

Professional Level – Options Module

Advanced Audit and Assurance (International)

September/December 2015



Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This question 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 question 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 Mondrian & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of Dali Co, a listed company specialising in the design and manufacture of equipment and machinery used in the quarrying industry. You are planning the audit of the financial statements for the year ending 31 December 2015. The projected financial statements for the 2015 year end recognise revenue of \$138 million (2014 – \$135 million), profit before tax of \$9.8 million (2014 – \$9.2 million) and total assets of \$90 million (2014 – \$85 million). Dali Co became listed in its home jurisdiction on 1 March 2015, and is hoping to achieve a listing on a foreign stock exchange in June 2016.

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

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| <p>To: Audit manager From: Audit engagement partner, Sam Hockney Regarding: Audit planning – Dali Co</p> <hr/> <p>Hello</p> <p>I need you to start planning the audit of Dali Co. I know you are new to this audit client, so I have provided you with some background information, the results of some preliminary analytical review performed by one of the audit team members, and notes from a discussion I had with the company’s audit committee yesterday. I require you to prepare briefing notes for use in the audit planning meeting which will be held next week. In these notes you are required to:</p> <p>(a) (i) Evaluate the audit risks to be considered in planning the audit of Dali Co; and (18 marks) (ii) Recommend the additional information which would be relevant in the evaluation of audit risk. (5 marks)</p> <p>(b) Explain the principal audit procedures to be performed in respect of:</p> <p>(i) The valuation of work in progress and; (4 marks) (ii) The recognition and measurement of the government grant. (4 marks)</p> <p>Thank you.</p> |
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Company background

Dali Co was established 20 years ago and has become known as a leading supplier of machinery used in the quarrying industry, with its customers operating quarries which extract stone used mainly for construction. Its customer base is located solely in its country of incorporation but most of the components used in Dali Co’s manufacturing process are imported from foreign suppliers.

The machines and equipment made by Dali Co are mostly made to order in the company’s three manufacturing sites. Customers approach Dali Co to design and develop a machine or piece of equipment specific to their needs. Where management considers that the design work will be significant, the customer is required to pay a 30% payment in advance, which is used to fund the design work. The remaining 70% is paid on delivery of the machine to the customer. Typically, a machine takes three months to build, and a smaller piece of equipment takes on average six weeks. The design and manufacture of bespoke machinery involving payments in advance has increased during the year. Dali Co also manufactures a range of generic products which are offered for sale to all customers, including drills, conveyors and crushing equipment.

Notes from meeting with Dali Co audit committee

This year has been successful from a strategic point of view in that Dali Co achieved its stock exchange listing in March 2015, and in doing so raised a significant amount of equity finance. The company’s corporate governance was reviewed as part of the flotation process, resulting in the recruitment of three new non-executive directors and a new finance director.

In March 2015, a cash-settled share-based payment plan was introduced for senior executives, who will receive a bonus on 31 December 2017. The amount of the bonus will be based on the increase in Dali Co’s share price from

that at the date of the flotation, when it was \$2.90, to the share price at 31 December 2017. On the advice of the newly appointed finance director, no accounting entries have been made in respect of the plan, but the details relating to the cash-settled share-based payment plan will be disclosed in the notes to the financial statements.

The finance director recommended that the company's manufacturing sites should be revalued. An external valuation was performed in June 2015, resulting in a revaluation surplus of \$3.5 million being recognised in equity. The finance director has informed the audit committee that no deferred tax needs to be provided in respect of the valuation because the property is part of continuing operations and there is no plan for disposal.

In July 2015, a government grant of \$10 million was received as part of a government scheme to subsidise companies which operate in deprived areas. Specifically \$2 million of the grant compensates the company for wages and salaries incurred in the year to 31 December 2015. The remaining grant relates to the continued operations in the deprived area, with a condition of the grant being that the manufacturing site in that area will remain operational until July 2020.

All of the company's manufacturing sites will be closed at the year end to allow the inventory counts to take place. According to the most recent management accounts which are available, at 30 November 2015 work in progress is valued at \$12 million (2014 – \$9.5 million) and the majority of these orders will not be complete until after the year end. In recent weeks several customers have returned equipment due to faults, and Dali Co offers a warranty to guarantee that defective items will be replaced free of charge.

Preliminary analytical review (extract) and other financial information

| | Based on projected figures to 31 December 2015 | Based on audited figures to 31 December 2014 |
|-------------------------------|--|--|
| Operating margin | 15% | 13% |
| Inventory days | 175 days | 150 days |
| Receivables collection period | 90 days | 70 days |
| Trade payables payment period | 60 days | 55 days |
| Earnings per share | 75 cents per share | – |
| Share price | \$3.50 | – |

Required:

Respond to the instructions in the audit partner's email. (31 marks)

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

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

(35 marks)

2 Malevich & Co is a firm of Chartered Certified Accountants offering audit and assurance services to a large portfolio of clients. You are a manager in the audit department responsible for the audit of two clients, Kandinsky Co and the Rothko University, both of which have a financial year ended 31 July 2015. The audits of both clients are being completed and you are reviewing issues which have been raised by the audit seniors.

(a) Kandinsky Co is a manufacturer of luxury food items including chocolate and other confectionery which are often sold as gift items individually or in hampers containing a selection of expensive items from the range of products. Due to an economic recession sales of products have fallen sharply this year, and measures have been implemented to support the company's cash flow. You are aware that the company only has \$150,000 in cash at the year end.

Extracts from the draft financial statements and other relevant information are given below.

| | Note | July 2015 (Draft) \$'000 | July 2014 (Actual) \$'000 |
|---|------|--------------------------------|---------------------------------|
| Revenue | | 2,440 | 3,950 |
| Operating expenses | | (2,100) | (2,800) |
| Finance charge | | (520) | (500) |
| (Loss)/profit before tax | | (180) | 650 |
| Total assets | | 10,400 | 13,500 |
| Long-term liabilities – bank loan | 1 | 3,500 | 3,000 |
| Short-term liabilities – trade payables | 2 | 900 | 650 |
| Disclosed in notes to financial statements: | | | |
| Undrawn borrowing facilities | 3 | 500 | 1,000 |
| Contingent liability | 4 | 120 | – |

Notes:

1. The bank loan was extended in March 2015 by drawing on the borrowing facilities offered by the bank. The loan carries a fixed interest rate and is secured on the company's property including the head office and manufacturing site. The first repayment of loan capital is due on 30 June 2016 when \$350,000 is due to be paid.
2. Kandinsky Co renegotiated its terms of trade with its main supplier of cocoa beans, and extended payment terms from 50 days to 80 days in order to improve working capital.
3. The borrowing facilities are due to be reviewed by the bank in April 2016 and contain covenants including that interest cover is maintained at 2, and the ratio of bank loan to operating profit does not exceed 4:1.
4. The contingent liability relates to a letter of support which Kandinsky Co has provided to its main supplier of cane sugar which is facing difficult trading conditions.

Required:

In respect of the audit of Kandinsky Co:

- (i) **Identify and explain the matters which may cast significant doubt on the company's ability to continue as a going concern; and** (9 marks)
- (ii) **Recommend the audit procedures to be performed in relation to the going concern matters identified.** (6 marks)

(b) The Rothko University, a public sector entity, is a small university with approximately 2,000 students, which was established 10 years ago and specialises in vocational study programmes leading to the award of degrees in business, accountancy, finance, law and marketing. The highest performing students achieve a distinction on completing their degree programme, indicating excellence in the knowledge and understanding of their subject. Students pay tuition fees of \$10,000 per year, and the degree programme is typically three years long.

The audit work in respect of the year ended 31 July 2015 is almost complete, but the audit senior has not yet completed the audit work in respect of performance information which is being published with the annual financial statements for the first time this year. It is a requirement in the jurisdiction in which the Rothko University is located that the performance information is audited as part of the external audit.

Details on the performance information are given below.

| Performance area | Performance measure | 2015 result |
|-------------------------|--|--------------------|
| Graduation rate | % of students who complete their degree programme | 85% |
| Academic performance | % of students achieving a distinction | 20% |
| Employability | % of students who on graduation obtain graduate level employment | 65% |
| Course satisfaction | % of students who rate their university experience as excellent or very good | 70% |

Required:

- (i) Discuss the relevance and measurability of the reported performance information; and**
- (ii) Recommend the examination procedures to be used in auditing the performance information.**

Note: The total marks will be split equally between each part. (10 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3** You are a manager in the assurance department at Raphael & Co, a firm of Chartered Certified Accountants. Your firm has been appointed by Sanzio Co to perform a due diligence review of a potential acquisition target, Titian Tyres Co. As part of the due diligence review and to allow for consideration of an appropriate offer price, Sanzio Co has requested that you identify and value all the assets and liabilities of Titian Tyres Co, including items which may not currently be reported in the statement of financial position.

Sanzio Co is a large, privately owned company operating only in this country, which sells spare parts and accessories for cars, vans and bicycles. Titian Tyres Co is a national chain of vehicle service centres, specialising in the repair and replacement of tyres, although the company also offers a complete range of engine and bodywork services as well. If the acquisition is successful, the management of Sanzio Co intends to open a Titian Tyres service centre in each of its stores.

One of the reasons for Titian Tyres Co's success is their internally generated customer database, which records all customer service details. Using the information contained on the database software, the company's operating system automatically informs previous customers when their vehicle is due for its next service via email, mobile phone text or automated letter. It also informs a customer service team to telephone the customer if they fail to book a service within two weeks of receiving the notification. According to the management of Titian Tyres Co, repeat business makes up over 60% of annual sales and management believes that this is a distinct competitive advantage over other service centres.

Titian Tyres Co also recently purchased a licence to distribute a new, innovative tyre which was designed and patented in the United States. The tyre is made of 100% recycled materials and, due to a new manufacturing process, is more hardwearing and therefore needs replacing less often. Titian Tyres Co paid \$5 million for the licence in January 2015 and the company is currently the sole, licenced distributor in this country.

During a brief review of Titian Tyres Co's financial statements for the year ended 30 June 2015, you notice a contingent liability disclosure in the notes relating to compensation claims made after the fitting of faulty engine parts during 2014. The management of Titian Tyres Co has stated that the fault lies with the manufacturer of the part and that they have made a claim against the manufacturer for the total amount sought by the affected customers.

Required:

- (a) Describe the purpose of a due diligence assignment and compare the scope of a due diligence assignment with that of an audit of historical financial statements.** (6 marks)
- (b) (i) Recommend, with reasons, the principal additional information which should be made available to assist with your valuation of Titian Tyres Co's intangible assets.**
- (ii) Explain the specific enquiries you should make of Titian Tyres Co's management relevant to the contingent liability disclosed in the financial statements.**

Note: The total marks will be split equally between each part. (14 marks)

(20 marks)

4 You are a manager in Monet & Co, a firm of accountants which has 12 offices and 30 partners, 10 of whom are members of ACCA. As an expert in ethics and professional conduct, you have been asked to advise the partners on the following issues, which were raised at a recent meeting.

(a) An advertisement has been drafted as part of the firm's drive to increase the number of clients. It is suggested that it should be placed in a number of quality national as well as local newspapers:

Have you had enough of your accountant charging you too much for poor quality services?
Does your business need a kick-start?

Look no further; Monet & Co provides the most comprehensive range of finance and accountancy services in the country as well as having the leading tax team in the country who are just waiting to save you money.

Still not sure? We guarantee to be cheaper than your existing service provider and for the month of January we are offering free business advice to all new audit clients.

Drop in and see us at your local office for a free consultation.

Monet & Co, Chartered Certified Accountants.

(7 marks)

(b) The planning for the audit of Renoir Co's financial statements for the year ending 31 March 2016 will commence shortly. In preparation the audit partner telephoned Renoir Co's finance director, Jim Cassatt, to set up a planning meeting and to remind him that fees relating to a tax engagement from the previous year were still outstanding. Mr Cassatt raised concerns about the conduct of the previous audit, stating numerous examples of when he and his staff had been interrupted when they were busy. He stated that he wanted guarantees that this year's audit will be more efficient, less intrusive and cheaper, otherwise he will seek an alternative auditor. (7 marks)

(c) Your firm audits the publisher Homer Winslow Co. During its recent audit, the company's finance director commented on growing competition in the digital publishing sector. One rapidly expanding competitor, Pissarro Co, was specifically referred to. You are aware that your firm recently acquired another accountancy firm, Maar Associates, and that Pissarro Co is one of their clients. It is hoped that the audit of Pissarro Co will be transferred to your department to take advantage of your specialism in media and publishing. (6 marks)

Required:

Evaluate each of the issues described above, commenting on the ethical and professional issues raised and recommend any actions necessary in response to the issues identified.

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

(20 marks)

- 5 You are an audit manager at Rockwell & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of the Hopper Group, a listed audit client which supplies ingredients to the food and beverage industry worldwide.

The audit work for the year ended 30 June 2015 is nearly complete, and you are reviewing the draft audit report which has been prepared by the audit senior. During the year the Hopper Group purchased a new subsidiary company, Seurat Sweeteners Co, which has expertise in the research and design of sugar alternatives. The draft financial statements of the Hopper Group for the year ended 30 June 2015 recognise profit before tax of \$495 million (2014 – \$462 million) and total assets of \$4,617 million (2014: \$4,751 million). An extract from the draft audit report is shown below:

Basis of modified opinion (extract)

In their calculation of goodwill on the acquisition of the new subsidiary, the directors have failed to recognise consideration which is contingent upon meeting certain development targets. The directors believe that it is unlikely that these targets will be met by the subsidiary company and, therefore, have not recorded the contingent consideration in the cost of the acquisition. They have disclosed this contingent liability fully in the notes to the financial statements. We do not feel that the directors' treatment of the contingent consideration is correct and, therefore, do not believe that the criteria of the relevant standard have been met. If this is the case, it would be appropriate to adjust the goodwill balance in the statement of financial position.

We believe that any required adjustment may materially affect the goodwill balance in the statement of financial position. Therefore, in our opinion, the financial statements do not give a true and fair view of the financial position of the Hopper Group and of the Hopper Group's financial performance and cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of Matter Paragraph

We draw attention to the note to the financial statements which describes the uncertainty relating to the contingent consideration described above. The note provides further information necessary to understand the potential implications of the contingency.

Required:

- (a) **Critically appraise the draft audit report of the Hopper Group for the year ended 30 June 2015, prepared by the audit senior.**

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

- (b) The audit of the new subsidiary, Seurat Sweeteners Co, was performed by a different firm of auditors, Fish Associates. During your review of the communication from Fish Associates, you note that they were unable to obtain sufficient appropriate evidence with regard to the breakdown of research expenses. The total of research costs expensed by Seurat Sweeteners Co during the year was \$1.2 million. Fish Associates has issued a qualified audit opinion on the financial statements of Seurat Sweeteners Co due to this inability to obtain sufficient appropriate evidence.

Required:

Comment on the actions which Rockwell & Co should take as the auditor of the Hopper Group, and the implications for the auditor's report on the Hopper Group financial statements. (6 marks)

- (c) **Discuss the quality control procedures which should be carried out by Rockwell & Co prior to the audit report on the Hopper Group being issued.** (4 marks)

(20 marks)

End of Question Paper