

Professional Level – Options Module

Advanced Audit and Assurance (International)

Monday 1 June 2015



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 (INT)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

Section A – BOTH questions are compulsory and MUST be attempted

- 1 You are a manager in the audit department of Craggy & Co, a firm of Chartered Certified Accountants, and you have just been assigned to the audit of Ted Co, a new audit client of your firm, with a financial year ended 31 May 2015. Ted Co, a newly listed company, is a computer games designer and developer, and has grown rapidly in the last few years. The audit engagement partner, Jack Hackett, has sent you the following email:

<p>To: Audit manager From: Jack Hackett Regarding: Ted Co audit planning</p> <hr/> <p>Hello</p> <p>There are several tasks I require you to perform in respect of planning the audit of Ted Co. I held a meeting with the company's finance director, Len Brennan, yesterday, and I have provided you with some information from that meeting. In addition, I have asked one of the audit seniors to begin to carry out preliminary analytical review procedures on Ted Co's draft financial statements, and the results of the review performed so far are also provided to you.</p> <p>Using this information and your audit planning knowledge, you are required to prepare briefing notes for me to use when briefing the audit team. In the briefing notes you should:</p> <p>(a) Discuss the matters specific to the planning of an initial audit engagement which should be considered in developing the audit strategy. (6 marks)</p> <p>(b) Evaluate the audit risks to be considered in planning the audit of Ted Co. (17 marks)</p> <p>(c) Recommend the principal audit procedures to be performed in the audit of:</p> <p>(i) The portfolio of short-term investments, and (ii) The earnings per share figure. (8 marks)</p> <p>Thank you.</p>

Notes from meeting with Len Brennan

Ted Co was formed ten years ago by Dougal Doyle, a graduate in multimedia computing. The company designs, develops and publishes computer games including many highly successful games which have won industry awards. In the last two years the company invested \$100m in creating games designed to appeal to a broad, global audience and sales are now made in over 60 countries. The software used in the computer games is developed in this country, but the manufacture of the physical product takes place overseas.

Computer games are largely sold through retail outlets, but approximately 25% of Ted Co's revenue is generated through sales made on the company's website. In some countries Ted Co's products are distributed under licences which give the licence holder the exclusive right to sell the products in that country. The cost of each licence to the distributor depends on the estimated sales in the country to which it relates, and licences last for an average of five years. The income which Ted Co receives from the sale of a licence is deferred over the period of the licence. At 31 May 2015 the total amount of deferred income recognised in Ted Co's statement of financial position is \$18 million.

As part of a five-year strategic plan, Ted Co obtained a stock market listing in December 2014. The listing and related share issue raised a significant amount of finance, and many shares are held by institutional investors. Dougal Doyle retains a 20% equity shareholding, and a further 10% of the company's shares are held by his family members.

Despite being listed, the company does not have an internal audit department, and there is only one non-executive director on the board. These problems, which Ted Co's management is hoping to resolve in the next few months, are explained in the company's annual report, as required by the applicable corporate governance code.

Recently, a small treasury management function was established to manage the company's foreign currency transactions, which include forward exchange currency contracts. The treasury management function also deals with

short-term investments. In January 2015, cash of \$8 million was invested in a portfolio of equity shares held in listed companies, which is to be held in the short term as a speculative investment. The shares are recognised as a financial asset at cost of \$8 million in the draft statement of financial position. The fair value of the shares at 31 May 2015 is \$6 million.

As a listed company, Ted Co is required to disclose its earnings per share figure. Dougal Doyle would like this to be based on an adjusted earnings figure which does not include depreciation or amortisation expenses.

The previous auditors of Ted Co, a small firm called Crilly & Co, resigned in September 2014. The audit opinion on the financial statements for the year ended 31 May 2014 was unmodified.

Extract of draft financial statements and results of preliminary analytical review

Statement of profit or loss (extract)

	Year to 31 May 2015	Year to 31 May 2014	% change
	Draft	Actual	
	\$'000	\$'000	
Revenue	98,000	67,000	46.3% increase
Gross profit	65,000	40,000	62.5% increase
Operating profit	12,000	9,200	30.4% increase
Finance charge	4,000	3,800	5.3% increase
Profit before tax	8,000	5,400	48.1% increase
Earnings per share	89.6 cents per share	–	

Note: Earnings per share has been calculated as follows:

	\$'000	
Profit before tax	8,000	
Add: Depreciation	1,100	
Amortisation	6,000	
Adjusted profit before tax	<u>15,100</u>	
Adjusted profit before tax		<u>15,100,000</u>
Number of equity shares at 31 May 2015		16,850,000 = 89.6 cents per share

Statement of financial position (extract)

	31 May 2015	31 May 2014	% change
	Draft	Actual	
	\$'000	\$'000	
Non-current assets:			
Intangible assets – development costs	58,000	35,000	65.7% increase
Total assets	134,000	105,000	27.6% increase

Required:

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

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

Professional marks will be awarded for the presentation, clarity of explanations and logical flow of the briefing notes. (4 marks)

(35 marks)

2 The Adder Group (the Group) has been an audit client of your firm for several years. You have recently been assigned to act as audit manager, replacing a manager who has fallen ill, and the audit of the Group financial statements for the year ended 31 March 2015 is underway. The Group's activities include property management and the provision of large storage facilities in warehouses owned by the Group. The draft consolidated financial statements recognise total assets of \$150 million, and profit before tax of \$20 million.

(a) The audit engagement partner, Edmund Black, has asked you to review the audit working papers in relation to two audit issues which have been highlighted by the audit senior. Information on each of these issues is given below:

(i) In December 2014, a leisure centre complex was sold for proceeds equivalent to its fair value of \$35 million, the related assets have been derecognised from the Group statement of financial position, and a profit on disposal of \$8 million is included in the Group statement of profit or loss for the year. The remaining useful life of the leisure centre complex was 21 years at the date of disposal.

The Group is leasing back the leisure centre complex to use in its ongoing operations, paying a rental based on the market rate of interest plus 2%. At the end of the 20-year lease arrangement, the Group has the option to repurchase the leisure centre complex for its market value at that time.

(ii) In January 2015, the Group acquired 52% of the equity shares of Baldrick Co. This company has not been consolidated into the Group as a subsidiary, and is instead accounted for as an associate. The Group finance director's reason for this accounting treatment is that Baldrick Co's operations have not yet been integrated with those of the rest of the Group. Baldrick Co's financial statements recognise total assets of \$18 million and a loss for the year to 31 March 2015 of \$5 million.

Required:

In respect of the issues described above:

Comment on the matters to be considered, and explain the audit evidence you should expect to find in your review of the audit working papers.

Note: The marks will be split equally between each part. (16 marks)

(b) The audit senior also left the following note for your attention:

'I have been working on the audit of properties, including the Group's storage facility warehouses. Customers rent individual self-contained storage areas of a warehouse, for which they are given keys allowing access by the customer at any time. The Group's employees rarely enter the customers' storage areas.

It seems the Group's policy for storage contracts which generate revenue of less than \$10,000, is that very little documentation is required, and the nature of the items being stored is not always known. While visiting one of the Group's warehouses, the door to one of the customers' storage areas was open, so I looked in and saw what appeared to be potentially hazardous chemicals, stored in large metal drums marked with warning signs. I asked the warehouse manager about the items being stored, and he became very aggressive, refusing to allow me to ask other employees about the matter, and threatening me if I alerted management to the storage of these items. I did not mention the matter to anyone else at the client.'

Required:

Discuss the implications of the audit senior's note for the completion of the audit, commenting on the auditor's responsibilities in relation to laws and regulations, and on any ethical matters arising. (9 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a)** A high-quality audit features the exercise of professional judgement by the auditor, and importantly, a mind-set which includes professional skepticism throughout the planning and performance of the audit.

Required:

Explain the meaning of the term professional skepticism, and discuss its importance in planning and performing an audit. (5 marks)

You are an audit manager in Soprano & Co, working on the audit of the Tony Group (the Group), whose financial year ended on 31 March 2015. This is the first time you have worked on the Group audit. The draft consolidated financial statements recognise profit before tax of \$6 million (2014 – \$9 million) and total assets of \$90 million (2014 – \$82 million). The Group manufactures equipment used in the oil extraction industry.

Goodwill of \$10 million is recognised in the Group statement of financial position, having arisen on several business combinations over the last few years. An impairment review was conducted in March 2015 by Silvio Dante, the Group finance director, and this year an impairment of \$50,000 is to be recognised in respect of the goodwill.

Silvio has prepared a file of documentation to support the results of the impairment review, including notes on the assumptions used, his calculations, and conclusions. When he gave you this file, Silvio made the following comment:

‘I don’t think you should need any evidence other than that contained in my file. The assumptions used are straightforward, so you shouldn’t need to look into them in detail. The assumptions are consistent with how we conducted impairment reviews in previous years and your firm has always agreed with the assumptions used, so you can check that back to last year’s audit file. All of the calculations have been checked by the head of the Group’s internal audit department.’

Silvio has also informed you that two members of the sales team are suspected of paying bribes in order to secure lucrative customer contracts. The internal audit team were alerted to this when they were auditing cash payments, and found significant payments to several new customers being made prior to contracts being signed. Silvio has asked if Soprano & Co would perform a forensic investigation into the alleged bribery payments.

Required:

- (b) (i) Discuss how professional skepticism should be applied to the statement made by Silvio; and** (6 marks)
- (ii) Explain the principal audit procedures to be performed on the impairment of goodwill.** (5 marks)
- (c) Recommend the procedures to be used in performing a forensic investigation on the alleged bribery payments.** (4 marks)

(20 marks)

- 4 You are a senior manager in Bunk & Co, a global audit firm with offices in more than 30 countries. You are responsible for monitoring audit quality and ethical situations which arise in relation to audit clients. Wire Co is an audit client whose operations involve haulage and distribution. The audit report for the financial statements of Wire Co for the year ended 31 December 2014 was issued last week. You are conducting a review of the quality of that audit, and of any ethical issues which arose in relation to it. Relevant information obtained from a discussion with Lester Freeman, the audit engagement partner, is given below.
- (a) Wire Co's audit committee refused to agree to an increase in audit fees despite the company's operations expanding into new locations. In response to this, the materiality level was increased during the audit, and some review procedures were not carried out. To reduce sample sizes used in tests of detail, the samples were selected based on judgement rather than statistical methods. In addition, only parts of the population being tested were sampled, for example, certain locations were not included in the sample of non-current assets selected for physical verification. (6 marks)
- (b) Some of the audit work was performed by an overseas office of Bunk & Co in an 'off-shoring' arrangement. This practice is encouraged by Bunk & Co, whose managing partners see it as a way of improving audit efficiency. The overseas office performs the work at a lower cost, and it was largely low-risk, non-judgemental work included in this arrangement for the audit of Wire Co, for example, numerical checks on documentation. In addition, the overseas office read the minutes of board meetings to identify issues relevant to the audit. (5 marks)
- (c) In July 2014, Russell Bell, Wire Co's former finance director, joined Bunk & Co as an audit partner, working in the same office as Lester Freeman. Although Russell was not a member of the audit team, he did update Lester on some business developments which had taken place at the company during the period before he left. Russell held a number of equity shares in Wire Co, which he sold in January 2015. Since joining Bunk & Co, Russell has been developing initiatives to increase the firm's income. One initiative is that audit team members should be encouraged to cross-sell non-audit services and references to targets for the cross-selling of non-audit services to audit clients is now included in partner and employee appraisal documentation. (9 marks)

Required:

Comment on the quality control, ethical and professional issues raised in respect of the audit of Wire Co and the firm-wide policies of Bunk & Co, and recommend any actions to be taken by the audit firm.

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

(20 marks)

- 5 You are a manager in the audit department of Nidge & Co, a firm of Chartered Certified Accountants, responsible for the audit of Darren Co, a new audit client operating in the construction industry. Darren Co's financial year ended on 31 January 2015, and the draft financial statements recognise profit before tax of \$22.5 million (2014 – \$20 million) and total assets of \$370 million, including cash of \$3 million. The company typically works on three construction contracts at a time.

The audit is nearly complete and you are reviewing the audit working papers. The audit senior has brought several matters to your attention:

- (a) Darren Co is working on a major contract relating to the construction of a bridge for Flyover Co. Work started in July 2014, and it is estimated that the contract will be completed in September 2015. The contract price is \$20 million, and it is estimated that a profit of \$5 million will be made on completion of the contract. The full amount of this profit has been included in the statement of profit or loss for the year ended 31 January 2015. Darren Co's management believes that this accounting treatment is appropriate given that the contract was signed during the financial year, and no problems have arisen in the work carried out so far. (8 marks)
- (b) A significant contract was completed in September 2014 for Newbuild Co. This contract related to the construction of a 20-mile highway in a remote area. In November 2014, several large cracks appeared in the road surface after a period of unusually heavy rain, and the road had to be shut for ten weeks while repair work was carried out. Newbuild Co paid for these repairs, but has taken legal action against Darren Co to recover the costs incurred of \$40 million. Disclosure on this matter has been made in the notes to the financial statements. Audit evidence, including a written statement from Darren Co's lawyers, concludes that there is a possibility, but not a probability, of Darren Co having to settle the amount claimed. (6 marks)
- (c) For the first time this year, the financial statements are presented as part of an integrated report. Included in the integrated report are several key performance indicators, one of which states that Darren Co's profit before tax has increased by 20% from the previous year. (6 marks)

Required:

Discuss the implications of the matters described above on the completion of the audit and on the auditor's report, recommending any further actions which should be taken by the auditor.

Note: The mark allocation is shown next to each of the matters above.

(20 marks)

End of Question Paper