Professional Level – Options Module

Advanced Audit and Assurance (International)

Tuesday 2 June 2009

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 Champers Co operates a large number of restaurants throughout the country, which are operated under four well-known brand names. The company's strategy is to offer a variety of different dining experiences in restaurants situated in city centres and residential areas, with the objective of maximising market share in a competitive business environment. You are a senior audit manager in Carter & Co, a firm of Chartered Certified Accountants, and you are planning the audit of the financial statements of Champers Co for the year ended 31 May 2009. Extracts from the draft operating and financial review are shown below:

Key financial information

	31 May 2009 Draft $ million	31 May 2008 Actual $ million
Company revenue	1,500	1,350
Revenue is derived from four restaurant chains, each having a distinctive brand name:		
Happy Monkeys family bistros	800	660
Quick-bite outlets	375	400
City Sizzler grills	300	290
Green George cafés	25	–
Company profit before tax	135	155
Company total assets	4,200	3,350
Company cash at bank	116	350

Business segments

The Happy Monkeys chain of restaurants provides family-friendly dining in an informal setting. Most of the restaurants are located in residential areas. Each restaurant has a large children's play area containing climbing frames and slides, and offers a crèche facility, where parents may leave their children for up to two hours. Recently there has been some media criticism of the quality of the child care offered in one crèche, because a child had fallen from a climbing frame and was slightly injured. One of the Happy Monkeys restaurants was closed in December 2008 for three weeks following a health and safety inspection which revealed some significant breaches in hygiene standards in the kitchen.

The Quick-bite chain offers fast-food. The restaurants are located next to busy roads, in shopping centres, and at railway stations and airports. Champers Co has launched a significant marketing campaign to support the Quick-bite brand name. The draft statement of comprehensive income for the year ended 31 May 2009 includes an expense of $150 million in relation to the advertising and marketing of this brand. In January 2009 the company started to provide nutritional information on its menus in the Quick-bite restaurants, following pressure from the government for all restaurants to disclose more about the ingredients of their food. 50% of the revenue for this business segment is derived from the sale of 'chuckle boxes' – self-contained children's meals which contain a small toy.

The City Sizzler grills offer a more sophisticated dining experience. The emphasis is on high quality food served in luxurious surroundings. There are currently 250 City Sizzler grills, and Champers Co is planning to expand this to 500 by May 2010. The grills are all situated in prime city centre locations and are completely refurbished every two years.

The Green George café chain is a recent addition to the range of restaurants. There are only 30 restaurants in the chain, mostly located in affluent residential areas. The restaurants offer eco-friendly food, guaranteed to be free from artificial flavourings and colourings, and to have been produced in an environmentally sustainable manner. All of the 30 restaurants have been newly constructed by Champers Co, and are capitalised at $210 million. This includes all directly attributable costs, and borrowing costs capitalised relating to loans taken out to finance the acquisition of the sites and construction of the restaurants. Champers Co is planning to double the number of Green George cafés operating within the next twelve months.

Laws and regulations

Two new regulations were issued by the government recently which will impact on Champers Co. The regulations come into effect from September 2009.

(i) Minimum wage regulation has increased the minimum wage by 15%. One third of Champers Co's employees earn the minimum wage.
(ii) Advertising regulations now forbid the advertising of food in a manner specifically aimed at children.

Three audit juniors are joining your team for the forthcoming audit of Champers Co, and you have asked them to read through the permanent file to familiarise themselves with the client. One of the juniors has told you that he appreciates that auditors need to have a thorough understanding of the business of their client, but he does not know what aspects of the client's business this relates to, or how the understanding is developed.

Required:

(a) Prepare briefing notes to be used at a planning meeting with your audit team, in which you:

(i) identify and explain the aspects of a client's business which should be considered in order to gain an understanding of the company and its operating environment; and (6 marks)

(ii) recommend the procedures an auditor should perform in order to gain business understanding. (4 marks)

Professional marks will be awarded in part (a) for the clarity, format and presentation of the briefing notes. (2 marks)

(b) Using the information provided, evaluate the business risks facing Champers Co. (13 marks)

(c) Describe the principal audit procedures to be performed in respect of:

(i) the amount capitalised in relation to the construction of the new Green George cafés; and (5 marks)

(ii) the amount recognised as an expense for the advertising of the Quick-bite brand. (4 marks)

(34 marks)

2 (a) Explain FOUR reasons why a firm of auditors may decide NOT to seek re-election as auditor. (6 marks)

The Dragon Group is a large group of companies operating in the furniture retail trade. The group has expanded rapidly in the last three years, by acquiring several subsidiaries each year. The management of the parent company, Dragon Co, a listed company, has decided to put the audit of the group and all subsidiaries out to tender, as the current audit firm is not seeking re-election. The financial year end of the Dragon Group is 30 September 2009.

You are a senior manager in Unicorn & Co, a global firm of Chartered Certified Accountants, with offices in over 150 countries across the world. Unicorn & Co has been invited to tender for the Dragon Group audit (including the audit of all subsidiaries). You manage a department within the firm which specialises in the audit of retail companies, and you have been assigned the task of drafting the tender document. You recently held a meeting with Edmund Jalousie, the group finance director, in which you discussed the current group structure, recent acquisitions, and the group's plans for future expansion.

Meeting notes – Dragon Group

Group structure
The parent company owns 20 subsidiaries, all of which are wholly owned. Half of the subsidiaries are located in the same country as the parent, and half overseas. Most of the foreign subsidiaries report under the same financial reporting framework as Dragon Co, but several prepare financial statements using local accounting rules.

Acquisitions during the year
Two companies were purchased in March 2009, both located in this country:

(i) Mermaid Co, a company which operates 20 furniture retail outlets. The audit opinion expressed by the incumbent auditors on the financial statements for the year ended 30 September 2008 was qualified by a disagreement over the non-disclosure of a contingent liability. The contingent liability relates to a court case which is still on-going.
(ii) Minotaur Co, a large company, whose operations are distribution and warehousing. This represents a diversification away from retail, and it is hoped that the Dragon Group will benefit from significant economies of scale as a result of the acquisition.

Other matters
The acquisitive strategy of the group over the last few years has led to significant growth. Group revenue has increased by 25% in the last three years, and is predicted to increase by a further 35% in the next four years as the acquisition of more subsidiaries is planned. The Dragon Group has raised finance for the acquisitions in the past by becoming listed on the stock exchanges of three different countries. A new listing on a foreign stock exchange is planned for January 2010. For this reason, management would like the group audit completed by 31 December 2009.

Required:

(b) Recommend and describe the principal matters to be included in your firm's tender document to provide the audit service to the Dragon Group. (10 marks)

(c) Using the specific information provided, evaluate the matters that should be considered before accepting the audit engagement, in the event of your firm being successful in the tender. (7 marks)

Professional marks will be awarded in part (c) for the clarity and presentation of the evaluation. (2 marks)

(d) (i) Define 'transnational audit', and explain the relevance of the term to the audit of the Dragon Group; (3 marks)

(ii) Discuss TWO features of a transnational audit that may contribute to a high level of audit risk in such an engagement. (4 marks)

(32 marks)

Section B – TWO questions ONLY to be attempted

3 Robster Co is a company which manufactures tractors and other machinery to be used in the agricultural industry. You are the manager responsible for the audit of Robster Co, and you are reviewing the audit working papers for the year ended 28 February 2009. The draft financial statements show revenue of $10·5 million, profit before tax of $3·2 million, and total assets of $45 million.

Two matters have been brought to your attention by the audit senior, both of which relate to assets recognised in the statement of financial position for the first time this year:

Leases
In July 2008, Robster Co entered into five new finance leases of land and buildings. The leases have been capitalised and the statement of financial position includes leased assets presented as non-current assets at a value of $3·6 million, and a total finance lease payable of $3·2 million presented as a non-current liability.

Financial assets
Non-current assets include financial assets recognised at $1·26 million. A note to the financial statements describes these financial assets as investments classified as 'fair value through profit or loss', and the investments are described in the note as 'held for trading'. The investments are all shares in listed companies. A gain of $350,000 has been recognised in net profit in respect of the revaluation of these investments.

Required:

(a) In your review of the audit working papers, comment on the matters you should consider, and state the audit evidence you should expect to find in respect of:

(i) the leases; and (8 marks)

(ii) the financial assets. (5 marks)

(b) You are aware that Robster Co is seeking a listing in September 2009. The listing rules in this jurisdiction require that interim financial information is published half-way through the accounting period, and that the information should be accompanied by a review report issued by the company's independent auditor.

Required:

Explain the principal analytical procedures that should be used to gather evidence in a review of interim financial information. (4 marks)

(17 marks)

4 (a) IFAC's Code of Ethics for Professional Accountants states that a professional accountant is required to comply with five fundamental principles, one of which is the principle of 'professional competence and due care'.

Required:

Explain what is meant by the term 'professional competence and due care', and outline how firms of Chartered Certified Accountants can ensure that the principle is complied with. (4 marks)

(b) You are a senior manager in Clifden & Co, and you are responsible for the audit of Headford Co, a manufacturer of plastic toys which are exported all over the world. The following matter has been brought to your attention by the audit senior, who has just completed the planning of the forthcoming audit for the year ending 30 June 2009:

During a discussion with the production manager, it was revealed that there have been some quality control problems with the toys manufactured between March and May 2009. It was discovered that some of the plastic used in the manufacture of the company's products had been contaminated with a dangerous chemical which has the potential to explode if it is exposed to high temperatures. Headford Co did not recall any of the products which had been manufactured during that time from customers, as management felt that the risk of any injury being caused was remote.

Your firm has been invited to tender for the provision of the external audit service to Cong Co. You are aware that Cong Co operates in the same industry as Headford Co, and that the two companies often enter into highly publicised, aggressive advertising campaigns featuring very similar products. Cong Co is a much larger company than Headford Co, and there would be the opportunity to offer some non-audit services as well as the external audit.

Required:

Assess the ethical and professional issues raised, and recommend any actions necessary in respect of:

(i) the contaminated plastic used by Headford Co; and (8 marks)

(ii) the invitation to audit Cong Co. (5 marks)

(17 marks)

5 (a) Explain the term 'fraudulent financial reporting', illustrating your explanation with examples. (4 marks)

You are the partner responsible for performing an engagement quality control review on the audit of Pluto Co, a listed company. You are currently reviewing the engagement partner's proposed audit report on the financial statements of Pluto Co for the year ended 31 March 2009. During the year the company has undergone significant reorganisation, involving the discontinuance of two major business segments. Extracts of the proposed audit report are shown below:

Adverse opinion arising from disagreement about application of IAS 37

The directors have not recognised a provision in relation to redundancy costs associated with the reorganisation during the year. The reason is that they do not feel that a reliable estimate of the amount can be made, and so the recognition criteria of IAS 37 have not been met. We disagree with the directors as we feel that an estimate can be made. This matter is more fully explained in a note to the financial statements. We feel that this is a material misstatement as the profit for the year is overstated.

In our opinion, the financial statements do not show a true and fair view of the financial position of the company as of 31 March 2009, and of its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

Emphasis of matter paragraph

The directors have decided not to disclose the Earnings per Share for 2009, as they feel that the figure is materially distorted by significant discontinued operations in the year. Our opinion is not qualified in respect of this matter.

Required:

(b) Critically appraise the proposed audit report of Pluto Co for the year ended 31 March 2009.

Note: you are NOT required to re-draft the extracts from the audit report. (9 marks)

(c) Explain the matters to be considered in deciding who is eligible to perform an engagement quality control review for a listed client. (4 marks)

(17 marks)

End of Question Paper