

Professional Level – Options Module

Advanced Audit and Assurance (International)

Monday 2 December 2013



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)

ACCA

Section A – BOTH questions are compulsory and MUST be attempted

- 1 You are an audit manager in Compton & Co, responsible for the audit of the Stow Group (the Group). You are planning the audit of the Group financial statements for the year ending 31 December 2013. The Group's projected profit before tax for the year is \$200 million and projected total assets at 31 December are \$2,500 million.

The Group is a car manufacturer. Its operations are divided between a number of subsidiaries, some of which focus on manufacturing and distributing the cars, while others deal mainly with marketing and retail. All components of the Group have the same year end. The Group audit engagement partner, Chad Woodstock, has just sent you the following email.

<p>To: Audit manager From: Chad Woodstock, audit partner Subject: The Stow Group – audit planning</p> <hr/> <p>Hello</p> <p>We need to start planning the audit of The Stow Group. Yesterday I met with the Group finance director, Marta Bidford, and we discussed some restructuring of the Group which has taken place this year. A new wholly-owned subsidiary has been acquired – Zennor Co, which is located overseas in Farland. Another subsidiary, Broadway Co, was disposed of.</p> <p>I have provided you with a summary of issues which I discussed with Marta, and using this information I would like you to prepare briefing notes for my use in which you:</p> <p>(a) (i) Explain the risks of material misstatement to be considered in planning the Group audit, commenting on their materiality to the Group financial statements; and (12 marks)</p> <p>(ii) Identify any further information that may be needed. (4 marks)</p> <p>(b) Recommend the principal audit procedures to be performed in respect of the disposal of Broadway Co. (8 marks)</p> <p>Marta has told me that Zennor Co has a well established internal audit team. She has suggested that we use the internal audit team as much as possible when performing our audit of Zennor Co as this will reduce the audit fee. The Group audit committee appreciates that with the audit of the new subsidiary there will be some increase in our costs, but has requested that the audit fee for the Group as a whole is not increased from last year's fee. I have provided you with some information about the internal audit team and in your briefing notes I would like you to:</p> <p>(c) Discuss how Marta's suggestion impacts on the planning of the audit of Zennor Co's and of the Group's financial statements, and comment on any ethical issue raised. (7 marks)</p> <p>Thank you.</p>
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Acquisition of Zennor Co

In order to expand overseas, the Group acquired 100% of the share capital of Zennor Co on 1 February 2013. Zennor Co is located in Farland, where it owns a chain of car dealerships. Zennor Co's financial statements are prepared using International Financial Reporting Standards and are measured and presented using the local currency of Farland, the Dingu. At the present time, the exchange rate is 4 Dingu = \$1. Zennor Co has the same year end as the Group, and its projected profit for the year ending 31 December 2013 is 90 million Dingu, with projected assets at the same date of 800 million Dingu.

Zennor Co is supplied with cars from the Group's manufacturing plant. The cars are sent on cargo ships and take approximately six weeks to reach the main port in Farland, where they are stored until delivered to the dealerships. At today's date there are cars in transit to Zennor Co with a selling price of \$58 million.

A local firm of auditors was engaged by the Group to perform a due diligence review on Zennor Co prior to its acquisition. The Group's statement of financial position recognises goodwill at acquisition of \$60 million.

Compton & Co was appointed as auditor of Zennor Co on 1 March 2013.

Disposal of Broadway Co

On 1 September 2013, the Group disposed of its wholly-owned subsidiary, Broadway Co, for proceeds of \$180 million. Broadway Co operated a distribution centre in this country. The Group's statement of profit or loss includes a profit of \$25 million in respect of the disposal.

Broadway Co was acquired by a retail organisation, the Cornwall Group, which wished to bring its distribution operations in house in order to save costs. Compton & Co resigned as auditor to Broadway Co on 15 September 2013 to be replaced by the principal auditor of the Cornwall Group.

Zennor Co – Internal audit team

The internal audit team was established several years ago and is headed up by a qualified accountant, Jo Evesham, who has a lot of experience in designing systems and controls. Jo and her team monitor the effectiveness of operating and financial reporting controls, and report to the board of directors. Zennor Co does not have an audit committee as corporate governance rules in Farland do not require an internal audit function or an audit committee to be established.

During the year, the internal audit team performed several value for money exercises such as reviewing the terms negotiated with suppliers.

Required:

Respond to the instructions in the partner's email.

(31 marks)

Note: The mark allocation is shown against each of the instructions in the partner's email above.

Professional marks will be awarded for the structure and presentation of the briefing notes and for the clarity of explanations.

(4 marks)

(35 marks)

2 You are a manager in the business advisory department of Goleen & Co. Your firm has been approached to provide assurance to Baltimore Co, a company which is not an audit client of your firm, on a potential acquisition. You have just had a conversation with Mark Clear, Baltimore Co's managing director, who made the following comments:

'Baltimore Co is a book publisher specialising in publishing textbooks and academic journals. In the last few years the market has changed significantly, with the majority of customers purchasing books from online sellers. This has led to a reduction in profits, and we recognise that we need to diversify our product range in order to survive. As a result of this, we decided to offer a subscription-based website to customers, which would provide the customer with access to our full range of textbooks and journals online.

'On investigating how to set up this website, we found that we lack sufficient knowledge and resources to develop it ourselves and began to look for another company which has the necessary skills, with a view to acquiring the company. We have identified Mizzen Co as a potential acquisition, and we have approached the bank for a loan which will be used to finance the acquisition if it goes ahead.

'Baltimore Co has not previously acquired another company. We would like to engage your firm to provide guidance regarding the acquisition. I understand that a due diligence review would be advisable prior to deciding on whether to go ahead with the acquisition, but the other directors are not sure that this is required, and they don't understand what the review would involve. They are also unsure about the type of conclusion that would be issued and whether it would be similar to the opinion in an audit report.

'To help me brief the other directors and using the information I have provided, I would like you to:

- (a)** Discuss THREE benefits to Baltimore Co of a due diligence review being performed on Mizzen Co. (6 marks)
- (b)** Identify and explain the matters which you would focus on in your due diligence review and recommend the additional information which you will need to perform your work. (16 marks)
- (c)** Describe the type of conclusion which would be issued for a due diligence report and compare this to an audit report.' (3 marks)

Mark Clear has sent you the following information about Mizzen Co:

Company background

Mizzen Co was established four years ago by two university graduates, Vic Sandhu and Lou Lien, who secured funds from a venture capitalist company, BizGrow, to set up the company. Vic and Lou created a new type of website interface which has proven extremely popular, and which led to the company growing rapidly and building a good reputation. They continue to innovate and have won awards for website design. Vic and Lou have a minority shareholding in Mizzen Co.

Mizzen Co employs 50 people and operates from premises owned by BizGrow, for which a nominal rent of \$1,000 is paid annually. The company uses few assets other than computer equipment and fixtures and fittings. The biggest expense is wages and salaries and due to increased demand for website development, freelance specialists have been used in the last six months. According to the most recent audited financial statements, Mizzen Co has a bank balance of \$500,000.

The company has three revenue streams:

1. Developing and maintaining websites for corporate customers. Mizzen Co charges a one-off fee to its customers for the initial development of a website and for maintaining the website for two years. The amount of this fee depends on the size and complexity of the website and averages at \$10,000 per website. The customer can then choose to pay another one-off fee, averaging \$2,000, for Mizzen Co to provide maintenance for a further five years.
2. Mizzen Co has also developed a subscription-based website on which it provides access to technical material for computer specialists. Customers pay an annual fee of \$250 which gives them unlimited access to the website. This accounts for approximately 30% of Mizzen Co's total revenue.
3. The company has built up several customer databases which are made available, for a fee, to other companies for marketing purposes. This is the smallest revenue stream, accounting for approximately 20% of Mizzen Co's total revenue.

Extracts from audited financial statements

Statement of profit or loss and other comprehensive income

	Year ended 30 September 2013 \$'000	Year ended 30 September 2012 \$'000	Year ended 30 September 2011 \$'000	Year ended 30 September 2010 \$'000
Revenue	4,268	3,450	2,150	500
Operating expenses	(2,118)	(2,010)	(1,290)	(1,000)
Operating profit/(loss)	2,150	1,440	860	(500)
Finance costs	(250)	(250)	(250)	–
Profit/(loss) before tax	1,900	1,190	610	(500)
Tax expense	(475)	(300)	(140)	–
Profit/(loss) for the year	1,425	890	470	(500)

There were no items of other comprehensive income recognised in any year.

Required:

Respond to the request from Mark Clear.

Note: The mark allocation is shown against each of the instructions from Mark Clear above.

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3** Dasset Co operates in the coal mining industry. The company owns ten mines across the country from which coal is extracted before being sold onto customers who are energy providers. Coal mining companies operate under licence from the National Coal Mining Authority, an organisation which monitors the environmental impact of coal mining operations, and requires coal mines to be operated in compliance with strict health and safety regulations.

You are an audit manager in Burton & Co, responsible for the audit of Dasset Co and you are reviewing the audit working papers for the year ended 31 August 2013. The draft financial statements recognise profit before tax of \$18 million and total assets of \$175 million. The audit senior has left a note for your attention:

Accident at the Ledge Hill Mine

On 15 August 2013, there was an accident at the Ledge Hill Mine, where several of the tunnels in the mine collapsed, causing other tunnels to become flooded. This has resulted in one-third of the mine becoming inaccessible and for safety reasons, the tunnels will be permanently closed. However, Dasset Co's management thinks that the rest of the mine can remain operational, as long as improvements are made to ensure that the mine meets health and safety regulations.

Luckily no one was injured in the accident. However, the collapse caused subsidence which has damaged several residential properties in a village located above the mine. A surveyor has been commissioned to report on whether the properties need to be demolished or whether they can be safely repaired. A group of 20 residents has been relocated to rental properties in the local area and Dasset Co is meeting all expenses in relation to this.

The Ledge Hill Mine was acquired several years ago and is recognised in the draft statement of financial position at \$10 million. As no employees were injured in the accident, Dasset Co's management has decided not to report the accident to the National Coal Mining Authority.

Required:

In respect of the accident at the Ledge Hill Mine:

- (a) (i) Comment on the matters which you should consider; and
(ii) Describe the audit evidence which you should expect to find,
in undertaking your review of the audit working papers and financial statements of Dasset Co.**

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

- (b) In relation to management's decision not to report the accident to the National Coal Mining Authority, discuss Burton & Co's responsibilities and recommend the actions which should be taken by the firm. (6 marks)**

(20 marks)

- 4 You are an audit manager in Chester & Co, and you are reviewing three situations which have recently arisen with respect to potential and existing audit clients of your firm.

Tetbury Co's managing director, Juan Stanton, has approached Chester & Co to invite the firm to tender for its audit. Tetbury Co is a small, owner-managed company providing financial services such as arranging mortgages and advising on pension plans. The company's previous auditors recently resigned. Juan Stanton states that this was due to 'a disagreement on the accounting treatment of commission earned, and because they thought our controls were not very good.' You are aware that Tetbury Co has been investigated by the financial services authority for alleged non-compliance with its regulations. As well as performing the audit, Juan would like Chester & Co to give business development advice.

The audit of Stratford Co's financial statements for the year ended 30 November 2013 will commence shortly. You are aware that the company is in financial difficulties. Stratford Co's managing director, Colin Charlecote, has requested that the audit engagement partner accompanies him to a meeting with the bank where a new loan will be discussed, and the draft financial statements reviewed. Colin has hinted that if the partner does not accompany him to the meeting, he will put the audit out to tender. In addition, an invoice relating to interim audit work performed in August 2013 has not yet been paid.

Banbury Co is a listed entity, and its audit committee has asked Chester & Co to perform an actuarial valuation on the company's defined benefit pension plan. One of the audit partners is a qualified actuary and has the necessary skills and expertise to perform the service. Banbury Co has a year ending 28 February 2014, and the audit planning is due to commence next week. Its financial statements for the year ended 28 February 2013, in respect of which the audit report was unmodified, included total assets of \$35 million and a pension liability of \$105,000.

Required:

Identify and discuss the ethical and other professional issues raised, and recommend any actions that should be taken in respect of:

- (a) Tetbury Co; (8 marks)
- (b) Stratford Co; and (6 marks)
- (c) Banbury Co. (6 marks)

(20 marks)

- 5 (a) You are the manager responsible for the audit of Burford Co, a company which designs and manufactures engine parts. The audit of the financial statements for the year ended 31 July 2013 is nearing completion and you are reviewing the working papers of the going concern section of the audit file. The draft financial statements recognise a loss of \$500,000 (2012 – profit of \$760,000), and total assets of \$13.8 million (2012 – \$14.4 million).

The audit senior has left the following note for your attention:

'I have performed analytical review on Burford Co's year-end financial statements. The current ratio is 0.8 (2012 – 1.2), the quick ratio is 0.5 (2012 – 1.6). The latest management accounts show that ratios have deteriorated further since the year end, and the company now has a cash balance of only \$25,000. Burford Co has a long-term loan outstanding of \$80,000 with a covenant attached, which states that if the current ratio falls below 0.75, the loan can be immediately recalled by the lender.'

You are also aware that one of Burford Co's best-selling products, the QuickFire, has become technically obsolete during 2013 as customers now prefer more environmentally friendly engine parts. Historically, the QuickFire has generated 45% of the company's revenue. In response to customers' preference, \$1.3 million has been spent on designing a new product, the GreenFire, due for launch in February 2014, which will be marketed as an environmentally friendly product.

A cash flow forecast has been prepared for the year to 31 July 2014, indicating that based on certain assumptions, the company's cash balance is predicted to increase to \$220,000 by the end of the forecast period. Assumptions include:

1. The successful launch of the GreenFire product,
2. The sale of plant and machinery which was used to manufacture the QuickFire, generating cash proceeds of \$50,000, forecast to take place in January 2014,
3. A reduction in payroll costs of 15%, caused by redundancies in the QuickFire manufacturing plant, and
4. The receipt of a grant of \$30,000 from a government department which encourages innovation in environmentally friendly products, scheduled to be received in February 2014.

Required:

- (i) **Identify and explain the matters which cast doubt on the going concern status of Burford Co.** (6 marks)
- (ii) **Explain the audit evidence you should expect to find in your file review in respect of the cash flow forecast.** (8 marks)
- (b) Having completed the file review, you have concluded that the use of the going concern assumption is appropriate, but that there is significant doubt over Burford Co's ability to continue as a going concern. You have advised the company's audit committee that a note is required in the financial statements to describe the significant doubt over going concern. The audit committee is reluctant to include a detailed note to the financial statements due to fears that the note will highlight the company's problems and cause further financial difficulties, but have agreed that a brief note will be included.

Required:

In respect of the note on going concern to be included in Burford Co's financial statements, discuss the implications for the audit report and outline any further actions to be taken by the auditor. (6 marks)

(20 marks)

End of Question Paper