Professional Level – Options Module

Advanced Audit and Assurance (International)

Monday 1 December 2014

Paper P7 (INT)

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

ACCA

Section A – BOTH questions are compulsory and MUST be attempted

1 You are an audit manager in Davies & Co, responsible for the audit of Connolly Co, a listed company operating in the pharmaceutical industry. You are planning the audit of the financial statements for the year ending 31 December 2014, and the audit partner, Ali Stone, has sent you this email:

> To: Audit manager
>
> From: Ali Stone, Audit partner
>
> Subject: Audit planning – Connolly Co
>
> ---
>
> Hello
>
> I would like you to start planning the audit of Connolly Co. The company's finance director, Maggie Ram, has sent to me this morning some key financial information discussed at the latest board meeting. I have also provided you with minutes of a meeting I had with Maggie last week and some background information about the company. Using this information I would like you to prepare briefing notes for my use in which you:
>
> **(a)** Evaluate the business risks faced by Connolly Co; (11 marks)
>
> **(b)** Identify and explain FOUR risks of material misstatement to be considered in planning the audit; (8 marks)
>
> **(c)** Recommend the principal audit procedures to be performed in respect of the acquired 'Cold Comforts' brand name; and (5 marks)
>
> **(d)** Discuss the ethical issues relevant to the audit firm, and recommend appropriate actions to be taken. (7 marks)
>
> Thank you.

Background information

Connolly Co is a pharmaceutical company, developing drugs to be licensed for use around the world. Products include medicines such as tablets and medical gels and creams. Some drugs are sold over the counter at pharmacy stores, while others can only be prescribed for use by a doctor. Products are heavily advertised to support the company's brand names. In some countries television advertising is not allowed for prescription drugs.

The market is very competitive, encouraging rapid product innovation. New products are continually in development and improvements are made to existing formulations. Four new drugs are in the research and development phase. Drugs have to meet very stringent regulatory requirements prior to being licensed for production and sale. Research and development involves human clinical trials, the results of which are scrutinised by the licensing authorities.

It is common in the industry for patents to be acquired for new drugs and patent rights are rigorously defended, sometimes resulting in legal action against potential infringement.

Minutes from Ali Stone's meeting with Maggie Ram

Connolly Co has approached its bank to extend its borrowing facilities. An extension of $10 million is being sought to its existing loan to support the on-going development of new drugs. Our firm has been asked by the bank to provide a guarantee in respect of this loan extension.

In addition, the company has asked the bank to make cash of $3 million available in the event that an existing court case against the company is successful. The court case is being brought by an individual who suffered severe and debilitating side effects when participating in a clinical trial in 2013.

In January 2014, Connolly Co began to sell into a new market – that of animal health. This has been very successful, and the sales of veterinary pharmaceuticals and grooming products for livestock and pets amount to approximately 15% of total revenue for 2014.

Another success in 2014 was the acquisition of the 'Cold Comforts' brand from a rival company. Products to alleviate the symptoms of coughs and colds are sold under this brand. The brand cost $5 million and is being amortised over an estimated useful life of 15 years.

Connolly Co's accounting and management information systems are out of date. This is not considered to create any significant control deficiencies, but the company would like to develop and implement new systems next year. Management has asked our firm to give advice on the new systems as they have little specialist in-house knowledge in this area.

Key financial information

	2014 – Projected unaudited $'000	2013 – Actual audited $'000
Revenue	40,000	38,000
Operating profit	8,100	9,085
Operating margin	20%	24%
Earnings per share	25c	29c
Net cash flow	(1,200)	6,000
Research and development cash outflow in the year	(3,000)	(2,800)
Total development intangible asset recognised at the year end	50,000	48,000
Total assets	200,000	195,000
Gearing ratio (debt/equity)	0·8	0·9

Required:

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

Note: The split of marks is shown within the partner's email.

Professional marks will be awarded in question 1 for the presentation, clarity of explanations and logical flow of the answer. (4 marks)

(35 marks)

2 You are a manager in the audit department of Williams & Co and you are reviewing the audit working papers in relation to the Francis Group (the Group), whose financial year ended on 31 July 2014. Your firm audits all components of the Group, which consists of a parent company and three subsidiaries – Marks Co, Roberts Co and Teapot Co.

The Group manufactures engines which are then supplied to the car industry. The draft consolidated financial statements recognise profit for the year to 31 July 2014 of $23 million (2013 – $33 million) and total assets of $450 million (2013 – $455 million).

Information in respect of three issues has been highlighted for your attention during the file review.

(a) An 80% equity shareholding in Teapot Co was acquired on 1 August 2013. Goodwill on the acquisition of $27 million was calculated at that date and remains recognised as an intangible asset at that value at the year end. The goodwill calculation performed by the Group's management is shown below:

	$'000
Purchase consideration	75,000
Fair value of 20% non-controlling interest	13,000
	88,000
Less: Fair value of Teapot Co's identifiable net assets at acquisition	(61,000)
Goodwill	27,000

In determining the fair value of identifiable net assets at acquisition, an upwards fair value adjustment of $300,000 was made to the book value of a property recognised in Teapot Co's financial statements at a carrying value of $600,000.

A loan of $60 million was taken out on 1 August 2013 to help finance the acquisition. The loan carries an annual interest rate of 6%, with interest payments made annually in arrears. The loan will be repaid in 20 years at a premium of $5 million. (12 marks)

(b) In September 2014, a natural disaster caused severe damage to the property complex housing the Group's head office and main manufacturing site. For health and safety reasons, a decision was made to demolish the property complex. The demolition took place three weeks after the damage was caused. The property had a carrying value of $16 million at 31 July 2014.

A contingent asset of $18 million has been recognised as a current asset and as deferred income in the Group statement of financial position at 31 July 2014, representing the amount claimed under the Group's insurance policy in respect of the disaster. (7 marks)

(c) Marks Co supplies some of the components used by Roberts Co in its manufacturing process. At the year end, an intercompany receivable of $20 million is recognised in Marks Co's financial statements. Roberts Co's financial statements include a corresponding intercompany payables balance of $20 million and inventory supplied from Marks Co valued at $50 million. (6 marks)

Required:

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

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 Faster Jets Co is an airline company and is a new audit client of Brown & Co. You are responsible for the audit of the financial statements for the year ended 30 November 2014. The draft financial statements recognise revenue of $150 million and total assets of $250 million.

(a) During the year, Faster Jets Co purchased several large plots of land located near major airports at a cost of $12·5 million. The land is currently rented out and is classified as investment property, which is recognised in the draft financial statements at a fair value of $14·5 million. The audit partner has suggested the use of an auditor's expert to obtain evidence in respect of the fair value of the land.

Required:

In respect of the land recognised as investment property:

(i) Explain the additional information which you require to plan the audit of the land; and
(ii) Explain the matters to be considered in assessing the reliance which can be placed on the work of an auditor's expert.

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

(b) Your firm has also been engaged to perform a separate assurance engagement on Faster Jets Co's corporate social responsibility (CSR) report. This engagement will be performed by Brown & Co's specialist social and environmental assurance department and there are no ethical threats created by the provision of this service in addition to the audit. An extract from the draft CSR report is shown below:

CSR objective	CSR target	Performance in 2014
Continue to invest in local communities and contribute to charitable causes	Make direct charitable cash donations to local charities	Donations of $550,000 were made to local charities
	Build relationships with global charities and offer free flights to charitable organisations	800 free flights with a value of $560,000 were provided to charities
	Develop our Local Learning Initiative and offer free one day education programmes to schools	$750,000 was spent on the Local Learning Initiative and 2,250 children attended education days
Reduce environmental impact of operations	Reduce the amount of vehicle fuel used on business travel by our employees	The number of miles travelled in vehicles reduced by 5%, and the amount spent on vehicle fuel reduced by 7%

Required:

(i) Discuss the difficulties in measuring and reporting on social and environmental performance; and (4 marks)

(ii) Recommend the procedures to be used to gain assurance on the validity of the performance information in Faster Jets Co's CSR report. (6 marks)

(20 marks)

4 (a) You are an audit manager in Weston & Co which is an international firm of Chartered Certified Accountants with branches in many countries and which offers a range of audit and assurance services to its clients. Your responsibilities include reviewing ethical matters which arise with audit clients, and dealing with approaches from prospective audit clients.

The management of Jones Co has invited Weston & Co to submit an audit proposal (tender document) for their consideration. Jones Co was established only two years ago, but has grown rapidly, and this will be the first year that an audit is required. In previous years a limited assurance review was performed on its financial statements by an unrelated audit firm. The company specialises in the recruitment of medical personnel and some of its start up funding was raised from a venture capital company. There are plans for the company to open branches overseas to help recruit personnel from foreign countries.

Jones Co has one full-time accountant who uses an off-the-shelf accounting package to record transactions and to prepare financial information. The company has a financial year ending 31 March 2015.

The following comment was made by Bentley Jones, the company's founder and owner-manager, in relation to the audit proposal and potential audit fee:

'I am looking for a firm of auditors who will give me a competitive audit fee. I am hoping that the fee will be quite low, as I am willing to pay more for services that I consider more beneficial to the business, such as strategic advice. I would like the audit fee to be linked to Jones Co's success in expanding overseas as a result of the audit firm's advice. Hopefully the audit will not be too disruptive and I would like it completed within four months of the year end.'

Required:

(i) Explain the specific matters to be included in the audit proposal (tender document), other than those relating to the audit fee; and (8 marks)

(ii) Assuming that Weston & Co is appointed to provide the audit service to Jones Co, discuss the issues to be considered by the audit firm in determining a fee for the audit including any ethical matters raised. (6 marks)

(b) Ordway Co is a long-standing audit client of your firm and is a listed company. Bobby Wellington has acted as audit engagement partner for seven years and understands that a new audit partner needs to be appointed to take his place. Bobby is hoping to stay in contact with the client and act as the engagement quality control reviewer in forthcoming audits of Ordway Co.

Required:

Explain the ethical threats raised by the long association of senior audit personnel with an audit client and the relevant safeguards to be applied, and discuss whether Bobby Wellington can act as engagement quality control reviewer in the future audits of Ordway Co. (6 marks)

(20 marks)

5 The audit of Bradley Co's financial statements for the year ended 31 August 2014 is nearly complete, and the audit report is due to be issued next week. Bradley Co operates steel processing plants at 20 locations and sells its output to manufacturers and engineering companies. You are performing an engagement quality control review on the audit of Bradley Co, as it is a significant new client of your firm. The financial statements recognise revenue of $2·5 million, and total assets of $35 million.

(a) The audit senior who has been working on the audit of Bradley Co made the following comment when discussing the completion of the audit with you:

'We received the final version of the financial statements and the chairman's statement to be published with the financial statements yesterday. I have quickly looked at the financial statements but the audit manager said I need not perform a detailed review on the financial statements as the audit was relatively low risk. The manager also said that he had discussed the chairman's statement with the finance director so no further work on it is needed.'

Required:

Explain the quality control and other professional issues raised by the audit senior's comment in relation to the completion of the audit. (7 marks)

(b) The schedule of proposed adjustments to uncorrected misstatements included in Bradley Co's audit working papers is shown below, including notes to explain each matter included in the schedule. The audit partner is holding a meeting with management tomorrow, at which the uncorrected misstatements will be discussed.

		Statement of profit or loss		Statement of financial position	
	Proposed adjustments to uncorrected misstatements:	Debit $	Credit $	Debit $	Credit $
1.	Share-based payment scheme	300,000			300,000
2.	Restructuring provision		50,000	50,000	
3.	Additional allowance required for slow-moving inventory	10,000			10,000
	Totals	310,000	50,000	50,000	310,000

1. A share-based payment scheme was established in January 2014. Management has not recognised any amount in the financial statements in relation to the scheme, arguing that due to the decline in Bradley Co's share price, the share options granted are unlikely to be exercised. The audit conclusion is that an expense and related equity figure should be included in the financial statements.
2. A provision has been recognised in respect of a restructuring involving the closure of one of the steel processing plants. Management approved the closure at a board meeting in August 2014, but announced the closure to employees in September 2014. The audit conclusion is that the provision should not be recognised.
3. The estimate relates to slow-moving inventory in respect of a particular type of steel alloy for which demand has fallen. Management has already recognised a provision of $35,000, which is considered insufficient by the auditor.

Required:

(i) **Explain the matters which should be discussed with management in relation to each of the uncorrected misstatements; and** (9 marks)

(ii) **Assuming that management does not adjust the misstatements, justify an appropriate audit opinion and explain the impact on the auditor's report.** (4 marks)

(20 marks)

End of Question Paper