

Professional Level – Options Module

Advanced Audit and Assurance (Hong Kong)

Tuesday 7 June 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 senior audit manager in Suki & Co, a firm of Certified Public Accountants. This morning you have been re-assigned to the audit of Bill Co, a long-standing audit client of your firm, as the manager previously assigned to the client has been taken ill. Bill Co has a year ending 30 June 2011, and the audit planning has been largely completed by the previously assigned audit manager, Tara Lafayette, who had been recruited by your firm four months ago.

Bill Co is a property development company, specialising in the regeneration and refurbishment of old industrial buildings, which are sold for commercial or residential use. All property developments are performed under specifically negotiated fixed-price contracts. The company was founded 35 years ago by two brothers, Alex and Ben Bradley, who own the majority of the company's share capital. Alex and Ben are nearing retirement age, and are planning to sell the company within the next two years. The forecast revenue for the year ending 30 June 2011 is \$10.8 million, and the forecast profit before tax is \$2.5 million. The forecast statement of financial position recognises total assets of \$95 million.

You have just received the following email from the audit engagement partner:

<p>To: Audit manager From: Audit partner Regarding: Bill Co – audit planning</p> <hr/> <p>Hello</p> <p>Thanks for taking on the role of audit manager for the forthcoming audit of Bill Co.</p> <p>(i) I have just received some information on two significant issues that have arisen over the last week, from Sam Compton, the company's finance director. This information is provided in attachment 1.</p> <p>I am asking you to prepare briefing notes, for my use, in which you explain the matters that should be considered in relation to the treatment of these two issues in the financial statements, and also explain the financial statement risks relating to them. I also want you to recommend the planned audit procedures that should be performed in order to address those risks. (16 marks)</p> <p>(ii) In addition, please critically evaluate the planning that has been completed by the previously assigned audit manager. Relevant details are provided in attachment 2, which contains notes made by her, and placed on the current year audit file. Make sure you include discussion of any ethical matters arising from the notes, and recommend any actions you think necessary. (11 marks)</p> <p>Thanks.</p>

Attachment 1: Information from Sam Compton, finance director of Bill Co

In the last week, two significant issues have arisen at Bill Co. The first issue concerns a major contract involving the development of an old riverside warehouse into a conference centre in Bridgetown. An architect working on the development has discovered that the property will need significant additional structural improvements, the extra cost of which is estimated to be \$350,000. The contract was originally forecast to make a profit of \$200,000. The development is currently about one third complete, and will take a further 15 months to finish, including this additional construction work. The customer has been told that the completion of the contract will be delayed by around two months. However, the contract price is fixed, and so the additional costs must be covered by Bill Co.

The second issue concerns one of Bill Co's specialist divisions, which trades under the name 'Treasured Homes' and which deals exclusively in the redevelopment of non-industrial historic buildings such as castles and forts. These buildings are usually acquired as uninhabitable ruins, and are then developed into luxury residences for wealthy individuals. The management of Bill Co decided last week to sell this division, as although it is profitable, it generates a lower margin than other business divisions. 'Treasured Homes' operates separately from the rest of the business, and generates approximately 15% of the total revenue of the company. In a board minute dated 1 June 2011, it was noted that 'interest has already been expressed in this division from a potential buyer, and it is hoped that sale negotiations will soon commence, leading to sale in August 2011. There is a specific office

building and some other tangible assets that will be sold as part of the deal. These assets are recorded at \$7.6 million in the financial statements. No redundancies will be necessary as employees' contracts will transfer to the new owners.'

Attachment 2:

Planning Summary: Bill Co, year ending 30 June 2011, prepared by Tara Lafayette, manager previously assigned to the audit

The planning for the forthcoming audit is almost complete. Time has been saved by not carrying out procedures considered unnecessary for this long-standing audit client. Forecast accounts have been obtained and placed on file, and discussions held with management concerning business developments during the year. Analytical procedures have been performed on the statement of comprehensive income, but not on the statement of financial position, as there did not appear to be any significant movements in assets or liabilities since last year.

Management confirmed that there have been no changes to accounting systems and controls in the financial year. For this reason we do not need to carry out walk-through tests or review our documentation of the systems and controls.

Management also confirmed that there have been no changes to business operations, other than the potential sale of 'Treasured Homes'. All divisions are operating normally, generating sufficient profit and cash. For this reason, the business risk of Bill Co is assessed as low, and no further comments or discussions about business operations have been placed on file.

The matter that will demand the most audit work is the valuation of properties currently under development, especially the determination of the percentage completion of each development at the reporting date. Historically, we have engaged a property valuation expert to provide a report on this area. However, Bill Co has recently employed a newly qualified architect, who will be happy to provide us with evidence concerning the stage of completion of each property contract at the year end. Using this person to produce a report on all properties being developed will save time and costs.

Bill Co has recently completed the development of a luxury new office building in Newtown. Several of the office units are empty, and the management of Bill Co has offered the office space to our firm for a nominal rent of \$100 per year.

Required:

Respond to the partner's email. (27 marks)

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

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

- (b)** Ben and Alex Bradley have a sister, Jo, who runs an interior design company, Lantern Co. During a review of board minutes, performed as part of the planning of Bill Co's audit, it was discovered that Bill Co has paid \$225,000 to Lantern Co during the year, in respect of refurbishment of development properties. On further enquiry, it was also found that Lantern Co leases an office space from Bill Co, under an informal arrangement between the two companies.

Required:

(i) Explain the inherent limitations which mean that auditors may not identify related parties and related party transactions; and (4 marks)

(ii) Recommend the audit procedures to be performed in relation to Bill Co's transactions with Lantern Co. (4 marks)

(37 marks)

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Question 2 begins on page 5.**

- 2 (a) Butler Co is a new audit client of your firm. You are the manager responsible for the audit of the financial statements for the year ended 31 May 2011. Butler Co designs and manufactures aircraft engines and spare parts, and is a subsidiary of a multi-national group. Extracts from the draft financial statements are shown below:

Statement of financial position

	31 May 2011 Draft \$ million	31 May 2010 Actual \$ million
Assets		
Non-current assets		
Intangible assets (note 1)	200	180
Property, plant and equipment (note 2)	1,300	1,200
Deferred tax asset (note 3)	235	20
Financial assets	25	35
	<u>1,760</u>	<u>1,435</u>
Current assets		
Inventory	1,300	800
Trade receivables	2,100	1,860
	<u>3,400</u>	<u>2,660</u>
Total assets	<u><u>5,160</u></u>	<u><u>4,095</u></u>
Equity and liabilities		
Equity		
Share capital	300	300
Retained earnings	(525)	95
	<u>(225)</u>	<u>395</u>
Non-current liabilities		
Long-term borrowings (note 4)	1,900	1,350
Provisions (note 5)	185	150
	<u>2,085</u>	<u>1,500</u>
Current liabilities		
Short-term borrowings (note 6)	800	400
Trade payables	2,500	1,800
	<u>3,300</u>	<u>2,200</u>
Total equity and liabilities	<u><u>5,160</u></u>	<u><u>4,095</u></u>

Notes to the statement of financial position:

- Note 1 Intangible assets comprise goodwill on the acquisition of subsidiaries (\$80 million), and development costs capitalised on engine development projects (\$120 million).
- Note 2 Property, plant and equipment includes land and buildings valued at \$25 million, over which a fixed charge exists.
- Note 3 The deferred tax asset has arisen following several loss-making years suffered by the company. The asset represents the tax benefit of unutilised tax losses carried forward.
- Note 4 Long-term borrowings include a debenture due for repayment in July 2012, and a loan from Butler Co's parent company due for repayment in December 2012.
- Note 5 Provisions relate to warranties provided to customers.
- Note 6 Short-term borrowings comprise an overdraft (\$25 million), a short term loan (\$60 million) due for repayment in August 2011, and a bank loan (\$715 million) repayable in September 2011.

You have received an email from the audit partner responsible for the audit of Butler Co:

<p>To: Audit manager From: Audit partner Regarding: Butler Co – going concern issues</p> <hr/> <p>Hello</p> <p>I understand that the audit work on Butler Co commences this week. I am concerned about the future of the company, as against a background of economic recession, sales have been declining, several significant customer contracts have been cancelled unexpectedly, and competition from overseas has damaged the market share previously enjoyed by Butler Co.</p> <p>(i) Please prepare briefing notes, for my use, in which you identify and explain any matters arising from your review of the draft statement of financial position, and the cash flow forecast, which may cast significant doubt on the company's ability to continue as a going concern. The cash flow forecast has just been sent to me from the client, and is attached. It covers only the first three months of the next financial year, the client is currently preparing the forecasts for the whole 12 month period. Please be sceptical when reviewing the forecast, as the assumptions may be optimistic. (10 marks)</p> <p>(ii) In addition, please recommend the principal audit procedures to be carried out on the cash flow forecast. Your recommendations can be included in a separate section of the briefing notes. (8 marks)</p> <p>Thanks.</p>

Attachment: Cash flow forecast for the three months to 31 August 2011

	June 2011 \$ million	July 2011 \$ million	August 2011 \$ million
Cash inflows			
Cash receipts from customers (note 1)	175	195	220
Loan receipt (note 2)		150	
Government subsidy (note 3)			50
Sales of financial assets	50		
Total cash inflows	225	345	270
Cash outflows			
Operating cash outflows	200	200	290
Interest payments	40	40	40
Loan repayment			60
Total cash outflows	240	240	390
Net cash flow for the month	(15)	105	(120)
Opening cash	(25)	(40)	65
Closing cash	(40)	65	(55)

Notes to the cash flow forecast:

This cash flow forecast has been prepared by the management of Butler Co, and is based on the following assumptions:

1. Cash receipts from customers should accelerate given the anticipated improvement in economic conditions. In addition, the company has committed extra resources to the credit control function, in order to speed up collection of overdue debts.
2. The loan expected to be received in July 2011 is currently being negotiated with our parent company, Rubery Co.

3. The government subsidy will be received once our application has been approved. The subsidy is awarded to companies which operate in areas of high unemployment and it subsidises the wages and salaries paid to staff.

Required:

Respond to the email from the audit partner. (18 marks)

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

Professional marks will be awarded for presentation, and for the clarity of explanations provided. (2 marks)

- (b) Given the information provided relating to Butler Co, it is likely that the auditor may conclude on completion of all necessary audit procedures, that the use of the going concern assumption in the financial statements is appropriate, but that a material uncertainty, or several uncertainties, exist regarding the company's ability to continue as a going concern.

Required:

If audit procedures indicate that one or more material uncertainties exist regarding Butler Co's ability to continue as a going concern:

Explain the matters that should be considered in forming the audit opinion and the potential impacts on the auditor's report. (7 marks)

(27 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a)** Your firm has been approached by Wexford Co to provide the annual audit. Wexford Co operates a chain of bookshops across the country. The shops sell stationery such as diaries and calendars, as well as new books. The financial year will end on 31 July 2011, and this will be the first year that an audit is required, as previously the company was exempt from audit due to its small size.

The potential audit engagement partner, Wendy Kwan, recently attended a meeting with Ravi Shah, managing director of Wexford Co regarding the audit appointment. In this meeting, Ravi made the following comments:

‘Wexford Co is a small, owner-managed business. I run the company, along with my sister, Rita, and we employ a part-qualified accountant to do the bookkeeping and prepare the annual accounts. The accountant prepares management accounts at the end of every quarter, but Rita and I rarely do more than quickly review the sales figures. We understand that due to the company’s size, we now need to have the accounts audited. It would make sense if your firm could prepare the accounts and do the audit at the same time. We don’t want a cash flow statement prepared, as it is not required for tax purposes, and would not be used by us.

Next year we are planning to acquire another company, one of our competitors, which I believe is an existing audit client of your firm. For this reason, we require that your audit procedures do not include reading the minutes of board meetings, as we have been discussing some confidential matters regarding this potential acquisition.’

Required:

Identify and explain the professional and ethical matters that should be considered in deciding whether to accept the appointment as auditor of Wexford Co. (10 marks)

- (b)** Wexford Co’s financial statements for the year ended 31 July 2010 included the following balances:

Profit before tax	\$50,000
Inventory	\$25,000
Total assets	\$350,000

The inventory comprised stocks of books, diaries, calendars and greetings cards.

Required:

In relation to opening balances where the financial statements for the prior period were not audited:

Explain the audit procedures required by HKSA 510 (Clarified) *Initial Audit Engagements – Opening Balances*, and recommend the specific audit procedures to be applied to Wexford Co’s opening balance of inventory. (8 marks)

(18 marks)

- 4 Jacob Co, an audit client of your firm, is a large privately owned company whose operations involve a repair and maintenance service for domestic customers. The company offers a range of services, such as plumbing and electrical repairs and maintenance, and the repair of domestic appliances such as washing machines and cookers, as well as dealing with emergencies such as damage caused by flooding. All work is covered by a two-year warranty.

The directors of Jacob Co have been seeking to acquire expertise in the repair and maintenance of swimming pools and hot-tubs as this is a service increasingly requested, but not offered by the company. They have recently identified Locke Co as a potential acquisition. Preliminary discussions have been held between the directors of the two companies with a view to the acquisition of Locke Co by Jacob Co. This will be the first acquisition performed by the current management team of Jacob Co. Your firm has been asked to perform a due diligence review on Locke Co prior to further discussions taking place. You have been provided with the following information regarding Locke Co:

Locke Co is owner-managed, with three of the five board members being the original founders of the company, which was incorporated thirty years ago. The head office is located in a prestigious building, which is owned by the founders' family estate. The company recently acquired a separate piece of land on which a new head office is to be built.

The company has grown rapidly in the last three years as more affluent customers can afford the cost of installing and maintaining swimming pools and hot-tubs. The expansion was funded by a significant bank loan. The company relies on an overdraft facility in the winter months when less operating cash inflows arise from maintenance work.

Locke Co enjoys a good reputation, though this was tarnished last year by a complaint by a famous actor who claimed that, following maintenance of his swimming pool by Locke Co's employees, the water contained a chemical which damaged his skin. A court case is on-going and is attracting media attention.

The company's financial year end is 31 August. Its accounting function is outsourced to Austin Co, a local provider of accounting and tax services.

Required:

- (a) Explain THREE potential benefits of an externally provided due diligence review to Jacob Co. (6 marks)
- (b) Recommend additional information which should be made available for your firm's due diligence review, and explain the need for the information. (12 marks)

(18 marks)

- 5 (a) You are the manager responsible for the audit of the Nassau Group, which comprises a parent company and six subsidiaries. The audit of all individual companies' financial statements is almost complete, and you are currently carrying out the audit of the consolidated financial statements. One of the subsidiaries, Exuma Co, is audited by another firm, Jalousie & Co. Your firm has fulfilled the necessary requirements of HKSA 600 (Clarified) *Special Considerations – Audits of Group Financial Statements (Including the Work of Component Auditors)* and is satisfied as to the competence and independence of Jalousie & Co.

You have received from Jalousie & Co the draft audit report on Exuma Co's financial statements, an extract from which is shown below:

'Basis for Qualified Opinion (extract)

The company is facing financial damages of \$2 million in respect of an on-going court case, more fully explained in note 12 to the financial statements. Management has not recognised a provision but has disclosed the situation as a contingent liability. Under Hong Kong Financial Reporting Standards, a provision should be made if there is an obligation as a result of a past event, a probable outflow of economic benefit, and a reliable estimate can be made. Audit evidence concludes that these criteria have been met, and it is our opinion that a provision of \$2 million should be recognised. Accordingly, net profit and shareholders' equity would have been reduced by \$2 million if the provision had been recognised.

Qualified Opinion (extract)

In our opinion, except for effects of the matter described in the Basis for Qualified Opinion paragraph, the financial statements give a true and fair view of the financial position of Exuma Co as at 31 March 2011...'

An extract of Note 12 to Exuma Co's financial statements is shown below:

Note 12 (extract)

The company is the subject of a court case concerning an alleged breach of planning regulations. The plaintiff is claiming compensation of \$2 million. The management of Exuma Co, after seeking legal advice, believe that there is only a 20% chance of a successful claim being made against the company.

Figures extracted from the draft financial statements for the year ending 31 March 2011 are as follows:

	Nassau Group \$ million	Exuma Co \$ million
Profit before tax	20	4
Total assets	85	20

Required:

Identify and explain the matters that should be considered, and actions that should be taken by the group audit engagement team, in forming an opinion on the consolidated financial statements of the Nassau Group.

(10 marks)

- (b) A trainee accountant, Jo Castries, is assigned to your audit team. This is the first group audit that Jo has worked on. Jo made the following comment regarding the group audit:

'I understand that in a group audit engagement, one of the requirements is to design and perform audit procedures on the consolidation process. Please explain to me the principal audit procedures that are performed on the consolidation process.'

Required:

Respond to the trainee accountant's question.

(8 marks)

(18 marks)

End of Question Paper