

Professional Level – Options Module

Advanced Audit and Assurance (International)

September/December 2017 – Sample Questions



Time allowed: 3 hours 15 minutes

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.

This question paper must not be removed from the examination hall.

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Paper P7 (INT)

Section A – BOTH questions are compulsory and MUST be attempted

- 1 You are a manager in the audit department of Dove & Co, responsible for the audit of the Sunshine Hotel Group (the Group), which has a financial year ending 31 December 2017. The Group operates a chain of luxury hotels and it is planning to expand its operations over the next three years by opening hotels in countries with increasingly popular tourist destinations.

You are about to start planning the Group audit for forthcoming year end, and the audit engagement partner has just sent the following email to you:

<p>To: Audit manager</p> <p>From: John Starling, audit engagement partner</p> <p>Subject: Audit planning, the Sunshine Hotel Group</p> <hr/> <p>Hello</p> <p>I attended a planning meeting last week for the Sunshine Hotel Group (the Group) with the finance director and a representative of the Group audit committee, at which we discussed business developments during the year and plans for the future. I have provided you with my notes from this meeting, as well as some background information about the Group, as I know this is the first time that you are managing the audit. I have also provided you with an extract from an email which I received this morning from the Group finance director.</p> <p>Using the information provided you are required to prepare briefing notes for my use in which you:</p> <p>(a) Evaluate the business risks facing the Group. (10 marks)</p> <p>(b) Identify and explain the significant risks of material misstatement which should be evaluated as part of our audit planning. (10 marks)</p> <p>(c) In respect of the email received from the finance director:</p> <p>(i) Discuss the additional implications for planning the Group audit and explain any relevant actions to be taken by the firm, and (5 marks)</p> <p>(ii) Recommend the planned audit procedures to be performed on the claim of \$10 million, assuming that the audit team is given access to all relevant sources of audit evidence. (6 marks)</p> <p>Thank you.</p>
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Background information

The Group owns 20 hotels, all located in popular beachside holiday resorts. The hotels operate on an ‘all-inclusive’ basis, whereby guests can consume unlimited food and drink, and take part in a variety of water sports including scuba diving as part of the price of their holiday. Each hotel has at least four restaurants and a number of bars. The ‘Sunshine Hotel’ brand is a market leader, with significant amounts spent each year on marketing to support the brand. The hotels are luxurious and maintained to a very high standard and are marketed as exclusive adult-only luxury holiday destinations.

When customers book to stay in the hotel, they are charged a deposit equivalent to 20% of the total cost of their stay, and a further 20% is payable eight weeks before arrival. The remaining 60% is settled on departure. If a booking is cancelled prior to a week before a guest’s stay commences, then a full refund is given, but no refunds are given for cancellations within the week leading up to a guest’s stay.

Notes from meeting with finance director and representative of Group audit committee

The Group has seen continued growth, with revenue for the year to 31 December 2017 projected to be \$125 million (2016 – \$110 million), and profit before tax projected to be \$10 million (2016 – \$9 million).

According to the latest management accounts, the Group’s total assets are currently \$350 million. The ‘Sunshine Hotel’ brand is not recognised as an asset in the financial statements because it has been internally generated. The Group has cash of \$20 million at today’s date. Most of this cash is held on short-term deposit in a number of different currencies. Based on the latest management accounts, the Group’s gearing ratio is 25%.

In January 2017, the Group entered into an agreement with an internationally acclaimed restaurant chain, Moulin Blanche, to open new restaurants in its five most popular hotels. The agreement cost \$5 million, lasts for 10 years, and allows the Group to use the restaurant name, adopt the menus and decorate the restaurants in the style of Moulin Blanche. The cost of \$5 million has been recognised within marketing expenses for the year. After a period of refurbishment, the new restaurants opened in all five hotels on 1 July 2017.

Part of the Group strategy is to expand into new countries, and in July 2017 the Group purchased land in three new locations in Farland at a cost of \$75 million. There are currently no specific plans for the development of these locations due to political instability in the country. In addition to the Farland acquisitions, an existing hotel complex was purchased from a competitor for \$23 million. The hotel complex is located in a country where local legislation prohibits private ownership and use of beaches, so the Group's hotel guests cannot enjoy the private and exclusive use of a beach which is one of the Group's key selling points. For this reason, the Group has not yet developed the hotel complex and it is currently being used as a location for staff training. All of these assets are recognised at cost as property, plant and equipment in the Group statement of financial position. Due to the problems with these recent acquisitions, the Group is planning to invest in alternative locations, with capital expenditure on sites in new locations of \$45 million budgeted for 2018. This will be funded entirely from an undrawn borrowing facility with the Group's bank which has a fixed interest rate of 3.5% per annum.

Two of the Group's hotels are located in an area prone to hurricanes, and unfortunately only last week, a hurricane caused severe damage to both of these hotels. Under the Group's 'hurricane guarantee scheme', customers who were staying at the hotels at the time of the hurricane were transferred to other Group hotels, at no cost to the customer. Customers with bookings to stay at the closed hotels have been offered a refund of their deposits, or to transfer their reservation to a different Group hotel, under the terms of the scheme. The hotels are closed while the necessary repair work, which will take two months, is carried out at an estimated cost of \$25 million. The repair work will be covered by the Group's insurance policy, which typically pays half of the estimated cost of repair work in advance, with the balance paid when the repair work is completed. No accounting entries have been made as yet in relation to the hurricane.

Extract from email from the Group finance director to John Starling, audit engagement partner

John

The Group's lawyer has received a letter from Ocean Protection, a multi-national pressure group which aims to safeguard marine environments. Ocean Protection is claiming that our hotel guests are causing environmental damage to delicate coral reefs when scuba diving under the supervision of the Group's scuba diving instructors.

Ocean Protection is pressing charges against the Group, and alleges that our activities are in breach of international environmental protection legislation which is ratified by all of the countries in which the Group operates. Damages of \$10 million are being sought, Ocean Protection suggesting that this amount would be used to protect the coral reefs from further damage.

The Group is keen to avoid any media attention, so I am hoping to negotiate a lower level of payment and an agreement from Ocean Protection that they will not make the issue public knowledge.

From an accounting point of view, we do not want to recognise a liability, as the disclosures will draw attention to the matter. We will account for any necessary payment when it is made, which is likely to be next year.

I understand that your audit team will need to look at this issue, but I ask that you only speak to me about it, and do not speak to any other employees. Also, I do not want you to contact Ocean Protection as this could impact on our negotiation.

Required:

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

Note: The mark allocation is shown within the email.

Professional marks to be awarded for presentation, logical flow, and clarity of explanations provided. (4 marks)

(35 marks)

- 2 You are a manager in the audit department of Pigeon & Co, a firm of Chartered Certified Accountants. You are responsible for the audit of Goldfinch Gas Co, a company which is the main supplier of gas to business and residential customers across the country.

The audit fieldwork for the year ended 30 June 2017 is nearing completion. The draft financial statements recognise profit before tax of \$130 million (2016 – \$110 million), and total assets of \$1,900 million (2016 – \$1,878 million).

You are reviewing the audit files and the following matters have been noted for your attention by the audit senior:

(a) Decommissioning provision

A provision of \$430 million (2016 – \$488 million) is recognised as a long-term liability. The provision is in respect of decommissioning a number of gas production and storage facilities when they are at the end of their useful lives. The estimate of the decommissioning costs has been based on price levels and technology at the reporting date, and discounted to present value using an interest rate of 8% (2016 – 6%). The timing of decommissioning payments is dependent on the estimated useful lives of the facilities but is expected to occur by 2046, with the majority of the provision being utilised between 2025 and 2040.

The accounting policy note discusses the methodology used by management for determining the value of the decommissioning provision and states that this is an area of critical accounting judgements including key areas of estimation uncertainty. The estimate has been made by management. In previous years, a management expert was engaged to provide the estimate but as this was expensive, management decided to produce their own estimate for the year ended 30 June 2017. (10 marks)

(b) Depreciation

The draft statement of financial position includes plant and equipment, unrelated to gas production and storage facilities, with a carrying value of \$65 million. There was a change in the estimation technique used to determine the depreciation in respect of these assets during the year. Depreciation was previously calculated on a straight line basis over a 10-year useful life, but from 1 July 2016, the useful life has been amended to 15 years. The finance director explained to the audit team that the review of estimated useful life has been made on the basis that the assets are lasting longer than originally anticipated.

The change in depreciation policy has been accounted for as a prior year adjustment, resulting in an increase of \$20 million to property, plant and equipment and to retained earnings. The depreciation expense recognised in draft profit for the year to 30 June 2017 is \$12 million (2016 – \$15 million). (8 marks)

(c) Trade receivables

The draft statement of financial position recognises total trade receivables of \$450 million (2016 – \$390 million). The audit team has performed substantive analytical procedures on trade receivables with the following results:

Receivables collection period:	2017	2016
Residential customers	65 days	58 days
Business customers	50 days	55 days

The notes to the financial statements contain the following information relating to trade receivables:

Trade receivables:	2017 \$ million	2016 \$ million
Residential customers	158	145
Business customers	356	289
Less: allowance for credit losses	(64)	(44)
Net trade receivables	<u>450</u>	<u>390</u>

Receivables from business customers are generally reviewed for impairment on an individual basis when a customer changes their gas supplier, discontinuing their relationship with the Group. Receivables from residential customers are reviewed for impairment where they are more than 90 days late in paying their bill, or where customers have a history of late payment. Since a new customer billing system was introduced in September 2016, management has exercised additional judgement regarding the appropriate level of allowance for these trade receivables. (7 marks)

Required:

Comment on the matters to be considered, and explain the audit evidence you should expect to find during your file review in respect of each of the issues described above.

You are NOT required to explain the potential impact of the matters on the auditor's opinion or report.

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

(25 marks)

Section B – TWO questions ONLY to be attempted

- 3 (a) You are a manager in one of the assurance departments of Leopard & Co, a large firm of Chartered Certified Accountants. You are currently assigned to a due diligence engagement for one of your firm's audit clients, Cheetah Co, a manufacturer of bespoke furniture. The audit of Cheetah Co is conducted by a team from a different department; you have never been involved in the audit of this client.

The engagement is to conduct a financial and operational due diligence review of Zebra Co, a company which has been identified as a potential acquisition target by Cheetah Co, due to the synergies offered and the potential to expand the existing production facilities. As part of the due diligence review, you have been asked to provide a valuation of Zebra Co's assets and liabilities and an analysis of the company's operating profit forecasts. This will assist Cheetah Co in determining an appropriate purchase price for Zebra Co.

During the engagement fieldwork your team identified two matters, which require your further consideration, as follows:

1. While reviewing correspondence with customers in relation to outstanding receivables, one of the team found a letter from a large retailer, for which Zebra Co produces a number of unique products, providing advanced notice that they are not renewing their purchasing agreement when the current one expires. The customer advised that they are switching to a new entrant to the market who is substantially cheaper than Zebra Co. A brief analysis identified that the customer provides, on average, almost 5% of Zebra Co's annual revenues.
2. Zebra Co owns a piece of land which was given to it as a gift by the local authorities ten years ago. The land surrounds the entrance to the main production premises and is designated as a nature reserve. Restrictions were imposed on the usage of the land which also limit who the owner is able to sell the land to in the future. The land has zero carrying value in the financial statements.

No additional matters have arisen for your consideration. You are also aware that the financial statements for the last ten years have been audited and no modifications have been made to the auditor's opinion during this period.

Required:

In respect of the two matters identified above:

- (i) Explain why each matter requires further investigation as part of the due diligence review, and (6 marks)
- (ii) Recommend the investigation procedures to be performed. (6 marks)

- (b) The management team of Cheetah Co has also approached Leopard & Co to ask whether representatives of the firm would be available to attend a meeting with the company's bankers, who they are hoping will finance the acquisition of Zebra Co, to support the management team in conveying the suitability of the acquisition of Zebra Co. For the meeting the bank requires the most up-to-date interim accounts of Cheetah Co with the accompanying auditor's independent interim review report. Your firm is due to complete the interim review shortly and the management team of Cheetah Co has requested that the interim review is completed quickly so that it does not hold up negotiations with the bank, stating that if it does, it may affect the outcome of the next audit tender, which is due to take place after the completion of this year's audit.

Required:

Comment on the ethical and professional issues raised, and recommend any actions which should be taken in respect of the request from the management team of Cheetah Co. (8 marks)

(20 marks)

- 4 You are a senior manager at Cobra & Co, a firm of Chartered Certified Accountants. You are responsible for reviewing quality control and ethical matters which arise with the firm's portfolio of clients. During recent investigations you identified the following matters:

Asp Co

Asp Co currently qualifies as a small company in the jurisdiction in which it operates, with turnover of \$7.5 million (2016 – \$5.3 million), and as such is not required by law to have an audit. Until recently, your firm has provided a range of non-audit services to Asp Co including bookkeeping, payroll and tax computation and advice. The company recently obtained an offer for a significant amount of finance to help the company grow. The management of Asp Co has ambitious plans for growth which they believe will result in revenue doubling within one year and then continuing to grow at a similar rate for at least the next five years. In order to secure the funding, the directors have decided to have the financial statements audited and have asked if Cobra & Co will become the company's auditors, as well as continuing to provide the existing services. This will include auditing the financial statements for the year ended 31 July 2017 at the request of the new financiers.

Viper Co

You have been approached by Viper Co, a retail company, to provide audit and tax services. In response you have written to the outgoing auditor to ask if there are any matters which you should be made aware of which might prevent you from accepting the assignment. Despite a number of follow up phone calls, you have not been able to obtain a response from the outgoing audit firm. On discussing this with the management team of Viper Co, you are made aware that the company is suing the outgoing auditor for damages due to the detrimental effect on their reputation following the auditor issuing a modified opinion, which the directors of Viper Co felt was inappropriate. The reason for the modified opinion was the application of an accounting treatment which the outgoing auditor considered to be inappropriate and a material misstatement.

Adder Co

Adder Co is a listed audit client of your firm. The management team of Adder Co has asked you to perform a valuation of the shares of another audit client, Slowworm Co, with a view to buying the entire shareholding. Slowworm Co is a private company whose shares are owned entirely by the original founder, Mr Jim Slow.

Required:

Comment on the ethical and other professional issues raised, and recommend any actions which should be taken in respect of:

(a) Asp Co; (7 marks)

(b) Viper Co; (7 marks)

(c) Adder Co. (6 marks)

(20 marks)

5 (a) **Discuss the three types of misstatement identified in ISA 450 *Evaluation of Misstatements Identified During the Audit* and comment on why it is important for the auditor to consider the type of misstatement when evaluating their effect on the financial statements and determining the further actions to be taken.** (5 marks)

(b) You are responsible for the audit of Basking Co, a large, listed package delivery company. The audit of the financial statements for the year ended 31 July 2017 is nearly complete and you are reviewing the audit working papers. The financial statements recognise revenue of \$56,360 million (2016 – \$56,245 million), profit for the year of \$2,550 million (2016 – \$2,630 million) and total assets of \$37,546 million (2016 – \$38,765 million).

The uncorrected misstatements identified during the audit of Basking Co are described below. The audit engagement partner is holding a meeting with the management team of Basking Co next week, at which the uncorrected misstatements will be discussed.

(1) The accuracy of the depreciation charge was investigated for a sample of motor vehicles with a carrying value of \$4.5 million. The investigation revealed that the accounting system had failed to correctly depreciate vehicles acquired during the year. Consequently, depreciation in the sample had been understated, and the carrying value of the vehicles overstated, by \$350,000. The total value of all motor vehicles at the year end was \$125 million (2016 – \$131 million).

(2) In January 2017, the board of Basking Co approved a loan to, Mrs C Angel, who is a key member of the senior management team of the company. The total amount of the loan was \$75,000. Following a review of the board minutes, it was discovered that the directors agreed that the amount was clearly trivial and have, therefore, not disclosed the loan in the notes to the financial statements.

(3) During the year Basking Co reduced the value of their provision for customer refunds which is recognised in the financial statements. For the past five years the value of the provision has been calculated based on 7% of one month's sales, using an average monthly sales value. Management argued that due to improved internal processing systems, such a high rate of provision was no longer necessary and reduced it to 4%. Audit procedures found that refund levels were similar to previous years and there was insufficient evidence at this early stage to confirm whether the new system was more effective or not.

Required:

For each of the matters described above:

- (i) **Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements, and**
- (ii) **Assuming that management does not adjust the misstatements identified, evaluate the effect of each on the audit opinion.**

Note: The total marks will be split equally between each matter.

(15 marks)

(20 marks)

End of Question Paper