

Strategic Professional – Options

Advanced Audit and Assurance – International (AAA – INT)

Monday 3 December 2018



Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – This ONE question is compulsory and MUST be attempted

Section B – BOTH questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.

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

AAA – INT

Think Ahead

ACCA

The Association of
Chartered Certified
Accountants

Section A – This ONE question is compulsory and MUST be attempted

- 1** You are a manager in the audit department of Huntsman & Co, a firm of Chartered Certified Accountants, responsible for the audit of several companies and for evaluating the acceptance decisions in respect of potential new audit clients.

One of your audit clients is Redback Sports Co, which operates a chain of sport and leisure centres across the country. The company has a financial year ending 28 February 20X9, and you are about to start planning the audit. Stella Cross, the audit engagement partner, met with the company's finance director last week to discuss business developments in the year and recent financial performance.

In addition, Stella has been approached by Mick Emu, the managing director of Emu Gyms Co. Mick has enquired regarding whether Huntsman & Co can provide the company with an audit or limited assurance review, and Stella would like you to evaluate this request. Huntsman & Co already provides a payroll service to Emu Gyms Co and has assisted Mick with his personal tax planning in the past. Mick also has a suspicion that several employees are carrying out a fraud at the company, and he has asked whether an audit or limited assurance review would have alerted him earlier to the situation.

You are provided with the following exhibits:

1. An email you have received from Stella Cross, in respect of both Redback Sports Co and Emu Gyms Co.
2. Notes of a meeting which Stella held recently with the finance director of Redback Sports Co.
3. Extracts from the latest management accounts of Redback Sports Co.
4. Notes of a telephone conversation which Stella had yesterday with Mick Emu, managing director of Emu Gyms Co.

Required:

Respond to the instructions in the email from the audit engagement partner. (46 marks)

Note: The split of the mark allocation is shown in the partner's email (Exhibit 1).

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

(50 marks)

Exhibit 1 – Email from audit engagement partner

To: Audit manager

From: Stella Cross, Audit engagement partner for Redback Sports Co

Subject: Audit planning for Redback Sports Co, and evaluation of accepting Emu Gyms Co as a potential audit client

Hello

I have provided you with some information in the form of a number of exhibits which you should use to help you with planning the audit of Redback Sports Co for the financial year ending 28 February 20X9.

Using the information provided in Exhibits 2 and 3, I require you to prepare briefing notes for my own use, in which you:

- (a)** Evaluate the business risks to be considered in planning the company's audit. (8 marks)
- (b)** Evaluate the risks of material misstatement to be considered in developing the audit strategy and audit plan. (18 marks)
- (c)** Design the principal audit procedures to be used in the audit of the grant received from the government in September 20X8. (6 marks)

In Exhibit 4, I have also provided you with some information relating to Emu Gyms Co. In respect of this, in your briefing notes you should also:

- (d)** Evaluate the matters to be considered in deciding whether to accept an engagement to provide Emu Gyms Co with an audit or limited assurance review. (8 marks)
- (e)** In relation to the suspicion of fraud being carried out at Emu Gyms Co:
Discuss whether an audit or limited assurance review of financial statements in previous years could have uncovered the fraud. (6 marks)

Thank you.

Exhibit 2 – Notes of a meeting held on 30 November 20X8

Meeting attendees:

Stella Cross, audit engagement partner, Huntsman & Co

Aneta Bay, finance director, Redback Sports Co

Business background

Redback Sports Co operates 20 sport and leisure centres around the country. Each centre has a large gym and a swimming pool, and many also have tennis and badminton courts. Given the nature of the company's operations, it has to comply with health and safety regulations set by the national regulatory body, and its facilities are inspected regularly to ensure that all regulations are being followed, and for the company to retain its operating licence.

The company is not listed and therefore does not need to comply with local corporate governance regulations. However, the company's chief operating officer and chairman consider it good practice to have independent input to the board, and there are two non-executive directors. One of the non-executive directors is a leisure industry expert who was chairman of a rival company, Lyre Leisure Co, for ten years. The second non-executive director is an academic who specialises in organisational behaviour and who has written several books on performance management in the sport and leisure industry.

The company's board has approved a plan to expand through acquiring other leisure and sport facility providers. The strategy is not likely to be implemented for another two years, when the board would like the first acquisition to take place. However, potential target companies will be identified in the next 12 to 18 months. Ultimately, the board would like to seek a flotation of the company within five years, and they consider that expanding the company would improve profits and make a stock exchange listing more feasible.

Redback Sports Co has a small internal audit department with two staff who report to the finance director, as the board does not have an audit committee.

The company offers a membership scheme whereby, for an annual subscription, members can use the facilities at any of the centres. Customers who are not members can pay to access a centre for a day under the company's 'pay as you go' plan. The membership scheme accounts for approximately 85% of the company's revenue, with the remaining revenue resulting from 'pay as you go' sales.

Business developments in the year

The industry is competitive and the company's strategy is to encourage customers to renew their membership and to attract new members by offering a range of new activities. According to the finance director, a successful initiative which started in March 20X8 is the 'Healthy Kids' campaign; this offers children two hours coaching per week in a range of sports including swimming and tennis. This coaching is provided free as part of their parents' membership, and it has proved to be very successful – the finance director estimates that it has led to 3,000 new members since it was launched.

In June 20X8, the company opened a new coastal sport and leisure centre which, as well as offering the usual facilities, also has a scuba diving centre and offers other water sports facilities. An investment of \$12 million was also made in new gym equipment across all centres, to ensure that the company offers the most modern facilities to its customers.

An advertising campaign has been launched, to promote the company brand generally, and to make customers aware of the investments in the facilities which have been made. As part of this campaign, the company paid \$1 million to a famous athlete to endorse the company for a period of two years. The athlete will appear at the opening of the new coastal sports centre and has agreed to feature in poster advertisements for the next two years.

Redback Sports Co is also involved with a government initiative to help unemployed people have access to sport facilities. The company received a grant of \$2 million in September 20X8, under the terms of which it allows unemployed people three hours of free access to its facilities per month. By the end of November, 33,900 free hours of facility use have been provided under this scheme. The government intends the initiative to run for three years, to promote long-term health of participants.

A new data management system has been introduced, which integrates membership information with accounting software. This allows more efficient management of the customer database which is used extensively for marketing purposes, as well as providing more timely information on financial performance to management. Data from the

previous system was transferred to the new system in July 20X8, and the two systems ran in parallel for two months while training was given to staff and the new system was monitored. One feature of the new system is that it records and reports on the free hours of access provided to unemployed people, which the company has to report on a monthly basis to the government.

Exhibit 3 – Extracts from management accounts of Redback Sports Co

	Note	Based on projected figures to 28 February 20X9	Based on audited figures to 28 February 20X8
Revenue	1	\$53 million	\$45 million
Income from government grant	2	\$2 million	–
Operating margin	3	15%	10.7%
Profit before tax		\$6.9 million	\$4.6 million
Capital expenditure and associated borrowings	4	\$32 million	\$20 million
Cash		\$1.4 million	\$5.6 million
Total assets		\$130 million	\$110 million
Number of sport and leisure centres	5	20	18
Number of members	6	38,000	33,800
Number of 'pay as you go' entry tickets sold		108,000	102,600

Notes

- Revenue is forecast to increase significantly this year. This is largely due to the success of the advertising campaign featuring the celebrity athlete and the 'Healthy Kids' programme (referred to in Exhibit 2).
- The grant received of \$2 million, the details of which are explained in Exhibit 2, has been recognised in full as income for the year.
- The company's operating expenses includes the following items:

	20X9 \$'000	20X8 \$'000
Staff costs	15,300	14,300
Marketing	8,500	8,500
Maintenance and repairs of facilities	5,500	5,300

- Capital expenditure was mostly financed through borrowings. On 1 March 20X8, a ten-year \$30 million loan was received from the company's bank. The loan does not bear interest and is repayable at par value of \$34 million. As well as the bank loan, a loan of \$1 million was advanced to the company from its managing director, Bob Glider, on 1 July 20X8. The terms of this loan include 3% interest paid to Bob annually in arrears, and the capital will be repaid in seven years' time in 20Y5.
- Two new sport and leisure centres were opened this year. As well as the coastal sport and leisure centre (referred to in Exhibit 2), a new centre was opened in an affluent urban area in the capital city.
- The management information system shows that members visit a sport and leisure centre on average three times per week.

Exhibit 4 – Notes of a telephone conversation between Stella Cross and Mick Emu, managing director of Emu Gyms Co

Notes taken by Stella Cross:

Mick Emu phoned me this morning to discuss developments at Emu Gyms Co and to enquire whether our firm could carry out either an audit of the company's financial statements, or a limited assurance review of them. This would be the first time that the financial statements have been subject to audit or limited assurance review.

Business background

The company was founded by Mick in 20X5, and since that time our firm has provided a payroll service for the company's staff, which now number 35 employees working in the company's four gyms, all located in urban areas. We have also provided Mick with advice on his personal tax position and financial planning in respect of his retirement, as he wants to sell the company in a few years' time. Mick runs the company with his son, Steve, who is a qualified personal trainer, and with his daughter, Siobhan, who is the marketing director. The company employs one accountant who prepares the management and financial accounts and who deals with customer memberships.

The company has grown quite rapidly in the last year, with revenue of \$8 million for the financial year to 30 September 20X8, and with total assets of approximately \$5.5 million. The comparative figures for 20X7 were revenue of \$6.5 million and total assets of \$4.8 million.

Loan application

Mick thinks that it will be difficult to attract more members for his gyms in existing locations, and would like the company to expand by constructing a new gym. He has discussed a loan of \$4 million with the company's bank to fund the necessary capital expenditure. The bank manager has asked for the company's financial statements for the year to 30 September 20X8 and comparative information, and has also requested a cash flow and profit forecast for the next three years in order to make a lending decision within the next two months.

Mick has asked whether a representative of the firm can attend a meeting with Mick and the company's bank manager, to support the loan application and answer questions from the bank manager, assuming that we are engaged to perform either an audit or a limited assurance review on the financial statements.

Suspected fraud

Mick mentioned that one of the reasons he would like an audit or limited assurance review of the financial statements is because he has noticed some unusual trends in the company's financial information. This has led him to suspect that several employees are carrying out a fraud. Each gym has a small shop selling gym wear and a café, where customers can buy light meals, drinks and snacks. Mick has noticed that the cash receipts from sales in the shops and cafés have reduced significantly in the last year, however, there has been no reduction in purchases from suppliers. As a consequence, the gross margin for these sales as reported in the management accounts has fallen from 32% to 26%. This indicated to him that staff members could be giving away items for free to customers, or they could be taking inventories from the shops and cafés for their personal use or to sell.

The shops and cafés keep a relatively small amount of inventory which is replenished on a regular basis. Until this year, sales in the shops represented approximately 5%, and café sales represented approximately 8% of the company's revenue. The figures for this year are 3% and 6% respectively.

Mick wonders whether the potential fraud would have been uncovered earlier, had the financial statements been subject to audit or limited assurance review in previous years.

Section B – BOTH questions are compulsory and MUST be attempted

- 2 Daley Co is a family owned, unlisted company which imports motor cars. The company buys cars from a variety of car manufacturers for sale to car dealerships and vehicle leasing companies within its own domestic market. Daley Co has been a client of your firm for the last three years and you are the newly appointed audit manager on the audit for the year ended 31 August 20X8. The audit for the current reporting period is nearing completion and you are reviewing the working papers of the going concern section of the audit file.

Extracts from the draft financial statements and other relevant information are given below.

Statement of financial position

	31 August 20X8 Draft \$ million	31 August 20X7 Actual \$ million
Assets		
Non-current assets		
Property, plant and equipment	13.5	14.6
	<u>13.5</u>	<u>14.6</u>
Current assets		
Inventory	5.8	3.7
Trade receivables	3.7	2.6
Cash at bank and in hand	–	0.6
	<u>9.5</u>	<u>6.9</u>
Total assets	<u>23.0</u>	<u>21.5</u>
Equity and liabilities		
Equity		
Share capital	1.0	1.0
Retained earnings	1.3	4.7
	<u>2.3</u>	<u>5.7</u>
Non-current liabilities		
Long-term borrowings	11.2	12.4
Provisions	3.5	0.5
	<u>14.7</u>	<u>12.9</u>
Current liabilities		
Trade payables	4.2	2.9
Bank overdraft	1.8	–
	<u>6.0</u>	<u>2.9</u>
Total equity and liabilities	<u>23.0</u>	<u>21.5</u>

Statement of profit or loss for the year

	31 August 20X8	31 August 20X7
	Draft	Actual
	\$ million	\$ million
Revenue	11.3	8.8
Cost of sales	(4.4)	(2.9)
Gross profit	6.9	5.9
Other operating expenses	(9.1)	(1.3)
Operating profit	(2.2)	4.6
Finance costs	(1.5)	(0.7)
Profit before taxation	(3.7)	3.9
Taxation	0.3	(1.3)
Net (loss)/profit for year	(3.4)	2.6

You have also ascertained the following information during your review:

1. Daley Co has undergone a period of rapid expansion in recent years and is intending to buy new warehousing facilities in January 20X9 at a cost of \$4.3 million.
2. In order to finance the new warehousing facilities, the company is in the process of negotiating new finance from its bankers. The loan application is for an amount of \$5 million and is to be repaid over a period of four years.
3. The provision of \$3.5 million in this year's statement of financial position relates to legal actions from five of Daley Co's largest customers. The actions relate to the claim that the company has sold cars which did not comply with domestic regulations.
4. A major new competitor has moved in to Daley Co's market in October 20X8.
5. The going concern working papers include a cash flow forecast for the 12 months ending 31 August 20X9. The cash flow forecast assumes that Daley Co's revenue will increase by 25% next year and that following the reorganisation of its credit control facility, its customers will pay on average after 60 days. The forecast also assumes that the bank will provide the new finance in January 20X9 and that the company will have a positive cash balance of \$1.7 million by 31 August 20X9.
6. The financial statements have been prepared on a going concern basis and make no reference to any significant uncertainties in relation to going concern.

Required:

- (a) Using analytical review where appropriate, evaluate the matters which may cast doubt on Daley Co's ability to continue as a going concern. (10 marks)
- (b) Explain the audit evidence in respect of the cash flow forecast which you would expect to find in your review of the audit working papers on going concern. (9 marks)

You have established through discussions with Daley Co's directors that they do not wish to disclose uncertainties over the going concern status of the company in the notes to the financial statements.

Required:

- (c) Explain the possible reasons why the directors may wish to exclude these disclosures and evaluate the possible implications for the auditor's report. (6 marks)

(25 marks)

- 3** You are an audit manager in Thomasson & Co, a firm of Chartered Certified Accountants. You have recently been assigned to the audit of Clean Co for the year ended 30 September 20X8. Clean Co is an unlisted company and has been an audit client of your firm for a number of years.

Clean Co is a national distributor of cleaning products. The company buys the cleaning products from wholesalers and employs a team of approximately 750 sales staff around the country who sell the company's products to both domestic households and small to medium-sized businesses. Around 75% of Clean Co's sales transactions are cash-based and each of the company's sales staff prepares a cash sales report on a monthly basis. According to Clean Co's chief executive, Simon Blackers, and in order to foster 'an entrepreneurial spirit' amongst his staff, each staff member (including the senior management team) is encouraged to make cash sales and is paid on a commission basis to sell the company's products to friends and family. Mr Blackers leads the way with this scheme and recently sold cleaning products with a value of \$33,000 to a business associate of his. He has transferred these funds directly into an off-shore bank account in the company's name on which he is the sole signatory.

Review of audit working papers

Your review of the audit working papers and an initial meeting with Mr Blackers have identified the following potential issues:

Following your review of the audit engagement letter and the working papers of the taxation section of the audit file, you have established that Thomasson & Co performed the taxation computation for Clean Co and completed the tax returns for both the company and Mr Blackers personally. All of the taxation services have been invoiced to Clean Co as part of the total fee for the audit and professional services. Mr Blackers' personal tax return includes a significant number of transactions involving the purchase and sale of properties in various international locations. The taxation working papers include a detailed review of a number of off-shore bank accounts in Mr Blackers' name which identified the property transactions.

During your initial meeting with Mr Blackers, he informed you that Clean Co is planning to develop a new website in order to offer online sales to its customers. He has asked Thomasson & Co to provide assistance with the design and implementation of the website and online sales system.

As a result of your audit review visit at the client's premises, you have learned that the audit team was invited to and subsequently attended Clean Co's annual office party. The client provided each member of the audit team with a free voucher worth \$30 which could be redeemed at the venue during the party. The audit senior, Paula Metcalfe, who has worked on the audit for the last three years has informed you that the audit team has always been encouraged to attend the party in order to develop good client relations.

Required:

- (a) (i) **Discuss the policies and procedures which Thomasson & Co should have in place in relation to an anti-money laundering programme; and** (4 marks)
- (ii) **Evaluate whether there are any indicators of money laundering activities by either Clean Co or its staff.** (6 marks)
- (b) **Comment on the ethical and professional issues arising from your review of the audit working papers and recommend any actions which should now be taken by Thomasson & Co.** (15 marks)

(25 marks)

End of Question Paper