

Professional Level – Options Module

# Advanced Audit and Assurance (Hong Kong)

Tuesday 8 December 2009

**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 (a) HKSA 520 *Analytical Procedures* requires that the auditor performs analytical procedures during the initial risk assessment stage of the audit. These procedures, also known as preliminary analytical review, are usually performed before the year end, as part of the planning of the final audit.

**Required:**

- (i) **Explain, using examples, the reasons for performing analytical procedures as part of risk assessment; and**
- (ii) **Discuss the limitations of performing analytical procedures at the planning stage of the final audit.**

(6 marks)

- (b) **Explain and differentiate between the terms ‘overall audit strategy’ and ‘audit plan’.** (4 marks)

You are the manager responsible for the audit of Papaya Co, a listed company, which operates a chain of supermarkets, with a year ending 31 December 2009. There are three business segments operated by the company – two segments are supermarket chains which operate under internally generated brand names, and the third segment is a new financial services division.

The first business segment comprises stores branded as ‘Papaya Mart’. This segment makes up three-quarters of the supermarkets of the company, and are large ‘out of town’ stores, located on retail parks on the edge of towns and cities. These stores sell a wide variety of items, including food and drink, clothing, household goods, and electrical appliances. In September 2009, the first overseas Papaya Mart opened in Farland. This expansion was a huge drain on cash resources, as it involved significant capital expenditure, as well as an expensive advertising campaign to introduce the Papaya Mart brand in Farland.

The second business segment comprises the rest of the supermarkets, which are much smaller stores, located in city centres, and branded as ‘Papaya Express’. The Express stores offer a reduced range of products, focussing on food and drink, especially ready meals and other convenience items.

The company also established a financial services division on 1 January 2009, which offers loans, insurance services and credit cards to customers.

The following information was provided during a recent meeting held with the finance director of Papaya Co. All of the matters outlined in the notes below are potentially material to the financial statements.

**Notes from meeting held 29 November 2009**

On 31 August 2009, Papaya Co received notice from a government body that it is under investigation, along with three other companies operating supermarket chains, for alleged collusion and price fixing activities. If it is found guilty, significant financial penalties will be imposed on Papaya Co. The company is vigorously defending its case.

To help cash flows in a year of expansion, the company raised finance by issuing debentures which are potentially convertible into equity on maturity in 2015.

To manage the risk associated with overseas expansion, in October 2009, the company entered for the first time into several forward exchange contracts which end in February 2010. The contracts were acquired at no cost to Papaya Co and are categorised as ‘fair value through profit or loss’ financial instruments.

The property market has slumped this year, and significant losses were made on the sale of some plots of land which were originally acquired for development potential. The decision to sell the land was made as it is becoming increasingly difficult for the company to receive planning permission to build supermarkets on the land. Land is recognised at cost in the statement of financial position.

Papaya Co has 35 warehouses which store non-perishable items of inventory. Due to new regulation, each warehouse is required to undergo a major health and safety inspection every three years. All warehouses were inspected in January 2009, at a cost of \$25,000 for each inspection.

Using the specific information provided in respect of Papaya Co:

(c) Explain the information that you would require in order to perform analytical procedures during the planning of the audit. (6 marks)

(d) Assess the financial statements risks to be addressed when planning the final audit for the year ending 31 December 2009, producing your answer in the form of briefing notes to be used at the audit planning meeting. (16 marks)

Professional marks will be awarded in part (d) for the format of the answer, and for the clarity of assessment provided. (2 marks)

**(34 marks)**

- 2 You are a manager in Grape & Co, a firm of Certified Public Accountants. You have been temporarily assigned as audit manager to the audit of Banana Co, because the engagement manager has been taken ill. The final audit of Banana Co for the year ended 30 September 2009 is nearing completion, and you are now reviewing the audit files and discussing the audit with the junior members of the audit team. Banana Co designs and manufactures equipment such as cranes and scaffolding, which are used in the construction industry. The equipment usually follows a standard design, but sometimes Banana Co designs specific items for customers according to contractually agreed specifications. The draft financial statements show revenue of \$12.5 million, net profit of \$400,000, and total assets of \$78 million.

The following information has come to your attention during your review of the audit files:

During the year, a new range of manufacturing plant was introduced to the factories operated by Banana Co. All factory employees received training from an external training firm on how to safely operate the machinery, at a total cost of \$500,000. The training costs have been capitalised into the cost of the new machinery, as the finance director argues that the training is necessary in order for the machinery to generate an economic benefit.

After the year end, Cherry Co, a major customer with whom Banana Co has several significant contracts, announced its insolvency, and that procedures to shut down the company had commenced. The administrators of Cherry Co have suggested that the company may be able to pay approximately 25% of the amounts owed to its trade payables. A trade receivable of \$300,000 is recognised on Banana Co's statement of financial position in respect of this customer.

In addition, one of the junior members of the audit team voiced concerns over how the audit had been managed. The junior said the following:

'I have only worked on two audits prior to being assigned to the audit team of Banana Co. I was expecting to attend a meeting at the start of the audit, where the partner and other senior members of the audit team discussed the audit, but no meeting was held. In addition, the audit manager has been away on holiday for three weeks, and left a senior in charge. However, the senior was busy with other assignments, so was not always available.

I was given the task of auditing the goodwill which arose on an acquisition made during the year. I also worked on the audit of inventory, and attended the inventory count, which was quite complicated, as Banana Co has a lot of work-in-progress. I tried to be as useful as possible during the count, and helped the client's staff count some of the raw materials. As I had been to the inventory count, I was asked by the audit senior to challenge the finance director regarding the adequacy of the provision against inventory, which the senior felt was significantly understated.

Lastly, we found that we were running out of time to complete our audit procedures. The audit senior advised that we should reduce the sample sizes used in our tests as a way of saving time. He also suggested that if we picked an item as part of our sample for which it would be time consuming to find the relevant evidence, then we should pick a different item which would be quicker to audit.'

**Required:**

**In respect of the specific information provided:**

- (a) **Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of:**
- (i) **The training costs that have been capitalised into the cost of the new machinery; and**
  - (ii) **The trade receivable recognised in relation to Cherry Co.** (12 marks)
- (b) **Evaluate the audit junior's concerns regarding the management of the audit of Banana Co.** (10 marks)

- (c) There are specific regulatory obligations imposed on accountants and auditors in relation to detecting and reporting money laundering activities. You have been asked to provide a training session to the new audit juniors on auditors' responsibilities in relation to money laundering.

**Required:**

**Prepare briefing notes to be used at your training session in which you:**

- (i) Explain the term 'money laundering'. Illustrate your explanation with examples of money laundering offences, including those which could be committed by the accountant; and
- (ii) Explain the policies and procedures that a firm of Certified Public Accountants should establish in order to meet its responsibilities in relation to money laundering. (10 marks)

Professional marks will be awarded in part (c) for the format of the answer, and the quality of the explanations provided. (2 marks)

**(34 marks)**

**Section B – TWO questions ONLY to be attempted**

**3** Your audit client, Apricot Co, is intending to purchase a new warehouse at a cost of \$500,000. One of the directors of the company, Pik Choi, has agreed to make the necessary finance available through a director's loan to the company. This arrangement has been approved by the other directors, and the cash will be provided on 30 March 2010, one day before the purchase is due to be completed. Pik's financial advisor has asked to see a cash flow projection of Apricot Co for the next three months. Your firm has been asked to provide an assurance report to Pik's financial advisor on this prospective financial information.

The cash flow forecast is shown below:

	January 2010 \$'000	February 2010 \$'000	March 2010 \$'000
<b>Operating cash receipts:</b>			
Cash sales	125	135	140
Receipts from credit sales	580	600	625
<b>Operating cash payments:</b>			
Purchases of inventory	(410)	(425)	(425)
Salaries	(100)	(100)	(100)
Overheads	(175)	(175)	(175)
<b>Other cash flows:</b>			
Dividend payment		(80)	
Purchase of new licence	(35)		
Fixtures for new warehouse			(60)
Loan receipt			500
Payment for warehouse			(500)
<b>Cash flow for the month</b>	(15)	(45)	5
Opening cash	100	85	40
<b>Closing cash</b>	85	40	45

The following information is relevant:

- Apricot Co is a wholesaler of catering equipment and frozen food. Its customers are mostly restaurant chains and fast food outlets.
- Customers who pay in cash receive a 10% discount. Analysis has been provided showing that for sales made on credit, 20% of customers pay in the month of the sale, 60% pay after 45 days, 10% after 65 days, 5% after 90 days, and the remainder are bad debts.
- Apricot Co pays for all purchases within 30 days in order to take advantage of a 12% discount from suppliers.
- Overheads are mainly property rentals, utility bills, insurance premiums and general office expenses.
- Apricot Co needs to have a health and safety licence as it sells food. Each licence is valid for one year and is issued once an inspection has taken place.
- A profit forecast has also been prepared for the year ending 31 December 2010 to help with internal planning and budgeting.

This is the first time that Apricot Co has requested an assurance report, and the directors are unsure about the contents of the report that your firm will issue. They understand that it is similar in format to an audit report, but that the specific contents are not the same.

**Required:**

**(a) Recommend the procedures that should be performed on the cash flow forecast for the three months ending 31 March 2010 in order to provide an assurance report as requested by Apricot Co.** (11 marks)

**(b) Explain the main contents of the report that will be issued on the prospective financial information.** (5 marks)

**(16 marks)**

- 4 (a) As a result of the International Audit and Assurance Standards Board's Clarity Project, many revised and redrafted ISAs that have been issued will become effective for audits of financial statements for periods beginning on or after 15 December 2009. One of the objectives of the Clarity Project is to clarify mandatory requirements. This has been done by changing the wording used in the ISAs to indicate requirements which are expected to be applied in all audits. Some argue that this will introduce a more prescriptive (rules-based) approach to auditing, and that a principles-based approach is more desirable.

**Required:**

- (i) **Contrast the prescriptive and the principles-based approaches to auditing; and** (2 marks)
- (ii) **Outline the arguments for and against a prescriptive (rules-based) approach to auditing.** (5 marks)
- (b) You are a manager in the audit department of Peaches & Co, a firm of Certified Public Accountants. One of your responsibilities is to act as a mentor to new recruits into the department. A new junior auditor, Glen Rambaran, has asked you to answer some questions which relate to issues encountered in his first few weeks working at Peaches & Co. The questions are shown below:
- (i) When I was on my initial training course, there was a session on ethics in which the presenter talked about being intimidated by a client. I assume this does not mean physical intimidation, so what is an intimidation threat? (3 marks)
- (ii) I know that Peaches & Co is facing competition from a new audit firm, and that our firm is advertising its services in a national newspaper. What are the rules on advertising for new clients? (3 marks)
- (iii) I heard one of the audit managers say that our firm had lost an audit client to a competitor because of lowballing. What is lowballing and is it allowed? (3 marks)

**Required:**

**For each of the three questions raised, provide a response to the audit junior, in which you identify and explain the ethical or professional issue raised.**

**(16 marks)**

5 (a) Guidance on subsequent events is given in HKSA 560 (Revised) *Subsequent Events*.

**Required:**

**Explain the auditor's responsibility in relation to subsequent events.**

(6 marks)

(b) You are the manager responsible for the audit of Lychee Co, a manufacturing company with a year ended 30 September 2009. The audit work has been completed and reviewed and you are due to issue the audit report in three days. The draft audit opinion is unmodified. The financial statements show revenue for the year ended 30 September 2009 of \$15 million, net profit of \$3 million, and total assets at the year end are \$80 million.

The finance director of Lychee Co telephoned you this morning to tell you about the announcement yesterday, of a significant restructuring of Lychee Co, which will take place over the next six months. The restructuring will involve the closure of a factory, and its relocation to another part of the country. There will be some redundancies and the estimated cost of closure is \$250,000. The financial statements have not been amended in respect of this matter.

**Required:**

**In respect of the announcement of the restructuring:**

(i) **Comment on the financial reporting implications, and advise the further audit procedures to be performed; and**

(6 marks)

(ii) **Recommend the actions to be taken by the auditor if the financial statements are not amended.**

(4 marks)

**(16 marks)**

**End of Question Paper**