Professional Level – Options Module

Advanced Audit and Assurance (International)

March/June 2016 – Sample Questions

Paper P7 (INT)

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.

Think Ahead ACCA

The Association of Chartered Certified Accountants

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The question paper begins on page 3.

Section A – BOTH questions are compulsory and MUST be attempted

1 You are an audit manager in Montreal & Co, a firm of Chartered Certified Accountants, and you are responsible for the audit of the Vancouver Group (the Group). The Group operates in the supply chain management sector, offering distribution, warehousing and container handling services.

The Group comprises a parent company, Vancouver Co, and two subsidiaries, Toronto Co and Calgary Co. Both of the subsidiaries were acquired as wholly owned subsidiaries many years ago. Montreal & Co audits all of the individual company financial statements as well as the Group consolidated financial statements.

You are beginning to plan the Group audit for the financial year ending 31 July 2016, and the audit engagement partner has sent you the following email:

> **To: Audit manager**
>
> **From: Albert Franks, audit engagement partner**
>
> **Subject: The Vancouver Group – audit planning**
>
> ---
>
> **Hello**
>
> I held a meeting yesterday with Hannah Peters, the Group finance director. A representative of the Group audit committee was also at the meeting to discuss two issues raised for our attention by the committee. Hannah gave me some projected financial information for the Group's forthcoming year end, along with comparatives and explanatory notes, and we discussed some matters relevant to the Group this year. I am preparing for the audit team briefing next week at which there will be a number of recent recruits into the audit department whose first assignment will be the Vancouver Group.
>
> I have attached some notes from my meeting as well as the financial information provided by Hannah. Using this information you are required to prepare briefing notes for use in the audit team briefing in which you:
>
> **(a)** Explain why analytical procedures are performed as a fundamental part of our risk assessment at the planning stage of the audit. (5 marks)
>
> **(b)** Identify and explain the audit risks which should be considered in planning the Group audit. You should ensure that you consider all of the information provided as well as utilising analytical procedures, where relevant, to identify the audit risks. (18 marks)
>
> **(c)** Discuss the ethical issues relevant to Montreal & Co, and recommend any actions which should be taken by our firm. (8 marks)
>
> **Thank you.**

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

The Group has not changed its operations significantly this year. However, it has completed a modernisation programme of its warehousing facilities at a cost of $25 million. The programme was financed with cash raised from two sources: $5 million was raised from a debenture issue, and $20 million from the sale of 5% of the share capital of Calgary Co, with the shares being purchased by an institutional investor.

An investigation into the Group's tax affairs started in January 2016. The tax authorities are investigating the possible underpayment of taxes by each of the companies in the Group, claiming that tax laws have been breached. The Group's tax planning was performed by another firm of accountants, Victoria & Co, but the Group's audit committee has asked if our firm will support the Group by looking into its tax position and liaising with the tax authorities in respect of the tax investigation on its behalf. Victoria & Co has resigned from their engagement to provide tax advice to the Group. The matter is to be resolved by a tribunal which is scheduled to take place in September 2016.

The Group audit committee has also asked whether one of Montreal & Co's audit partners can be appointed as a non-executive director and serve on the audit committee. The audit committee lacks a financial reporting expert, and the appointment of an audit partner would bring much needed knowledge and experience.

Financial information provided by the Group finance director

Consolidated statement of financial position

	Note	Projected 31 July 2016 $m	Actual 31 July 2015 $m
Assets			
Non-current assets			
Property, plant and equipment	1	230	187
Intangible assets – goodwill		30	30
Deferred tax asset	2	10	15
Total non-current assets		270	232
Current assets			
Inventories		35	28
Trade and other receivables		62	45
Cash and cash equivalents		–	10
Total current assets		97	83
Total assets		367	315
Equity and liabilities			
Equity			
Equity share capital		50	50
Retained earnings		126	103
Non-controlling interest	3	5	–
Total equity		181	153
Non-current liabilities			
Debenture		60	55
Provisions	4	6	12
Total non-current liabilities		66	67
Current liabilities			
Trade and other payables		105	95
Overdraft		15	–
Total current liabilities		120	95
Total liabilities		186	162
Total equity and liabilities		367	315

Consolidated statement of profit or loss for the year to 31 July

	Projected 2016 $m	Actual 2015 $m
Revenue	375	315
Operating expenses	(348)	(277)
Operating profit	27	38
Profit on disposal of shares in Calgary Co	10	–
Finance costs	(4)	(3)
Profit before tax	33	35
Tax expense	(10)	(15)
Profit for the year	23	20

Notes:

1. Several old warehouses were modernised during the year. The modernisation involved the redesign of the layout of each warehouse, the installation of new computer systems, and the replacement of electrical systems.
2. The deferred tax asset is in respect of unused tax losses (tax credits) which accumulated when Toronto Co was loss making for a period of three years from 2009 to 2012.
3. The non-controlling interest has arisen on the disposal of shares in Calgary Co. On 1 January 2016, a 5% equity shareholding in Calgary Co was sold, raising cash of $20 million. The profit made on the disposal is separately recognised in the Group statement of profit or loss.
4. The provisions relate to onerous leases in respect of vacant properties which are surplus to the Group's requirements.

Required:

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

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

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

(35 marks)

2 You are a senior manager in Macau & Co, a firm of Chartered Certified Accountants. In your capacity as engagement quality control reviewer, you have been asked to review the audit files of Stanley Co and Kowloon Co, both of which have a financial year ended 31 December 2015, and the audits of both companies are nearing completion.

(a) Stanley Co is a frozen food processor, selling its products to wholesalers and supermarkets. From your review of the audit working papers, you have noted that the level of materiality was determined to be $1·5 million at the planning stage, and this materiality threshold has been used throughout the audit. There is no evidence on the audit file that this threshold has been reviewed during the course of the audit.

From your review of the audit planning, you know that a new packing machine with a cost of $1·6 million was acquired by Stanley Co in March 2015, and is recognised in the draft statement of financial position at a carrying amount of $1·4 million at 31 December 2015. The packing machine is located at the premises of Aberdeen Co, a distribution company which is used to pack and distribute a significant proportion of Stanley Co's products. The machine has not been physically verified by a member of the audit team. The audit working papers conclude that 'we have obtained the purchase invoice and order in relation to the machine, and therefore can conclude that the asset is appropriately valued and that it exists. In addition, the managing director of Aberdeen Co has confirmed in writing that the machine is located at their premises and is in working order. No further work is needed in respect of this item.'

Inventory is recognised at $2 million in the draft statement of financial position. You have reviewed the results of audit procedures performed at the inventory count, where the test counts performed by the audit team indicated that the count of some items performed by the company's staff was not correct. The working papers state that 'the inventory count was not well organised' and conclude that 'however, the discrepancies were immaterial, so no further action is required'.

The audit senior spoke to you yesterday, voicing some concerns about the performance of the audit. A summary of his comments is shown below:

'The audit manager and audit engagement partner came to review the audit working papers on the same day towards the completion of the audit fieldwork. The audit partner asked me if there had been any issues on the sections of the audit which I had worked on, and when I said there had been no problems, he signed off the working papers after a quick look through them.

When reading the company's board minutes, I found several references to the audit engagement partner, Joe Lantau. It appears that Joe recommended that the company use the services of his brother, Mick Lantau, for advice on business development, as Mick is a management consultant. Based on that recommendation, Mick has provided a consultancy service to Stanley Co since September 2015. I mentioned this to Joe, and he told me not to record it in the audit working papers or to discuss it with anyone.'

Required:

Comment on the quality of the audit performed discussing the quality control, ethical and other professional issues raised. (13 marks)

(b) Kowloon Co works on contracts to design and manufacture large items of medical equipment such as radiotherapy and X-ray machines. The company specialises in the design, production and installation of bespoke machines under contract with individual customers, which are usually private medical companies. The draft financial statements recognise profit before tax of $950,000 and total assets of $7·5 million.

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

'One of Kowloon Co's major customers is the Bay Medical Centre (BMC), a private hospital. In June 2015 a contract was entered into, under the terms of which Kowloon Co would design a new radiotherapy machine for BMC. The machine is based on a new innovation, and is being developed for the specific requirements of BMC. It was estimated that the design and production of the machine would take 18 months with estimated installation in December 2016. As at 31 December 2015, Kowloon Co had invested heavily in the contract, and design costs totalling $350,000 have been recognised as work in progress in the draft statement of financial position. Deferred income of $200,000 is also recognised as a current liability, representing a payment made by BMC to finance part of the design costs. No other accounting entries have been made in respect of the contract with BMC.

As part of our subsequent events review, inspection of correspondence between Kowloon Co and BMC indicates that the contract has been cancelled by BMC as it is unable to pay for its completion. It appears that BMC lost a significant amount of funding towards the end of 2015, impacting significantly on the financial position of the company. The manager responsible for the BMC contract confirms that BMC contacted him about the company's financial difficulties in December 2015.

The matter has been discussed with Kowloon Co's finance director, who has stated that he is satisfied with the current accounting treatment and is not proposing to make any adjustments in light of the cancellation of the contract by BMC. The finance director has also advised that the loss of BMC as a customer will not be mentioned in the company's integrated report, as the finance director does not consider it significant enough to warrant discussion.

Kowloon Co is currently working on six contracts for customers other than BMC. Our audit evidence concludes that Kowloon Co does not face a threat to its going concern status due to the loss of BMC as a customer.'

Your review of the audit work performed on going concern supports this conclusion.

Required:

(i) Comment on the matters to be considered, and recommend the actions to be taken by the auditor; and (7 marks)

(ii) Explain the audit evidence you would expect to find in your review of the audit working papers. (5 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3 (a) According to ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*:

'When identifying and assessing the risks of material misstatement due to fraud, the auditor shall, based on a presumption that there are risks of fraud in revenue recognition, evaluate which types of revenue, revenue transactions or assertions give rise to such risks.'

Required:

Discuss why the auditor should presume that there are risks of fraud in revenue recognition and why ISA 240 requires specific auditor responses in relation to the risks identified. (7 marks)

(b) You are the manager responsible for the audit of York Co, a chain of health and leisure clubs owned and managed by entrepreneur Phil Smith. The audit for the year ended 30 November 2015 is nearing completion and the draft financial statements recognise total assets of $27 million and profit before tax of $2·2 million. The audit senior has left the following file notes for your consideration during your review of the audit working papers:

(i) Cash transfers

During a review of the cash book, a receipt of $350,000 was identified which was accompanied by the description 'BD'. Bank statements showed that the following day a nearly identical amount was transferred into a bank account held in a foreign country. When I asked the financial controller about this, she requested that I speak to Mr Smith, as he has sole responsibility for cash management. According to Mr Smith, an old friend of his, Brian Davies, has loaned the money to the company to fund further expansion and the money has been invested until it is needed. Documentary evidence concerning the transaction has been requested from Mr Smith but has not yet been received. (7 marks)

(ii) Legal dispute

At the year end York Co reversed a provision relating to an ongoing legal dispute with an ex-employee who was claiming $150,000 for unfair dismissal. This amount was provided in full in the financial statements for the year ended 30 November 2014 but has now been reversed because Mr Smith believes it is now likely that York Co will successfully defend the legal case. Mr Smith has not been available to discuss this matter and no additional documentary evidence has been made available since the end of the previous year's audit. The audit report was unmodified in the previous year. (6 marks)

Required:

Evaluate the implications for the completion of the audit, recommending any further actions which should be taken by your audit firm.

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

(20 marks)

4 You are a manager at Chennai & Co, a firm of Chartered Certified Accountants. One of the partners has asked you to investigate and respond to a number of issues which have arisen with two different companies.

(a) Delhi Co, a potential new client, is a privately owned and rapidly expanding company which currently operates below the audit threshold in the country in which it is based. The company's management is currently considering having either a full audit or a limited assurance review of their financial statements. The partner would like you to assist the management of Delhi Co by writing a response to them in which you:

(i) Explain the difference between an audit of historical financial statements and a limited assurance review. (4 marks)

(ii) Discuss the relative advantages and disadvantages to Delhi Co of having an audit of their historical financial statements as opposed to a limited assurance review. (8 marks)

Delhi Co was incorporated in 2005, with founder and chief executive Mr Nimesh Dattani as the sole shareholder. After a period of rapid growth, Delhi Co took out a ten-year bank loan facility in June 2007 to finance Mr Dattani's ambitious expansion plans. This was supported by a further injection of financial capital in 2014 through a new issue of shares in the company. The shares were sold to Mr Robert Hyland, an ex-business partner of Mr Dattani. The sale gave Mr Hyland a 40% shareholding in Delhi Co. He has no involvement in the management of the company.

Until recently Delhi Co operated with a small accounting department, comprising one full-time member of staff and one part-time employee. Due to the expansion of the company and Mr Dattani's plans to expand the customer base internationally, it has been necessary to increase the size of the accounting function to include two new full-time members of staff. Both of the new recruits are part-qualified accountants and Mr Dattani has committed to sponsoring them through their remaining training and ACCA examinations.

Required:

Prepare the response to the management of Delhi Co as requested by the partner.

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

(b) The audit committee of another client, Mumbai Co, has asked the partner to consider whether it would be possible for the audit team to perform a review of the company's internal control system. A number of recent incidents have raised concerns amongst the management team that controls have deteriorated and that this has increased the risk of fraud, as well as inefficient commercial practices. The audit report for the audit of the financial statements of Mumbai Co for the year ended 31 March 2016 was signed a few weeks ago. Mumbai Co is a listed company.

Required:

In respect of the request for Chennai & Co to review Mumbai Co's internal control systems:

Identify and discuss the relevant ethical and professional issues raised, and recommend any actions necessary. (8 marks)

(20 marks)

5 You are the manager responsible for the audit of Boston Co, a producer of chocolate and confectionery. The audit of the financial statements for the year ended 31 December 2015 is nearly complete and you are reviewing the audit working papers. The financial statements recognise revenue of $76 million, profit before tax for the year of $6·4 million and total assets of $104 million.

The summary of uncorrected misstatements included in Boston Co's audit working papers, including notes, is shown below. The audit engagement partner is holding a meeting with the management team of Boston Co next week, at which the uncorrected misstatements will be discussed.

	Statement of profit or loss		Statement of financial position	
Summary of uncorrected misstatements:	**Debit $**	**Credit $**	**Debit $**	**Credit $**
(i) Impairment	400,000			400,000
(ii) Borrowing costs		75,000	75,000	
(iii) Irrecoverable debt	65,000			65,000
(iv) Investment		43,500	43,500	
Totals	465,000	118,500	118,500	465,000

(i) During the year Boston Co impaired one of its factories. The carrying value of the assets attributable to the factory as a single, cash-generating unit totalled $3·6 million at the year end. The fair value less costs of disposal and the value in use were estimated to be $3 million and $3·5 million respectively and accordingly the asset was written down by $100,000 to reflect the impairment. Audit procedures revealed that management used growth rates attributable to the company as a whole to estimate value in use. Using growth rates attributable to the factory specifically, the audit team estimated the value in use to be $3·1 million.

(ii) Interest charges of $75,000 relating to a loan taken out during the year to finance the construction of a new manufacturing plant were included in finance charges recognised in profit for the year. The manufacturing plant is due for completion in November 2016.

(iii) One of Boston Co's largest customers, Cleveland Co, is experiencing financial difficulties. At the year end Cleveland Co owed Boston Co $100,000, against which Boston Co made a 5% specific allowance. Shortly after the year end Cleveland Co paid $30,000 of the outstanding amount due but has since experienced further problems, leading to their primary lender presenting a formal request that Cleveland Co be liquidated. If successful, only secured creditors are likely to receive any reimbursement.

(iv) During the year Boston Co purchased 150,000 shares in Nebraska Co for $4·00 per share. Boston Co classified the investment as a financial asset held at fair value through profit or loss. On 31 December 2015, the shares of Nebraska Co were trading for $4·29. At the year end the carrying value of the investment in Boston Co's financial statements was $600,000.

Required:

(a) Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements, including an assessment of their individual impact on the financial statements; and

(b) Assuming that management does not adjust any of the misstatements, discuss the effect on the audit opinion and auditor's report.

The following mark allocation is provided as guidance for this question:

(a) 14 marks
(b) 6 marks

(20 marks)

End of Question Paper