expenses (ii)	100	–

- (i) In June 2008 Bluebell Co granted 50 million share options to executives and employees of the company. The cost of the share option scheme is being recognised over the three year vesting period of the scheme. It is currently assumed that all of the options will vest and the expense is calculated on that basis. Bluebell Co operates in a tax jurisdiction in which no deferred tax consequences arise from share-based payment schemes.
- (ii) In September 2008, three hotels situated near a major river were severely damaged by a flood. All of the hotels, which were constructed by Bluebell Co only two years ago, need extensive repairs and refurbishment at an estimated cost of \$100 million, which has been provided in full. All of the buildings are insured for damage caused by flooding.

Note 3: Other operating income includes:	2008	2007
	\$m	\$m
Profit on property disposal (iii)	125	10

- (iii) Eight properties were sold in March 2008 to Daffodil Fund Enterprises (DFE). Bluebell Co entered into a management contract with DFE and is continuing to operate the eight hotels under a 15 year agreement. Under the terms of the management contract, Bluebell Co receives an annual financial return based on the profit made by the eight hotels. At the end of the contract, Bluebell Co has the option to repurchase the hotels, and it is likely that the option will be exercised.

Extracts from the Statement of Financial Position	2008	2007
	\$m	\$m
Property, plant and equipment (note 4)	1,265	1,135
Deferred tax asset (note 5)	285	335
Deferred tax liability (note 6)	(735)	(638)
Total assets	2,870	2,230

Note 4: Property, Plant and Equipment (extract)

On 31 October 2008 all of Bluebell Co's owned hotels were revalued. A revaluation gain of \$250 million has been recognised in the statement of changes in equity and in the statement of financial position.

Note 5: Deferred Tax Asset (extract)

The deferred tax asset represents unutilised tax losses which accumulated in the loss making periods 2004–2007 inclusive. Bluebell Co is confident that future taxable trading profits will be generated in order for the tax losses to be utilised.

Note 6: Deferred Tax Liability (extract)	Temporary differences relating to Property, plant and equipment
	\$m
1 December 2007	638
Charged to equity	88
Charged to tax expense	9
30 November 2008	<u>735</u>

Required:

- (a) **Using the specific information provided, identify and explain the financial statement risks to be addressed when planning the final audit of Bluebell Co for the year ended 30 November 2008.** (14 marks)
- (b) **Describe the principal audit procedures to be carried out in respect of the following:**
- (i) **The measurement of the share-based payment expense;** (6 marks)
- (ii) **The recoverability of the deferred tax asset.** (4 marks)

A new internal auditor, Daisy Rosepetal, has recently joined Bluebell Co. She has been asked by management to establish and to monitor a variety of social and environmental Key Performance Indicators (KPIs). Daisy has no experience in this area, and has asked you for some advice. It has been agreed with Bluebell Co's audit committee that you are to provide guidance to Daisy to help her in this part of her role, and that this does not impair the objectivity of the audit.

- (c) **Recommend EIGHT KPIs which could be used to monitor Bluebell Co's social and environmental performance, and outline the nature of evidence that should be available to provide assurance on the accuracy of the KPIs recommended. Your answer should be in the form of briefing notes to be used at a meeting with Daisy Rosepetal.**

Note: requirement (c) includes 2 professional marks. (10 marks)

(34 marks)

2 (a) Define the following terms:

- (i) Forensic Accounting;**
- (ii) Forensic Investigation;**
- (iii) Forensic Auditing.**

(6 marks)

You are a manager in the forensic investigation department of your audit firm. The directors of a local manufacturing company, Crocus 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 Gita Thrales, the finance director of Crocus Co, the notes of this conversation are shown below:

Notes of discussion with Gita Thrales

Four months ago Crocus 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, Gita performs 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 Gita 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, Gita 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.

Gita 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. Gita believes that he may have been involved with the suspected fraud.

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

Required:

(b) Prepare a report to be sent to Gita Thrales (the finance director), in which you:

- (i) Describe the objectives of a forensic investigation; and**
- (ii) Explain the steps involved in a forensic investigation into the payroll fraud, including examples of procedures that could be used to gather evidence.**

Note: requirement (b) includes 3 professional marks.

(14 marks)

(c) Assess how the fundamental ethical principles of IFAC's *Code of Ethics for Professional Accountants* should be applied to the provision of a forensic investigation service.

(6 marks)

(26 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a)** Financial statements often contain material balances recognised at fair value. For auditors, this leads to additional audit risk.

Required:

Discuss this statement.

(7 marks)

- (b)** You are the manager responsible for the audit of Poppy Co, a manufacturing company with a year ended 31 October 2008. In the last year, several investment properties have been purchased to utilise surplus funds and to provide rental income. The properties have been revalued at the year end in accordance with HKAS 40 *Investment Property*, they are recognised on the statement of financial position at a fair value of \$8 million, and the total assets of Poppy Co are \$160 million at 31 October 2008. An external valuer has been used to provide the fair value for each property.

Required:

- (i) Recommend the enquiries to be made in respect of the external valuer, before placing any reliance on their work, and explain the reason for the enquiries;** (7 marks)
- (ii) Identify and explain the principal audit procedures to be performed on the valuation of the investment properties.** (6 marks)

(20 marks)

- 4 You are a senior manager in Becker & Co, a firm of Certified Public Accountants offering audit and assurance services mainly to large, privately owned companies. The firm has suffered from increased competition, due to two new firms of accountants setting up in the same town. Several audit clients have moved to the new firms, leading to loss of revenue, and an over staffed audit department. Bob McEnroe, one of the partners of Becker & Co, has asked you to consider how the firm could react to this situation. Several possibilities have been raised for your consideration:
1. Murray Co, a manufacturer of electronic equipment, is one of Becker & Co's audit clients. You are aware that the company has recently designed a new product, which market research indicates is likely to be very successful. The development of the product has been a huge drain on cash resources. The managing director of Murray Co has written to the audit engagement partner to see if Becker & Co would be interested in making an investment in the new product. It has been suggested that Becker & Co could provide finance for the completion of the development and the marketing of the product. The finance would be in the form of convertible debentures. Alternatively, a joint venture company in which control is shared between Murray Co and Becker & Co could be established to manufacture, market and distribute the new product.
 2. Becker & Co is considering expanding the provision of non-audit services. Ingrid Sharapova, a senior manager in Becker & Co, has suggested that the firm could offer a recruitment advisory service to clients, specialising in the recruitment of finance professionals. Becker & Co would charge a fee for this service based on the salary of the employee recruited. Ingrid Sharapova worked as a recruitment consultant for a year before deciding to train as an accountant.
 3. Several audit clients are experiencing staff shortages, and it has been suggested that temporary staff assignments could be offered. It is envisaged that a number of audit managers or seniors could be seconded to clients for periods not exceeding six months, after which time they would return to Becker & Co.

Required:

Identify and explain the ethical and practice management implications in respect of:

- (a) **A business arrangement with Murray Co.** (7 marks)
- (b) **A recruitment service offered to clients.** (7 marks)
- (c) **Temporary staff assignments.** (6 marks)

(20 marks)

- 5 (a) Compare and contrast the responsibilities of management, and of auditors, in relation to the assessment of going concern. You should include a description of the procedures used in this assessment where relevant.** (7 marks)

You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Dexter Co, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Dexter Co is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers conclude that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note explaining the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

- (b) Consider and comment on the possible reasons why the directors of Dexter Co are reluctant to provide the note to the financial statements.** (5 marks)

- (c) Identify and discuss the implications for the audit report if:**

- (i) the directors refuse to disclose the note;** (4 marks)
(ii) the directors agree to disclose the note. (4 marks)

(20 marks)

End of Question Paper