Strategic Professional – Options

Advanced Audit and Assurance – International (AAA – INT)

Monday 2 March 2020

AAA INT ACCA EN

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 It is 1 July 20X5. You are a manager in the audit department of Atlanta & Co, a firm of Chartered Certified Accountants. You are working on the audit of the Rick Group (the Group), which has a financial year ending 30 September 20X5. The Group, a listed entity, offers an internet television network, with over 10 million subscription members in eight countries.

You are provided with the following exhibits:

1. An email which you have received from the Group audit engagement partner.
2. Background information and matters relevant to audit planning.
3. Selected financial information from the Group management accounts.
4. An extract from the audit strategy document prepared by Neegan Associates, the component auditor which audits one of the Group's subsidiaries.
5. Details of the planned acquisition of a new foreign subsidiary, Michonne Co, and a possible joint audit arrangement.

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: Carol Morgan, Audit engagement partner

Subject: Audit planning for the Rick Group

Date: 1 July 20X5

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 the Rick Group (the Group) for the financial year ending 30 September 20X5.

I require you to prepare briefing notes for my own use, in which you:

(a) Using the information in **all exhibits**, evaluate the audit risks to be considered in planning the Group audit. (24 marks)

(b) Using the information provided in Exhibit 4:

(i) Evaluate the extract from the component auditor's strategy, commenting on the audit strategy responses and ethical matters relating to the issues identified; and (10 marks)

(ii) Design the principal audit procedures which you will instruct the component auditor to perform on the sale of property to the Group chief executive officer. (6 marks)

(c) Using Exhibit 5, discuss whether it is appropriate for a joint audit to be performed on Michonne Co, commenting on the advantages and disadvantages of a joint audit arrangement. (6 marks)

Thank you

Exhibit 2 – Background information

The Group started to offer an internet streaming service for films and TV programmes ten years ago. The Group's business model is to acquire licences for films and TV programmes and customers pay a monthly subscription fee to access them and watch online.

The Group has a subsidiary in each country in which it offers its subscription service. Atlanta & Co audits all of the subsidiaries with the exception of Daryl Co, one of the Group's foreign subsidiaries, which is audited by a local firm called Neegan Associates. All companies within the Group have the same financial year end, and with the exception of Daryl Co, which reports under local accounting standards, the Group companies all use IFRS® Standards as their financial reporting framework.

Matters relevant to audit planning

Following a discussion between the Group audit engagement partner and a representative of the Group audit committee, several matters were noted as being relevant to the audit planning:

Annual incentive scheme

For several years, the Group has operated an annual incentive scheme for staff, under the terms of which employees are eligible to receive an annual incentive payment linked to the achievement of selected targets. The scheme operates across all Group companies, with some employees' targets linked to profitability, while others are aligned to non-financial measures including customer satisfaction. Participants in the scheme are entitled to earn a maximum annual incentive payment of 5% of their salary. Approximately 6,590 employees, including the senior executive directors, are entitled to participate in the annual incentive scheme. Last year the average bonus payment was $1,250 per participant.

Legal case

In January 20X5, a legal case was initiated against the Group by Glenn Co, a film production company. Glenn Co claims that the Group has infringed copyright by streaming a film in specific countries for which a licence has not been acquired. The Group insists that the film is covered by a general licence which was acquired several years ago. The Group finance director is not willing to recognise the legal claim within the financial statements as he is confident that the claim against the Group will not be successful, and he does not want to discuss it further with the audit team, emphasising that there is no relevant documentation available for evaluation at this time.

Daryl Co

Neegan Associates provides the audit service to Daryl Co, one of the Group's foreign subsidiaries. Daryl Co is one of the Group's larger subsidiaries, it is a listed company in its home jurisdiction, with total assets of $140 million. Daryl Co is the only subsidiary which does not follow IFRS Standards, as in its local jurisdiction companies must follow local accounting rules. It uses the same currency as the rest of the Group.

Daryl Co was acquired several years ago, and goodwill of $38 million is recognised in the Group financial statements in respect of the company.

Exhibit 3 – Selected financial information

	Note	Projected to 30 September 20X5 $ million	Actual to 30 September 20X4 $ million
Group revenue	1	980	780
Operating profit		78·4	70·2
Profit before tax		60·1	58·7
Total assets		780	600
Included in total assets:			
Intangible assets – licences	2	580	420
Intangible assets – goodwill	3	135	135
Number of subscription customers		10,500,000	8,070,000

Notes:

1. The Group's main source of revenue is from monthly membership fees. Members are billed in advance of the start of their monthly membership and revenue is recognised when the bill is sent to the customer, all of whom pay by credit card. The price of a regular subscription has remained at $8·20 per month throughout 20X4 and 20X5. Occasionally, the Group offers a free trial period to new customers. This year, the Group also introduced a new premium subscription package, which allows customers to add two family members to their subscription for an additional fee of $5 per month.

2. The Group acquires content licences per title in order to stream film and TV content to its subscribers. The content licences are each for a fixed time period, varying between three and five years. The Group capitalises the cost per title as an intangible asset. Group policy is to amortise licences over a five-year period, the finance director justifies this as being 'the most prudent' accounting treatment.

3. Goodwill arising on business combinations is tested annually for impairment in accordance with IAS® 36 *Impairment of Assets*. Due to the strong performance of the Group, no impairment of goodwill has been recognised in recent years.

Exhibit 4 – Extract from component auditor strategy document

The three points below are an extract from the audit strategy prepared by Neegan Associates in relation to their audit of Daryl Co. Other sections of the audit strategy, including the audit risk assessment, have been reviewed by the Group audit team and are considered satisfactory so you do not need to consider them.

Issue identified by Neegan Associates	Audit strategy response by Neegan Associates
Materiality *Internet services in the country have been subject to considerable disruption. As a result of this, a significant number of customers have cancelled their subscriptions and the company is projected to make a loss this year.*	Materiality will be based on total assets for the first time this year due to the significant reduction in revenue and profit. Based on 1% of assets, materiality is determined at \$1·4 million. In the previous year, materiality based on revenue was determined to be \$1·2 million.
Payroll *From 1 October 20X4, payroll accounting services are provided to Daryl Co by Neegan Associates as an additional non-audit engagement.*	**Planned audit procedures:** – Agree the total payroll figure, estimated to be \$6 million, from the statement of profit or loss to the payroll reports generated by Neegan Associates. – No further audit procedures are considered necessary.
Sale of property *Daryl Co sold a small, unused building located on the coast to the Group's chief executive officer (CEO) in February 20X5, for \$50,000. The amount is still outstanding for payment.* *The Group CEO is planning to use the property as a holiday home.*	**Planned audit procedures:** – Confirm \$50,000 is included in receivables within current assets. – No further audit procedures are considered necessary because the transaction is not material to the financial statements, and local accounting rules do not require disclosure of the transaction.

Exhibit 5 – Potential new subsidiary

The Group is planning the acquisition of a new foreign subsidiary, Michonne Co, which is located in Farland. The negotiations are at an advanced stage, and it is likely that the acquisition will take place in October 20X5.

The Group's audit committee has suggested that if the acquisition goes ahead, due to the distant location of the company and the fact that Atlanta & Co has no offices in Farland, a joint audit could be performed with Michonne Co's current auditors, Lucille Associates, a small local firm of Chartered Certified Accountants.

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Question 2 begins on page 8.

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Section B – BOTH questions are compulsory and MUST be attempted

2 It is 1 July 20X5. You work in the audit department of Saul & Co. The Goodman Group (the Group) is an audit client of your firm and the audit for the financial year ended 31 December 20X4 is in the completion stage. The Group, which is not listed, installs and maintains security systems for businesses and residential customers.

Materiality for the audit of the Group financial statements has been determined to be $400,000. You are reviewing the audit working papers, and have gathered the following information:

Fraud

The Group finance director has informed the audit team that during the year, a fraud was carried out by a manager, Mike Trout, in one of the Group's procurement departments. The manager had raised fictitious supplier invoices and paid the invoiced amounts into his personal bank account. When questioned by the Group's finance director, Mike Trout confessed that he had stolen $40,000 from the Group. The finance director asked the audit team not to perform any procedures in relation to the fraud, as the amount is immaterial. He also stated that the financial statements would not be adjusted in relation to the fraud.

The only audit evidence on file is a written representation from management acknowledging the existence of the fraud, and a list of the fictitious invoices which had been raised by the manager, provided by the finance director. The audit working papers conclude that the fraud is immaterial and no further work is needed.

Development costs

In August 20X4, the Group commenced development of a new security system, and incurred expenditure of $600,000 up to the financial year end, which has been capitalised as an intangible non-current asset. The only audit evidence obtained in relation to this balance is as follows:

– Agreement of a sample of the costs included in the $600,000 capitalised to supporting documentation such as supplier invoices.
– Cash flow projection for the project, which indicates that a positive cash flow will be generated by 20X8. The projection has been arithmetically checked.
– A written representation from management stating that 'management considers that the development of this new product will be successful'.

You are aware that when the Group finance director was asked about the cash flow projection which he had prepared, he was reluctant to answer questions, simply saying that 'the assumptions underlying the projection have been agreed to assumptions contained in the Group's business plan'. He provided a spreadsheet showing the projection but the underlying information could not be accessed as the file was password protected and the Group finance director would not provide the password to the audit team.

Trade receivables

Trade receivables recognised in the Group's current assets includes a balance of $500,000 relating to a specific customer, Hamlyn Co. Audit procedures indicate that at 31 December 20X4, the balance was more than six months overdue for payment. In relation to this balance, the following procedures have been performed:

– Agreement of the balance to invoices and original customer order.
– Discussion with the Group credit controller who states that 'we are in discussions with Hamlyn Co and we are confident that some or all of the amount due to us will be paid. We have always allowed this customer extended credit terms and they have always paid eventually.'

Hamlyn Co was included in the trade receivables direct confirmation audit procedure, whereby a sample of customers were asked to confirm the outstanding balance, but no reply was received.

Required:

(a) **(i)** **Discuss the implications of the fraud for the completion of the audit, and the actions to be taken by the auditor.** (6 marks)

In respect of the development costs and trade receivables:

(ii) **Comment on the sufficiency and appropriateness of the audit evidence obtained, and**

(iii) **Recommend the actions to be taken by the auditor, including the further evidence which should be obtained.** (11 marks)

(b) The audit work is now complete and the Group auditor's report is due to be issued in the next few days. Materiality for the audit of the Group financial statements has continued to be determined to be $400,000. You have been tasked with reviewing the draft auditor's report and the following supplementary information which has been prepared at the end of the audit:

– The audit partner has concluded that the fraud is immaterial and that all necessary work has been performed by the audit team.

– Further audit procedures were successfully performed on the development costs, and a conclusion was reached by the audit team that the recognition of the $600,000 as an intangible asset is appropriate.

– A letter was received from Hamlyn Co's administrators on 29 July 20X5, stating that Hamlyn Co is in liquidation, and that its creditors will receive a payment of 10% of outstanding balances. The audit team has concluded that $50,000 can remain recognised as a trade receivable, and that $450,000 should be written off as irrecoverable. However, the Group refuses to make any adjustment, and the full $500,000 remains recognised as a trade receivable in the final Group financial statements.

Draft auditor's report

Based on the above conclusions, the audit supervisor has drafted the auditor's report which includes the following extract:

> Basis for opinion and opinion
>
> Audit procedures indicate that trade receivables are overstated by $500,000. For this reason we consider that the Group financial statements are likely to be materially misstated and do not fairly present the financial position and performance of the Group for the year ended 31 December 20X4.
>
> Emphasis of matter
>
> There are two matters to which we draw your attention:
>
> 1. A fraud was discovered, as a result of which we have determined that $40,000 was stolen from the Group. This does not impact the financial statements but we wish to highlight the illegal activity which took place during the year.
> 2. The Group finance director obstructed our audit by refusing to allow access to audit evidence. He has also refused to adjust the financial statements in relation to the material misstatement of trade receivables, which led to the qualified audit opinion being issued. For this reason, we wish to resign as auditor with immediate effect.

Required:

Critically appraise the extract from the proposed auditor's report of the Goodman Group for the year ended 31 December 20X4.

Note: You are NOT required to re-draft the extracts from the auditor's report. (8 marks)

(25 marks)

3 (a) It is 1 July 20X5. You are a manager in Moritz & Co, a firm of Chartered Certified Accountants which offers a range of services to audit and non-audit clients. Your firm has been asked to consider a potential engagement to review and provide an assurance report on prospective financial information (PFI) for Lavenza Co, which is not an audit client of your firm. Moritz & Co has already conducted specific client identification procedures in line with money laundering regulations with satisfactory results.

Lavenza Co has approached your firm in order to obtain an independent assurance opinion on a cash flow forecast which is being prepared for its bankers in support of an application for an increase in its existing overdraft facility. The following cash flow forecast has been prepared by Lavenza Co for the 12 months to 30 June 20X6:

Lavenza Co cash flow forecast for the 12 months ending 30 June 20X6

	3 months to 30 September 20X5 $'000	3 months to 31 December 20X5 $'000	3 months to 31 March 20X6 $'000	3 months to 30 June 20X6 $'000
Operating cash receipts				
Cash sales – high street shops	4,343	4,690	5,065	5,471
Cash sales – online	6,782	7,053	7,335	7,628
Receipts from credit sales – online	11,987	12,346	12,717	13,099
	23,112	24,089	25,117	26,198
Operating cash payments				
Purchases of inventory	(10,846)	(11,388)	(11,730)	(12,316)
Salaries	(7,254)	(7,109)	(7,180)	(7,384)
Overheads	(6,459)	(6,265)	(6,391)	(6,659)
	(24,559)	(24,762)	(25,301)	(26,359)
Other cash flows				
Initial costs of new high street shops	(2,143)	(1,128)		
Online marketing campaign	(624)	(431)	(386)	(278)
	(2,767)	(1,559)	(386)	(278)
Cash flow for the period	(4,214)	(2,232)	(570)	(439)
Opening cash	(9,193)	(13,407)	(15,639)	(16,209)
Closing cash	(13,407)	(15,639)	(16,209)	(16,648)

The following information is also relevant:

1. Lavenza Co is a retailer of academic text books which it sells through its own network of book shops and online through its website. The revenue from the website includes both cash sales and sales on credit to educational institutions. The company has provided historical analysis from its trade receivables ledger indicating that for sales made on credit, 10% pay in the month of the sale, 62% after 30 days, 16% after 60 days, 8% after 90 days and the remainder are irrecoverable debts.
2. Lavenza Co receives a settlement discount from its principal suppliers of 8% if it pays within 14 days of receipt of the inventory. It is company policy to make the early payment wherever possible. If the company pays after 45 days, it incurs a late payment penalty of 5%.
3. The company already has an established presence in large cities with universities but has seen a decline in its core operations in recent years which has led to a decrease in revenue and a fall in liquidity. In order to reverse these trends, the company is planning to extend its operations by opening new shops in small cities with universities and large colleges.
4. Lavenza Co's management is planning an online marketing campaign targeted at the university sector which they believe will increase the company's market share by approximately 3%.
5. The company has an existing overdraft facility of $12 million with its bankers and has requested an increase in the facility to $17 million.

Required:

(i) Explain the matters to be considered by Moritz & Co before accepting the engagement to review and report on Lavenza Co's prospective financial information; and (6 marks)

(ii) Assuming Moritz & Co accepts the engagement, recommend the examination procedures to be performed in respect of Lavenza Co's cash flow forecast. (9 marks)

(b) You have also been asked to provide an accountant's report for an audit client, Beaufort Co, which intends to list on the stock market in September 20X5.

Beaufort Co has been an audit client of Moritz & Co for the last eight years, preparing financial statements to 31 March each year. Throughout this period, the managing partner at your firm, Frances Stein, has taken personal responsibility for the audit and has increased the total fee income from the client to the level where it represented 16·2% of Moritz & Co's total fee income in 20X5 (15·4%: 20X4). In addition to performing the annual audit, Moritz & Co also provides accounting and bookkeeping services for Beaufort Co. The accounting and bookkeeping services include the preparation of the monthly payroll for the client and maintaining all of the financial records of a small, immaterial division of the company.

The managing director of Beaufort Co, Margaret Shelley, has asked your firm for assistance in the preparation of the share prospectus document which will be used to support the company's flotation. The contents of the prospectus document will include the following elements:

– Key historical financial information prepared to 31 August 20X5;
– Profit forecasts;
– A summary of the key risks relating to the client's business; and
– A business plan outlining the future prospects of the company and recommending the shares to investors.

Margaret Shelley has asked if Mortiz & Co can also provide an accountant's report which will be included in the prospectus and which will cover each of these elements.

Beaufort Co is also currently reviewing the audit appointment and is looking for an audit firm which is capable of taking it through the listing process and providing a full range of services in the future.

Required:

Comment on the ethical and professional issues arising as a result of Beaufort Co's planned listing and the services which it has requested from Moritz & Co. (10 marks)

(25 marks)

End of Question Paper