

Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Monday 5 December 2011

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) You are a manager in Maple & Co, responsible for the audit of Oak Co, a listed company. Oak Co manufactures electrical appliances such as televisions and radios, which are then sold to retail outlets. You are aware that during the last year, Oak Co lost several customer contracts to overseas competitors. However, a new division has been created to sell its products directly to individual customers via a new website, which was launched on 1 November 2011.

You are about to commence planning the audit for the year ending 31 December 2011, and you have received an email from Holly Elm, the audit engagement partner.

To: Audit manager
From: Holly Elm, Audit partner
Subject: Oak Co – audit planning

Hello

(i) I would like you to start planning the audit of Oak Co. You need to perform a preliminary analytical review on the financial information and accompanying notes provided by Rowan Birch, the finance director of Oak Co. Using this information and the results of your analytical review, please prepare notes for inclusion in the planning section of the working papers, which identify and explain the principal audit risks to be considered in planning the final audit. Your notes should include any calculations performed. (23 marks)

(ii) Please also recommend the principal audit procedures which should be performed in respect of:

(1) the recognition and measurement of the share-based payment plan, and
 (2) the classification of the new lease. (8 marks)

Thank you.

Financial information provided by Rowan Birch:

Statement of comprehensive income (extract from management accounts)

	Note	11 months to 30 November 2011 \$'000	11 months to 30 November 2010 \$'000
Revenue		25,700	29,300
Cost of sales		(15,420)	(15,900)
Gross profit		10,280	13,400
Operating expenses	1	(6,200)	(7,750)
Operating profit		4,080	5,650
Finance costs		(1,500)	(1,500)
Profit before tax		2,580	4,150

Statement of financial position

	Note	30 November 2011 \$'000	30 November 2010 \$'000
ASSETS			
Non-current assets			
Property plant and equipment	2, 3	90,000	75,750
Intangible assets	4	1,250	–
		<u>91,250</u>	<u>75,750</u>
Current assets			
Inventory		1,800	1,715
Trade receivables		4,928	4,815
Cash and cash equivalents		100	2,350
		<u>6,828</u>	<u>8,880</u>
Total assets		<u><u>98,078</u></u>	<u><u>84,630</u></u>
EQUITY AND LIABILITIES			
Equity			
Share capital		20,000	20,000
Revaluation reserve	3	10,000	–
Retained earnings		32,278	34,895
Total equity		<u>62,278</u>	<u>54,895</u>
Non-current liabilities			
Long-term borrowings	5	25,000	25,000
Provisions	6	1,000	1,250
Finance lease payable	2	5,000	–
		<u>31,000</u>	<u>26,250</u>
Current liabilities			
Bank overdraft	7	1,300	–
Trade and other payables		3,500	3,485
		<u>4,800</u>	<u>3,485</u>
Total liabilities		<u>35,800</u>	<u>29,735</u>
Total equity and liabilities		<u><u>98,078</u></u>	<u><u>84,630</u></u>

Notes:

1. Oak Co established an equity-settled share-based payment plan for its executives on 1 January 2011. 250 executives and senior managers have received 100 share options each, which vest on 31 December 2013 if the executive remains in employment at that date, and if Oak Co's share price increases by 10% per annum. No expense has been recognised this year as Oak Co's share price has fallen by 5% in the last six months, and so it is felt that the condition relating to the share price will not be met this year end.
2. On 1 July 2011, Oak Co entered into a lease which has been accounted for as a finance lease and capitalised at \$5 million. The leased property is used as the head office for Oak Co's new website development and sales division. The lease term is for five years and the fair value of the property at the inception of the lease was \$20 million.
3. On 30 June 2011 Oak Co's properties were revalued by an independent expert.
4. A significant amount has been invested in the new website, which is seen as a major strategic development for the company. The website has generated minimal sales since its launch last month, and advertising campaigns are currently being conducted to promote the site.

5. The long-term borrowings are due to be repaid in two equal instalments on 30 September 2012 and 2013. Oak Co is in the process of renegotiating the loan, to extend the repayment dates, and to increase the amount of the loan.
6. The provision relates to product warranties offered by the company.
7. The overdraft limit agreed with Oak Co's bank is \$1.5 million.

Required:

Respond to the email from the audit partner. (31 marks)

Note: the split of the mark allocation is shown within the partner's email.

Professional marks will be awarded for the presentation and clarity of your answer. (2 marks)

- (b)** Maple & Co is suffering from declining revenue, and as a result of this, another audit manager has been asked to consider how to improve the firm's profitability. In a conversation with you this morning he mentioned the following:

'We really need to make our audits more efficient. I think we should fix materiality at the planning stage at the maximum possible materiality level for all audits, as this would reduce the work we need to do.

I also think we can cut the firm's overheads by reducing our spending on training. We spend a lot on expensive training courses for junior members of the audit team, and on Continuing Professional Development for our qualified members of staff.

We could also guarantee our clients that all audits will be completed quicker than last year. Reducing the time spent on each assignment will improve the firm's efficiency and enable us to take on more audit clients.'

Required:

Comment on the practice management and quality control issues raised by the audit manager's suggestions to improve the audit firm's profitability. (6 marks)

(39 marks)

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Question 2 begins on page 6.**

- 2 Willow Co is a print supplier to businesses, printing catalogues, leaflets, training manuals and stationery to order. It specialises in using 100% recycled paper in its printing, a fact which is promoted heavily in its advertising.

You are a senior audit manager in Bark & Co, and you have just been placed in charge of the audit of Willow Co. The audit for the year ended 31 August 2011 is nearing completion, and the audit engagement partner, Jasmine Berry, has sent you an email:

To: Audit manager
From: Jasmine Berry, Audit partner
Subject: Audit completion and other issues – Willow Co

Hello

The manager previously assigned to the audit of Willow Co has been moved to another urgent assignment, so thank you for stepping in to take on the manager's role this late in the audit. The audit report is due to be issued in two weeks' time, and the audit senior has prepared a summary of matters for your consideration.

I have been asked to attend a meeting with the audit committee of Willow Co tomorrow, so I need you to update me on how the audit has progressed. I am asking you to prepare briefing notes for my use in which you:

(a) Assess the audit implications of the THREE issues related to audit work raised by the audit senior. Your assessment should consider the sufficiency of evidence obtained, explain any adjustments that may be necessary to the financial statements, and describe the impact on the audit report if these adjustments are not made. You should also recommend any further audit procedures necessary. (15 marks)

(b) Explain the matters, other than the three issues related to audit work raised by the audit senior, which should be brought to the attention of the audit committee of Willow Co. (8 marks)

Thanks

Summary of issues for manager's attention, prepared by audit senior

Materiality has been determined as follows:

\$800,000 for assets and liabilities

\$250,000 for income and expenses

Issues related to audit work performed:

(i) Audit work on inventory

Audit procedures performed at the inventory count indicated that printed inventory items with a value of \$130,000 were potentially obsolete. These items were mainly out of date training manuals. The finance director, Cherry Laurel, has not written off this inventory as she argues that the paper on which the items are printed can be recycled and used again in future printing orders. However, the items appear not to be recyclable as they are coated in plastic. The junior who performed the audit work on inventory has requested a written representation from management to confirm that the items can be recycled and no further procedures relevant to these items have been performed.

(ii) Audit work on provisions

Willow Co is involved in a court case with a competitor, Aspen Co, which alleges that a design used in Willow Co's printed material copies one of Aspen Co's designs which are protected under copyright. Our evidence obtained is a verbal confirmation from Willow Co's lawyers that a claim of \$125,000 has been made against Willow Co, which is probable to be paid. Cherry Laurel has not made a provision, arguing that it is immaterial. Cherry refused our request to ask the lawyers to confirm their opinion on the matter in writing, saying it is not worth bothering the lawyers again on such a trivial matter.

(iii) Audit work on current assets

Willow Co made a loan of \$6,000 to Cherry Laurel, the finance director, on 30 June 2011. The amount is recognised as a current asset. The loan carries an interest rate of 4% which we have confirmed to be the market

rate for short-term loans and we have concluded that the loan is an arm's length transaction. Cherry has provided written confirmation that she intends to repay the loan by 31 March 2012. The only other audit work performed was to agree the cash payment to the cash book. Details of the loan made to Cherry have not been separately disclosed in the financial statements.

Other issues for your attention:

Property revaluations

Willow Co currently adopts an accounting policy of recognising properties at cost. During the audit of non-current assets Willow Co's property manager said that the company is considering a change of accounting policy so that properties would be recognised at fair value from 1 January 2012.

Non-current asset register

The audit of non-current assets was delayed by a week. We had asked for the non-current asset register reconciliation to be completed by the client prior to commencement of our audit procedures on non-current assets, but it seems that the person responsible for the reconciliation went on holiday having forgotten to prepare the reconciliation. This happened on last year's audit as well, and the issue was discussed with the audit committee at that time.

Procurement procedures

We found during our testing of trade payables that an approved supplier list is not maintained, and invoices received are not always matched back to goods received notes. This was mentioned to the procurement manager, who said that suppliers are switched fairly often, depending on which supplier is the cheapest, so it would be difficult to maintain an up-to-date approved supplier list.

Financial controller

Mia Fern, Willow Co's financial controller, owns a holiday home overseas. It appears that she offered the audit team free use of the holiday home for three weeks after the audit, as a reward for the team's hard work. She also bought lunch for the audit team on most days.

Required:

Respond to the partner's email. (23 marks)

Note: the split of the mark allocation is shown within the email.

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

(25 marks)

Section B – TWO questions ONLY to be attempted

3 You are a manager in the audit department of Beech & Co, responsible for the audits of Fir Co, Spruce Co and Pine Co. Each company has a financial year ended 31 July 2011, and the audits of all companies are nearing completion. The following issues have arisen in relation to the audit of accounting estimates and fair values:

(a) Fir Co

Fir Co is a company involved in energy production. It owns several nuclear power stations, which have a remaining estimated useful life of 20 years. Fir Co intends to decommission the power stations at the end of their useful life and the statement of financial position at 31 July 2011 recognises a material provision in respect of decommissioning costs of \$97 million (2010 – \$110 million). A brief note to the financial statements discloses the opening and closing value of the provision but no other information is provided.

Required:

Comment on the matters that should be considered, and explain the audit evidence you should expect to find in your file review in respect of the decommissioning provision. (8 marks)

(b) Spruce Co

Spruce Co is also involved in energy production. It has a trading division which manages a portfolio of complex financial instruments such as derivatives. The portfolio is material to the financial statements. Due to the specialist nature of these financial instruments, an auditor's expert was engaged to assist in obtaining sufficient appropriate audit evidence relating to the fair value of the financial instruments. The objectivity, capabilities and competence of the expert were confirmed prior to their engagement.

Required:

Explain the procedures that should be performed in evaluating the adequacy of the auditor's expert's work. (5 marks)

(c) Pine Co

Pine Co operates a warehousing and distribution service, and owns 120 properties. During the year ended 31 July 2011, management changed its estimate of the useful life of all properties, extending the life on average by 10 years. The financial statements contain a retrospective adjustment, which increases opening non-current assets and equity by a material amount. Information in respect of the change in estimate has not been disclosed in the notes to the financial statements.

Required:

Identify and explain the potential implications for the auditor's report of the accounting treatment of the change in accounting estimates. (5 marks)

(18 marks)

4 You are an audit manager in Cedar & Co, responsible for the audit of Chestnut Co, a large company which provides information technology services to business customers. The finance director of Chestnut Co, Jack Privet, contacted you this morning, saying:

'I was alerted yesterday to a fraud being conducted by members of our sales team. It appears that several sales representatives have been claiming reimbursement for fictitious travel and client entertaining expenses and inflating actual expenses incurred. Specifically, it has been alleged that the sales representatives have claimed on expenses for items such as gifts for clients and office supplies which were never actually purchased, claimed for business-class airline tickets but in reality had purchased economy tickets, claimed for non-existent business mileage and used the company credit card to purchase items for personal use.

I am very worried about the scale of this fraud, as travel and client entertainment is one of our biggest expenses. All of the alleged fraudsters have been suspended pending an investigation, which I would like your firm to conduct. We will prosecute these employees to attempt to recoup our losses if evidence shows that a fraud has indeed occurred, so your firm would need to provide an expert witness in the event of a court case. Can we meet tomorrow to discuss this potential assignment?'

Chestnut Co has a small internal audit department and in previous years the evidence obtained by Cedar & Co as part of the external audit has indicated that the control environment of the company is generally good. The audit opinion on the financial statements for the year ended 31 March 2011 was unmodified.

Required:

- (a) **Assess the ethical and professional issues raised by the request for your firm to investigate the alleged fraudulent activity.** (6 marks)
- (b) **Explain the matters that should be discussed in the meeting with Jack Privet in respect of planning the investigation into the alleged fraudulent activity.** (6 marks)
- (c) **Evaluate the arguments for and against the prohibition of auditors providing non-audit services to audit clients.** (6 marks)

(18 marks)

- 5 (a) You are the manager responsible for the audit of Yew Co, a company which designs and develops aircraft engines. The audit for the year ended 31 July 2011 is nearing completion and the audit senior has left the following file note for your attention:

'I have just returned from a meeting with the management of Yew Co, and there is a matter I want to bring to your attention. Yew Co's statement of financial position recognises an intangible asset of \$12.5 million in respect of capitalised research and development costs relating to new aircraft engine designs. However, market research conducted by Yew Co in relation to these new designs indicated that there would be little demand in the near future for such designs. Management has provided written representation that they agree with the results of the market research.

Currently, Yew Co has a cash balance of only \$125,000 and members of the management team have expressed concerns that the company is finding it difficult to raise additional finance.

The new aircraft designs have been discussed in the chairman's statement which is to be published with the financial statements. The discussion states that 'developments of new engine designs are underway, and we believe that these new designs will become a significant source of income for Yew Co in the next 12 months.'

Yew Co's draft financial statements include profit before tax of \$23 million, and total assets of \$210 million.

Yew Co is due to publish its annual report next week, so we need to consider the impact of this matter urgently.'

Required:

Discuss the implications of the audit senior's file note on the completion of the audit and on the auditor's report, recommending any further actions that should be taken by the auditor. (12 marks)

- (b) You are responsible for answering technical queries from other managers and partners of your firm. An audit partner left the following note on your desk this morning:

(i) 'I am about to draft the audit report for my client, Sycamore Co. I am going on holiday tomorrow and want to have the audit report signed and dated before I leave. The only thing outstanding is the written representation from management – I have verbally confirmed the contents with the finance director who agreed to send the representations to the audit manager within the next few days. I presume this is acceptable?' (3 marks)

(ii) 'We are auditing Sycamore Co for the first time. The prior period financial statements were audited by another firm. We are aware that the auditor's report on the prior period was qualified due to a material misstatement of trade receivables. We have obtained sufficient appropriate evidence that the matter giving rise to the misstatement has been resolved and I am happy to issue an unmodified opinion. But should I refer to the prior year modification in this year's auditor's report?' (3 marks)

Required:

Respond to the audit partner's comments.

Note: the split of the mark allocation is shown within the question.

(18 marks)

End of Question Paper