Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Tuesday 3 June 2008

Paper P7 (HKG)

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

ACCA

Section A – BOTH questions are compulsory and MUST be attempted

1 You are a senior audit manager in Mitchell & Co, a firm of Certified Public Accountants. You are reviewing some information regarding a potential new audit client, Medix Co, a supplier of medical instruments. Extracts from notes taken at a meeting that you recently held with the finance director of Medix Co, Ricardo Feller, are shown below:

Meeting notes – meeting held 1 June 2008 with Ricardo Feller

Medix Co is a provider of specialised surgical instruments used in medical procedures. The company is owner managed, has a financial year ending 30 June 2008, and has invited our firm to be appointed as auditor for the forthcoming year end. The audit is not going out to tender. Ricardo Feller has been with the company since January 2008, following the departure of the previous finance director, who is currently taking legal action against Medix Co for unfair dismissal.

Company background

Medix Co manufactures surgical instruments which are sold to hospitals and clinics. Due to the increased use of laser surgery in the last four years, demand for traditional metal surgical instruments, which provided 75% of revenue in the year ended 30 June 2007, has declined rapidly. Medix Co is expanding into the provision of laser surgery equipment, but research and development is at an early stage. The directors feel confident that the laser instruments currently being designed will eventually receive the necessary licence for commercial production, and that the laser product will replace surgical instruments as a leading source of revenue. There is currently one scientist working on the laser equipment, subcontracted by Medix Co on a freelance basis. The building in which the research is being carried out has recently been significantly extended by the construction of a large laboratory.

A considerable revenue stream is derived from agents who are not employed by Medix Co. The agents earn a commission based on the value of sales they have secured for Medix Co during the year. There are many suppliers into the market and agents are used by all manufacturers as a means of marketing and distributing their products.

The company's manufacturing facility is located in another country, where operating costs are significantly lower. The facility is under the control of a local manager who visits the head office of Medix Co annually for a meeting with senior management. Products are imported via aeroplane. The overseas plant and equipment is owned by the company and was constructed 12 years ago specifically for the manufacture of metal surgical instruments.

The company has a bank overdraft facility and makes use of the facility most months. A significant bank loan, which will carry a variable interest rate, is currently being negotiated. The terms of the loan will be finalised once the audited financial statements have been viewed by the bank.

After receiving permission from Medix Co, you held a discussion with the current audit partner of Medix Co, Mick Evans, who runs a small accounting and audit practice of which he is one of two partners. Mick told you the following:

'Medix Co has been an audit client for three years. We took over from the previous auditors following a disagreement between them and the directors of Medix Co over fees. As we are a small practice with low overheads we could offer lower fees than our predecessors. We could also do the audit very quickly, which pleased the client, as they like to keep costs as low as possible.

During our audits we have found the internal systems and controls to be quite weak. Despite our recommendations, there always seemed to be a lack of interest in making improvements to the accounting systems, as this was seen to be a 'waste of money'. There have been two investigations by the tax authorities, which we did not deal with, as we are not tax experts. In the end the directors sorted it all out, and I believe that the tax matter is now resolved.

We never had a problem getting access to accounting books and records. However, the managing director, Jon Tate, once gave us what he described as 'the wrong cash book' by mistake, and replaced it with the 'proper version' later in the day. We never found out why he was keeping two cash books, but cash was an immaterial asset so we didn't worry about it too much.

We are resigning as auditors because the work load is too much for our small practice, and as Medix Co is our only audit client we have decided to focus on providing non-audit services in the future.'

You have also found a recent press cutting regarding Medix Co:

> Extract from local newspaper – business section, 2 June 2008
> It appears that local company Medix Co has breached local planning regulations by building an extension to its research and development building for which no local authority approval has been given. The land on which the premises is situated has protected status as a 'greenfield' site which means approval by the local authority is necessary for any modification to commercial buildings.
>
> A representative of the local planning office stated today: 'We feel that this is a serious breach of regulations and it is not the first time that Medix Co has deliberately ignored planning rules. The company was successfully sued in 2003 for constructing an access road without receiving planning permission, and we are considering taking legal action in respect of this further breach of planning regulations. We are taking steps to ensure that these premises should be shut down within a month. A similar breach of regulations by a different company last year resulted in the demolition of the building.'

Required:

(a) Using the information provided, identify and explain the principal business risks facing Medix Co. (12 marks)

(b) (i) Discuss the relationship between the concepts of 'business risk' and 'financial statement risk'; and (4 marks)

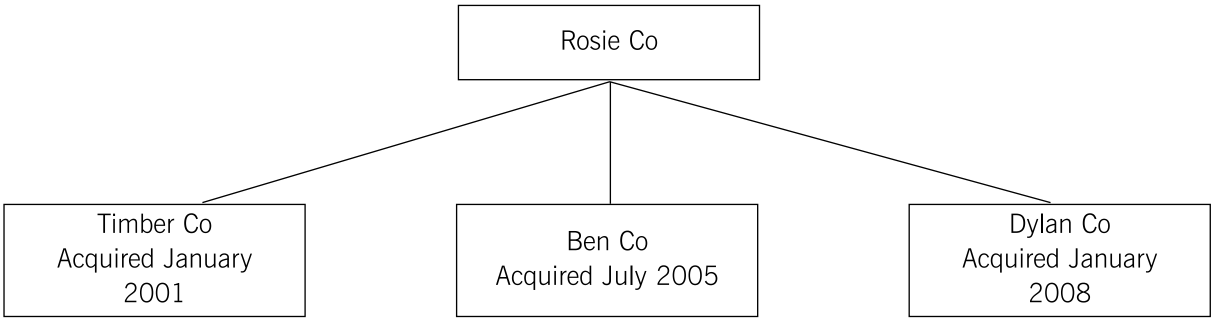
(ii) Identify and explain the potential financial statement risks caused by the breach of planning regulations discussed in the press cutting. (6 marks)

(c) Prepare briefing notes, to be used by an audit partner in your firm, assessing the professional, ethical and other issues to be considered in deciding whether to proceed with the appointment as auditor of Medix Co.

Note: requirement (c) includes 2 professional marks. (12 marks)

(34 marks)

2 Rosie Co is the parent company of an expanding group of companies. The group's main business activity is the manufacture of engine parts. In January 2008 the acquisition of Dylan Co was completed, and the group is currently considering the acquisition of Maxwell Co, a large company which would increase the group's operating facilities by around 40%. All subsidiaries are wholly owned. The group structure is summarised below:



You are an audit manager in Chien & Co, a firm of Certified Public Accountants, and you are reviewing the working papers completed on the final audit of Rosie Co and the Rosie Group for the year ended 31 January 2008. Your firm has audited all current components of the group for several years, but the target company Maxwell Co is audited by a different firm.

The management of Rosie Co has provided the audit team with some information about Maxwell Co to aid business understanding, but little audit work is considered necessary as the acquisition, if it goes ahead, will be after the audit report has been issued. Information provided includes audited financial statements for the year ended 31 January 2008, an organisational structure, several customer contracts, and prospective financial information for the next two years. This seems to be all of the information that the directors of Rosie Co have available. The finance director, Leo Sabat is hoping that the other directors will agree that an externally provided due diligence investigation should be carried out urgently, before any investment decision is made, however the other directors feel this is not needed, as the financial statements of Maxwell Co have already been audited. Leo has asked you to prepare a report to explain to the other directors the purpose of due diligence, and the difference between due diligence and an audit of financial statements, which will be presented at the next board meeting.

Goodwill on the acquisition of Dylan Co is recognised in the consolidated balance sheet at $750,000. The calculation provided by the client is shown below:

	$'000
Cost of Investment:	
Cash consideration	2,500
Deferred consideration payable 31 January 2009	1,500
Contingent consideration payable 31 January 2012 if Dylan Co's revenue grows 5% per annum	1,000
	5,000
Net assets acquired	(4,250)
Goodwill on acquisition	750

All of the figures in the schedule above are material to the financial statements of Rosie Co and the Rosie Group.

Required:

(a) Prepare a report to Leo Sabat (the finance director), in which you should:

(i) Describe the purpose, and evaluate the benefits of a due diligence investigation to the potential purchaser of a company; and (10 marks)

(ii) Compare the scope of a due diligence investigation with that of an audit of financial statements. (4 marks)

Note: requirement (a) includes 2 professional marks.

(b) (i) Explain the matters you should consider, and the evidence you would expect to find in respect of the carrying value of the cost of investment of Dylan Co in the financial statements of Rosie Co; and (7 marks)

(ii) State the principal audit procedures to be performed on the consolidation schedule of the Rosie Group. (4 marks)

(c) Maxwell Co is audited by Lead & Co, a firm of Certified Public Accountants. Leo Sabat has enquired as to whether your firm would be prepared to conduct a joint audit in cooperation with Lead & Co, on the future financial statements of Maxwell Co if the acquisition goes ahead. Leo Sabat thinks that this would enable your firm to improve group audit efficiency, without losing the cumulative experience that Lead & Co has built up while acting as auditor to Maxwell Co.

Required:

Define 'joint audit', and assess the advantages and disadvantages of the audit of Maxwell Co being conducted on a 'joint basis'. (7 marks)

(32 marks)

Section B – TWO questions ONLY to be attempted

3 (a) Discuss why the identification of related parties, and material related party transactions, can be difficult for auditors. (5 marks)

You are an audit manager responsible for providing hot reviews on selected audit clients within your firm of Certified Public Accountants. You are currently reviewing the audit working papers for Pulp Co, a long standing audit client, for the year ended 31 January 2008. The draft balance sheet of Pulp Co shows total assets of $12 million (2007 – $11·5 million).The audit senior has made the following comment in a summary of issues for your review:

'Pulp Co's balance sheet shows a receivable classified as a current asset with a value of $25,000. The only audit evidence we have requested and obtained is a management representation stating the following:

(1) that the amount is owed to Pulp Co from Jarvis Co,
(2) that Jarvis Co is controlled by Pulp Co's chairman, Peter Sheffield, and
(3) that the balance is likely to be received six months after Pulp Co's year end.

The receivable was also outstanding at the last year end when an identical management representation was provided, and our working papers noted that because the balance was immaterial no further work was considered necessary. No disclosure has been made in the financial statements regarding the balance. Jarvis Co is not audited by our firm and we have verified that Pulp Ltd does not own any shares in Jarvis Co.'

Required:

(b) In relation to the receivable recognised on the balance sheet of Pulp Co as at 31 January 2008:

(i) Comment on the matters you should consider. (5 marks)

(ii) Recommend further audit procedures that should be carried out. (4 marks)

(c) Discuss the quality control issues raised by the audit senior's comments. (3 marks)

(17 marks)

4 You are an audit manager in Smith & Co, a firm of Certified Public Accountants. You have recently been made responsible for reviewing invoices raised to clients and for monitoring your firm's credit control procedures. Several matters came to light during your most recent review of client invoice files:

Norman Co, a large private company, has not paid an invoice from Smith & Co dated 5 June 2007 for work in respect of the financial statement audit for the year ended 28 February 2007. A file note dated 30 November 2007 states that Norman Co is suffering poor cash flows and is unable to pay the balance. This is the only piece of information in the file you are reviewing relating to the invoice. You are aware that the final audit work for the year ended 28 February 2008, which has not yet been invoiced, is nearly complete and the audit report is due to be issued imminently.

Wallace Co, a private company whose business is the manufacture of industrial machinery, has paid all invoices relating to the recently completed audit planning for the year ended 31 May 2008. However, in the invoice file you notice an invoice received by your firm from Wallace Co. The invoice is addressed to Valerie Hobson, the manager responsible for the audit of Wallace Co. The invoice relates to the rental of an area in Wallace Co's empty warehouse, with the following comment handwritten on the invoice: '*rental space being used for storage of Ms Hobson's speedboat for six months – she is our auditor, so only charge a nominal sum of $100*'. When asked about the invoice, Valerie Hobson said that the invoice should have been sent to her private address. You are aware that Wallace Co sometimes uses the empty warehouse for rental income, though this is not the main trading income of the company.

In the 'miscellaneous invoices raised' file, an invoice dated last week has been raised to Software Supply Co, not a client of your firm. The comment box on the invoice contains the note '*referral fee for recommending Software Supply Co to several audit clients regarding the supply of bespoke accounting software*'.

Required:

Identify and discuss the ethical and other professional issues raised by the invoice file review, and recommend what action, if any, Smith & Co should now take in respect of:

(a) Norman Co; (8 marks)

(b) Wallace Co; and (5 marks)

(c) Software Supply Co. (4 marks)

(17 marks)

5 You are the manager responsible for the audit of Blod Co, a listed company, for the year ended 31 March 2008. Your firm was appointed as auditors of Blod Co in September 2007. The audit work has been completed, and you are reviewing the working papers in order to draft a report to those charged with governance. The balance sheet shows total assets of $78 million (2007 – $66 million). The main business activity of Blod Co is the manufacture of farm machinery.

During the audit of property, plant and equipment it was discovered that controls over capital expenditure transactions had deteriorated during the year. Authorisation had not been gained for the purchase of office equipment with a cost of $225,000. No material errors in the financial statements were revealed by audit procedures performed on property, plant and equipment.

An internally generated brand name has been included in the balance sheet at a fair value of $10 million. Audit working papers show that the matter was discussed with the financial controller, who stated that the $10 million represents the present value of future cash flows estimated to be generated by the brand name. The member of the audit team who completed the work programme on intangible assets has noted that this treatment appears to be in breach of HKAS 38 *Intangible Assets*, and that the management refuses to derecognise the asset.

Problems were experienced in the audit of inventories. Due to an oversight by the internal auditors of Blod Co, the external audit team did not receive a copy of inventory counting procedures prior to attending the count. This caused a delay at the beginning of the inventory count, when the audit team had to quickly familiarise themselves with the procedures. In addition, on the final audit, when the audit senior requested documentation to support the final inventory valuation, it took two weeks for the information to be received because the accountant who had prepared the schedules had mislaid them.

Required:

(a) (i) Identify the main purpose of including 'findings from the audit' (management letter points) in a report to those charged with governance. (2 marks)

(ii) From the information provided above, recommend the matters which should be included as 'findings from the audit' in your report to those charged with governance, and explain the reason for their inclusion. (7 marks)

The finance director of Blod Co, Uma Thorton, has requested that your firm type the financial statements in the form to be presented to shareholders at the forthcoming company general meeting. Uma has also commented that the previous auditors did not use a liability disclaimer in their audit report, and would like more information about the use of liability disclaimer paragraphs.

Required:

(b) Discuss the ethical issues raised by the request for your firm to type the financial statements of Blod Co. (3 marks)

(c) In the context of a standard unmodified audit report, describe the content of a liability disclaimer paragraph, and discuss the main arguments for and against the use of a liability disclaimer paragraph. (5 marks)

(17 marks)

End of Question Paper