Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Tuesday 7 December 2010

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 Jolie Co is a large company, operating in the retail industry, with a year ended 30 November 2010. You are a manager in Jen & Co, responsible for the audit of Jolie Co, and you have recently attended a planning meeting with Mo Pitt, the finance director of the company. As this is the first year that your firm will be acting as auditor for Jolie Co, you need to gain an understanding of the business risks facing the new client. Notes from your meeting are as follows:

Jolie Co sells clothing, with a strategy of selling high fashion items under the JLC brand name. New ranges of clothes are introduced to stores every eight weeks. The company relies on a team of highly skilled designers to develop new fashion ranges. The designers must be able to anticipate and quickly respond to changes in consumer preferences. There is a high staff turnover in the design team.

Most sales are made in-store, but there is also a very popular catalogue, from which customers can place an order on-line, or over the phone. The company has recently upgraded the computer system and improved the website, at significant cost, in order to integrate the website sales directly into the general ledger, and to provide an easier interface for customers to use when ordering and entering their credit card details. The new on-line sales system has allowed overseas sales for the first time.

The system for phone ordering has recently been outsourced. The contract for outsourcing went out to tender and Jolie Co awarded the contract to the company offering the least cost. The company providing the service uses an overseas phone call centre where staff costs are very low.

Jolie Co has recently joined the Ethical Trading Initiative. This is a 'fair-trade' initiative, which means that any products bearing the JLC brand name must have been produced in a manner which is clean and safe for employees, and minimises the environmental impact of the manufacturing process. A significant advertising campaign promoting Jolie Co's involvement with this initiative has recently taken place. The JLC brand name was purchased a number of years ago and is recognised at cost as an intangible asset, which is not amortised. The brand represents 12% of the total assets recognised on the statement of financial position.

The company owns numerous distribution centres, some of which operate close to residential areas. A licence to operate the distribution centres is issued by each local government authority in which a centre is located. One of the conditions of the licence is that deliveries must only take place between 8 am and 6 pm. The authority also monitors the noise level of each centre, and can revoke the operating licence if a certain noise limit is breached. Two licences were revoked for a period of three months during the year.

To help your business understanding, Mo Pitt has e-mailed to you extracts from the draft statement of comprehensive income, and the relevant comparative figures, which are shown below.

Extract from draft statement of comprehensive income

Year ending 30 November	**2010 Draft $ million**	**2009 Actual $ million**
Revenue:		
Retail outlets	1,030	1,140
Phone and on-line sales	425	395
Total revenue	**1,455**	**1,535**
Operating profit	245	275
Finance costs	(25)	(22)
Profit before tax	**220**	**253**
Additional information:		
Number of stores	210	208
Average revenue per store	$4·905 million	$5·77 million
Number of phone orders	680,000	790,000
Number of on-line orders	1,020,000	526,667
Average spend per order	$250	$300

Required:

(a) Prepare briefing notes to be used at a planning meeting with your audit team, in which you evaluate the business risks facing Jolie Co to be considered when planning the final audit for the year ended 30 November 2010. (15 marks)

Professional marks will be awarded in part (a) for the format of the answer and the clarity of the evaluation. (2 marks)

(b) Using the information provided, identify and explain FIVE financial statement risks. (10 marks)

(c) Recommend the principal audit procedures to be performed in respect of the valuation of the JLC brand name. (5 marks)

(32 marks)

2 You are a manager in Newman & Co, a global firm of Certified Public Accountants. You are responsible for evaluating proposed engagements and for recommending to a team of partners whether or not an engagement should be accepted by your firm.

Eastwood Co, a listed company, is an existing audit client and is an international mail services operator, with a global network including 220 countries and 300,000 employees. The company offers mail and freight services to individual and corporate customers, as well as storage and logistical services.

Eastwood Co takes its corporate social responsibility seriously, and publishes social and environmental key performance indicators (KPIs) in a Sustainability Report, which is published with the financial statements in the annual report. Partly in response to requests from shareholders and pressure groups, Eastwood Co's management has decided that in the forthcoming annual report, the KPIs should be accompanied by an independent assurance report. An approach has been made to your firm to provide this report in addition to the audit.

To help in your evaluation of this potential engagement, you have been given an extract from the draft Sustainability Report, containing some of the KPIs published by Eastwood Co. In total, 25 environmental KPIs, and 50 social KPIs are disclosed.

Extract from Sustainability Report	Year ended 31 October 2010 DRAFT	Year ended 31 October 2009 ACTUAL
CO_2 emissions (million tonnes)	26·8	28·3
Energy use (million kilowatt hours)	4,895	5,250
Charitable donations ($ million)	10·5	8·2
Number of serious accidents in the workplace	60	68
Average annual spend on training per employee	$180	$175

You have also had a meeting with Ali Monroe, the manager responsible for the audit of Eastwood Co, and notes of the meeting are given below.

Notes from meeting with audit manager, Ali Monroe

Newman & Co has audited Eastwood Co for three years, and it is a major audit client of our firm, due to its global presence and recent listing on two major stock exchanges. The audit is managed from our office in Oldtown, which is also the location of the global headquarters of Eastwood Co.

We have not done any work on the KPIs, other than review them for consistency, as we would with any 'other information' issued with the financial statements. The KPIs are produced by Eastwood Co's Sustainability Department, located in Fartown. We have not visited Eastwood Co's offices in Fartown as it is in a remote location overseas, and the departments based there are not relevant to the audit.

We have performed audit procedures on the charitable donations, as this is disclosed in a note to the financial statements, and our evidence indicates that there have been donations of $9 million this year, which is the amount disclosed in the note. However, the draft KPI is a different figure – $10·5 million, and this is the figure highlighted in the draft Chairman's Statement as well as the draft Sustainability Report. $9 million is material to the financial statements.

The audit work is nearly complete, and the annual report is to be published in about four weeks, in time for the company meeting, scheduled for 31 January 2011.

Your firm has recently established a sustainability reporting assurance team based in Oldtown, and if the engagement to report on the Sustainability Report is accepted, it would be performed by members of that team, who would not be involved with the audit.

Required:

(a) **Identify and explain the matters that should be considered in evaluating the invitation to perform an assurance engagement on the Sustainability Report of Eastwood Co.** (12 marks)

(b) **Recommend procedures that could be used to verify the following draft KPIs:**

(i) **The number of serious accidents in the workplace; and**

(ii) **The average annual spend on training per employee.** (6 marks)

(c) You have a trainee accountant assigned to you, who has read the notes taken at your meeting with Ali Monroe. She is unsure of the implications of the charitable donations being disclosed as a different figure in the financial statements compared with the other information published in the annual report.

Required:

Prepare briefing notes to be used in a discussion with the trainee accountant, in which you:

(i) **Explain the responsibility of the auditor in relation to other information published with the financial statements; and**

(ii) **Recommend the action to be taken by Newman & Co if the figure relating to charitable donations in the other information is not amended.** (8 marks)

Professional marks will be awarded in part (c) for the format and clarity of your answer. (2 marks)

(28 marks)

Section B – TWO questions ONLY to be attempted

3 Clooney Co is one of the world's leading leisure travel providers, operating under several brand names to sell package holidays. The company catered for more than 10 million customers in the last 12 months. Draft figures for the year ended 30 September 2010 show revenue of $3,200 million, profit before tax of $150 million, and total assets of $4,100 million. Clooney Co's executives earn a bonus based on the profit before tax of the company.

You are the manager responsible for the audit of Clooney Co. The final audit is nearing completion, and the following points have been noted by the audit senior for your attention:

In July 2010, thousands of holiday-makers were left stranded abroad after the company operating the main airline chartered by Clooney Co went into liquidation. The holiday-makers were forced to wait an average of two weeks before they could be returned home using an alternative airline. They have formed a group which is claiming compensation for the time they were forced to spend abroad, with the total claim amounting to $20 million. The items which the group is claiming compensation for include accommodation and subsistence costs, lost income and distress caused by the situation. The claim has not been recognised or disclosed in the draft financial statements, as management argues that the full amount payable will be covered by Clooney Co's insurance.

One part of the company's activities, operating under the Shelly's Cruises brand, provides cruise holidays. Due to economic recession, the revenue of the Shelly's Cruises business segment has fallen by 25% this year, and profit before tax has fallen by 35%. Shelly's Cruises contributed $640 million to total revenue in the year to 30 September 2010, and has identifiable assets of $235 million, including several large cruise liners. The Shelly's Cruises brand is not recognised as an intangible asset, as it has been internally generated.

On 15 November 2010, Clooney Co acquired Craig Co, a company offering adventure holidays for independent travellers. Craig Co represents a significant acquisition, but this has not been referred to in the financial statements.

Required:

Comment on the matters that you should consider, and state the audit evidence you should expect to find in your review of the audit working papers for the year ended September 2010 in respect of:

(a) The compensation claim, (8 marks)

(b) Shelly's Cruises, and (7 marks)

(c) The acquisition of Craig Co. (5 marks)

(20 marks)

4 **(a)** You are a manager in Neeson & Co, a firm of Certified Public Accountants, with three offices and 12 partners. About one third of the firm's clients are audit clients, the remainder are clients for whom Neeson & Co performs tax, accounting and business advisory services. The firm is considering how to generate more revenue, and you have been asked to evaluate two suggestions made by the firm's business development manager.

(i) An advertisement could be placed in national newspapers to attract new clients. The draft advertisement has been given to you for review:

> Neeson & Co is the largest and most professional accountancy and audit provider in the country. We offer a range of services in addition to audit, which are guaranteed to improve your business efficiency and save you tax.
>
> If you are unhappy with your auditors, we can offer a second opinion on the report that has been given.
>
> Introductory offer: for all new clients we offer a 25% discount when both audit and tax services are provided. Our rates are approved by ACCA.

(8 marks)

(ii) A new partner with experience in the banking sector has joined Neeson & Co. It has been suggested that the partner could specialise in offering a corporate finance service to clients. In particular, the partner could advise clients on raising debt finance, and would negotiate with the client's bank or other provider of finance on behalf of the client. The fee charged for this service would be contingent on the client obtaining the finance with a borrowing cost below market rate. (5 marks)

Required:

Evaluate each of the suggestions made above, commenting on the ethical and professional issues raised.

Note: the mark allocation is shown against each of the issues.

(b) You have set up an internal discussion board, on which current issues are debated by employees and partners of Neeson & Co. One posting to the board concerned the compulsory rotation of audit firms, whereby it has been suggested in the press that after a pre-determined period, an audit firm must resign from office, to be replaced by a new audit provider.

Required:

(i) **Explain the ethical threats created by a long association with an audit client.** (3 marks)

(ii) **Evaluate the advantages and disadvantages of compulsory audit firm rotation.** (4 marks)

(20 marks)

5 **(a)** You are the manager responsible for the audit of Willis Co, a large client of your audit firm, operating in the pharmaceutical industry. The audit work for the year ended 30 August 2010 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. You are aware that Willis Co is developing a new drug and has incurred significant research and development costs during the year, most of which have been capitalised as an intangible asset. The asset is recognised at a value of $4·4 million, the total assets recognised on the draft statement of financial position are $55 million, and Willis Co has a draft profit before tax of $3·1 million.

Having reviewed the audit working papers, you are also aware that management has not allowed the audit team access to the results of scientific tests and trials performed on the new drug being developed.

An extract from the draft audit report is shown below.

> Basis of opinion (extract)
>
> Evidence available to us in respect of the intangible asset capitalised was limited, because of restrictions imposed on our work by management. As a result of this we have been unable to verify the appropriateness of the amount capitalised, and we are worried that the asset may be overvalued. Because of the significance of the item, and the lack of integrity shown by management, we have been unable to form a view on the financial statements as a whole.
>
> Opinion (extract): Disclaimer on view given by financial statements
>
> Because of the lack of evidence that we could gain over the intangible asset, we are unable to form an opinion as to whether the financial statements are properly prepared in accordance with the relevant financial reporting framework.

Required:

(i) **Critically appraise the draft audit report of Willis Co for the year ended 30 August 2010, prepared by the audit senior;**

Note: You are NOT required to re-draft the extracts from the audit report. (10 marks)

(ii) **Identify and explain any other matters to be considered, and the actions to be taken by the auditor, in respect of the management-imposed limitation on scope.** (5 marks)

(b) You are also responsible for the audit of Moore Co, with a year ended 30 September 2010. The following notes have been left for your attention by the audit senior:

'Our audit testing performed so far on trade payables revealed some internal control deficiencies. Supplier statement reconciliations have not always been performed by the client, and invoices were often not approved before payment. We have found a few errors in the payables ledger and the individual accounts of suppliers making up the trade payables balance, the total of which is material to the statement of financial position.'

Required:

Recommend the further actions that should be taken by the auditor, and outline any reporting requirements in respect of the internal control deficiencies identified. (5 marks)

(20 marks)

End of Question Paper