

Professional Level – Options Module

# Advanced Audit and Assurance (Hong Kong)

Tuesday 8 June 2010

**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)

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** You are a senior audit manager in Vegas & Co, responsible for the audit of the Grissom Group, which has been an audit client for several years. The group companies all have a financial year ending 30 June 2010, and you are currently planning the final audit of the consolidated financial statements. The group's operations focus on the manufacture and marketing of confectionery and savoury snacks. Information about several matters relevant to the group audit is given below. These matters are all potentially material to the consolidated financial statements. None of the companies in the group are listed.

### **Grissom Co**

This is a non-trading parent company, which wholly owns three subsidiaries – Willows Co, Hodges Co and Brass Co, all of which are involved with the core manufacturing and marketing operations of the group. This year, the directors decided to diversify the group's activities in order to reduce risk exposure. Non-controlling interests representing long-term investments have been made in two companies – an internet-based travel agent, and a chain of pet shops. In the consolidated statement of financial position, these investments are accounted for as associates, as Grissom Co is able to exert significant influence over the companies.

As part of their remuneration, the directors of Grissom Co receive a bonus based on the profit before tax of the group. In April 2010, the group finance director resigned from office after a disagreement with the chief executive officer over changes to accounting estimates. A new group finance director is yet to be appointed.

### **Willows Co**

This company manufactures and distributes chocolate bars and cakes. In July 2009, production was relocated to a new, very large factory. One of the conditions of the planning permission for the new factory is that Willows Co must, at the end of the useful life of the factory, dismantle the premises and repair any environmental damage caused to the land on which it is situated.

### **Hodges Co**

This company's operations involve the manufacture and distribution of packaged nuts and dried fruit. The government paid a grant in November 2009 to Hodges Co, to assist with costs associated with installing new, environmentally friendly, packing lines in its factories. The packing lines must reduce energy use by 25% as part of the conditions of the grant, and they began operating in February 2010.

### **Brass Co**

This company is a new and significant acquisition, purchased in January 2010. It is located overseas, in Chocland, a developing country, and has been purchased to supply cocoa beans, a major ingredient for the goods produced by Willows Co. It is now supplying approximately half of the ingredients used in Willow Co's manufacturing. Chocland has not adopted Hong Kong Financial Reporting Standards, meaning that Brass Co's financial statements are prepared using local accounting rules. The company uses local currency to measure and present its financial statements.

### **Further information**

Your firm audits all components of the group with the exception of Brass Co, which is audited by a small local firm, Sidle & Co, based in Chocland. Audit regulations in Chocland are not based on Hong Kong Standards on Auditing.

**Required:**

- (a) Using the information provided, prepare briefing notes to be used in a discussion with your audit team, in which you evaluate the principal audit risks to be considered in your planning of the final audit of the consolidated financial statements for the year ending 30 June 2010.

Note: Ignore those risks that relate to reliance on another auditor. (18 marks)

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

- (b) Explain the factors that should be considered, and the procedures that should be performed, in deciding the extent of reliance to be placed on the work of Sidle & Co. (8 marks)

- (c) Recommend the principal audit procedures that should be performed on:

(i) The classification of non-controlling investments made by Grissom Co; (4 marks)

(ii) The condition attached to the grant received by Hodges Co. (4 marks)

**(36 marks)**

- 2 Mac Co is a large, private company, whose business activity is events management, involving the organisation of conferences, meetings and celebratory events for companies. Mac Co was founded 10 years ago by Danny Hudson and his sister, Stella, who still own the majority of the company's shares. The company has grown rapidly and now employs more than 150 staff in 20 offices.

You are a manager in the business advisory department of Flack & Co. Your firm has just been engaged to provide the internal audit service to Mac Co. In your initial conversation with Danny and Stella, you discovered that currently there is a small internal audit team, under the supervision of Lindsay Montana, a recently qualified accountant. Before heading up the internal audit department, Lindsay was a junior finance manager of the company. The members of the internal audit team will be reassigned to roles in the finance department once your firm has commenced the provision of the internal audit service.

Mac Co is not an existing client of your firm, and to gain further understanding of the company, you held a meeting with Lindsay Montana. Notes from this meeting are shown below.

**Notes of meeting held with Lindsay Montana on 1 June 2010**

The internal audit team has three employees, including Lindsay, who reports to the finance director. The other two internal auditors are currently studying for their professional examinations. The team was set up two years ago, and initially focused on introducing financial controls across all of Mac Co's offices. Nine months ago the finance director instructed the team to focus their attention on introducing operational controls in order to achieve cost savings due to a cash flow problem being suffered by the company. The team does not have time to perform much testing of financial or operational controls.

In the course of her work, Lindsay finds many instances of management policies not being adhered to, and the managers of each location are generally reluctant to introduce controls as they want to avoid bureaucracy and paperwork. As a result, Lindsay's recommendations are often ignored.

Three weeks ago, Lindsay discovered a fraud operating at one of the offices while reviewing the procedures relating to the approval of new suppliers and payments made to suppliers. The fraud involved an account manager authorising the payment of invoices received from fictitious suppliers, with payment actually being made into the account manager's personal bank account. Lindsay reported the account manager to the finance director, and the manager was immediately removed from office. This situation has highlighted to Danny and Stella that something needs to be done to improve controls within their organisation.

Danny and Stella are considering taking legal action against Mac Co's external audit provider, Manhattan & Co, because their audit procedures did not reveal the fraud.

Danny and Stella are deciding whether to set up an audit committee. Mac Co is not required to have an audit committee, but a disclosure note explaining whether an audit committee has been established is included in the annual report.

**Required:**

- (a) **Evaluate the benefits specific to Mac Co of outsourcing its internal audit function.** (6 marks)
- (b) **Explain the potential impacts on the external audit of Mac Co if the decision is taken to outsource its internal audit function.** (4 marks)
- (c) **Recommend procedures that could be used by your firm to quantify the financial loss suffered by Mac Co as a result of the fraud.** (4 marks)
- (d) **Prepare a report to be presented to Danny and Stella in which you:**
- (i) **Compare the responsibilities of the external auditor and of management in relation to the prevention and detection of fraud; and** (4 marks)
- (ii) **Assess the benefits and drawbacks for Mac Co in establishing an audit committee.** (4 marks)

Professional marks will be awarded in respect of requirement (d) for the presentation of your answer, and the clarity of your discussion. (2 marks)

**(24 marks)**

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

- 3 (a) Auditors should accept some of the blame when a company on which they have expressed an unmodified audit opinion subsequently fails, and they should also do more to highlight going concern problems being faced by a company.

**Required:**

**Discuss this statement.**

(8 marks)

- (b) You are the manager responsible for the audit of Juliet Co, and you are planning the final audit of the financial statements for the year ending 30 June 2010. Juliet Co is a supplier of components used in the manufacture of vehicle engines. Due to a downturn in the economy, and in the automotive industry particularly, the company has suffered a decline in sales and profitability over the last two years, mainly due to the loss of several key customer contracts. Many of Juliet Co's non-current assets are impaired in value, and a significant number of receivables balances have been written off in the last six months.

In response to the deteriorating market conditions, the management of Juliet Co decided to restructure the business. The main manufacturing facility will be reduced in size by two-thirds, and investment will be made in new technology to make the remaining operations more efficient, and to enable the manufacture of a wider variety of components for use in different types of engines and machinery. In order to fund this restructuring, the management of Juliet Co approached the company's bank with a request for a significant loan. You are aware that without the loan, Juliet Co is unlikely to be able to restructure successfully, which will raise significant doubt over its ability to continue as a going concern.

Your firm has been asked to advise on the necessary forecasts and projections that the bank will need to see in order to make a decision regarding the finance requested. Management has also requested that your firm attend a meeting with the bank at which the forecasts will be discussed.

**Required:**

- (i) **Identify and explain the matters that should be considered, and the principal audit procedures to be performed, in respect of the additional funding being sought.** (6 marks)
- (ii) **Comment on the ethical and other implications of the request for your firm to provide advice on the forecasts and projections, and to attend the meeting with the bank.** (6 marks)

**(20 marks)**

- 4 You are a manager in the audit department of Carter & Co, and you are dealing with several ethical and professional matters raised at recent management meetings, all of which relate to audit clients of your firm.
1. Fernwood Co has a year ending 30 June 2010. During this year, the company established a pension plan for its employees, and this year end the company will be recognising for the first time a pension deficit on the statement of financial position, in accordance with HKAS 19 *Employee Benefits*. The finance director of Fernwood Co has contacted the audit engagement partner, asking if your firm can provide a valuation service in respect of the amount recognised.
  2. The finance director of Hall Co has requested that a certain audit senior, Kia Nelson, be assigned to the audit team. This senior has not previously been assigned to the audit of Hall Co. On further investigation it transpired that Kia Nelson is the sister of Hall Co's financial controller.
  3. Collier Co has until recently kept important documents such as title deeds and insurance certificates in a safe at its head office. However, following a number of thefts from the head office the directors have asked if the documents could be held securely at Carter & Co's premises. The partners of Carter & Co are considering offering a custodial service to all clients, some of whom may want to deposit tangible assets such as paintings purchased as investments for safekeeping. The fee charged for this service would depend on the value of item deposited as well as the length of the safekeeping arrangement.
  4. Several audit clients have requested that Carter & Co provide technical training on financial reporting and tax issues. This is not a service that the firm wishes to provide, and it has referred the audit clients to a training firm, Gates Co, which is paying a referral fee to Carter & Co for each audit client which is referred.

**Required:**

**Identify and evaluate the ethical and other professional issues raised, in respect of:**

- |                  |           |
|------------------|-----------|
| (a) Fernwood Co; | (6 marks) |
| (b) Hall Co;     | (6 marks) |
| (c) Collier Co;  | (5 marks) |
| (d) Gates Co.    | (3 marks) |

**(20 marks)**

- 5 (a) You are the partner responsible for the audit of Grimes Co, for the year ended 30 April 2010. The final audit has been completed and you have asked the audit manager to draft the audit report. The manager is aware that there is guidance for auditors relating to audit reports in HKSA 706 (Clarified) *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report*. The manager has asked for your assistance in this matter.

**Required:**

(i) Define an 'Emphasis of Matter paragraph' and explain, providing examples, the use of such a paragraph; (6 marks)

(ii) Define an 'Other Matter paragraph' and explain, providing examples, the use of such a paragraph.

Note: You are not required to produce draft paragraphs. (4 marks)

- (b) You are also responsible for providing direction to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence. They have also heard that in some countries, it is possible to restrict liability by making a liability limitation agreement with an audit client.

**Required:**

(i) Explain FOUR methods that may be used by an audit firm to reduce exposure to litigation claims; (4 marks)

(ii) Assess the potential implications for the profession, of audit firms signing a liability limitation agreement with their audit clients. (6 marks)

**(20 marks)**

**End of Question Paper**