London School of Business & Finance

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ACCA

Paper P7 (International)

Advanced Audit & Assurance

Revision Mock Examination

September 2017

Question Paper

Time Allowed	3 hours 15 minutes	Reading, planning and writing

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.
You must NOT write in your answer booklet until instructed by the supervisor.

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The question paper begins on page 4.

Section A – BOTH questions are compulsory and MUST be attempted

1. Faurlin Co was established in 1975 and has had many years of successful growth and profits. The company makes baby-related furniture, such as cots, highchairs and playpens, and is the leading supplier to retail outlets in this industry. It has a reputation for quality, and being a very large company it can sell at very competitive prices, making it very difficult for competitors to enter the market. The company listed on its country's Stock Exchange in 1992 and its share price has risen steadily ever since.

On 18th June 2017 the company is due to finalise the acquisition of Helguson Co, a specialist manufacturer of car seats and booster seats for babies and young children, an area which Faurlin Co has been looking to expand into for some time. Being its first acquisition, Faurlin Co would become Faurlin Group at this point, and would prepare its first consolidated financial statements for the year ending 30th June 2017**.** The purchase price of Helguson Co will include some deferred contingent consideration, payable based on the profits of Helguson Co over the first three years after the acquisition date.

You are an audit senior in the firm Larson & Co, and your firm has audited Faurlin Co for three years. The client has asked you (should the acquisition go ahead) to also become auditor of Helguson Co, but wants the current auditor of Helguson Co to finish this year's audit process as they have already started their planning work. If your firm accepts this suggestion, your firm would be nominated for appointment at the next AGM, scheduled to take place in October 2017. The directors of Faurlin Co have mentioned that there are some extremely sensitive issues at Helguson Co regarding the acquisition, and have warned you that there may be problems answering all of the questions you are likely to ask during your audit, should you be appointed. However, they have suggested that it is too early to worry about such things, and have proposed that these matters are discussed in more detail once the current year audit is nearing completion.

The internal testing department of Faurlin Co has identified a repetitive defect with some of the materials purchased from a new overseas supplier. This material is no longer in use, but a significant number of products have already been made using the material, and most of these have already been sold. The company announced a Product Recall during April 2017, and is currently dealing with the repair work necessary to correct the faults. In some cases, the company cannot repair the items and is having to offer replacements or give refunds. The directors of Faurlin Co are very worried about the product recall, as they fear it may materially affect their performance-related bonuses this year.

In October 2016 Faurlin Co sold several machines to Tanglin Co. The machines had been purchased by Faurlin Co three years ago and were being depreciated over their ten year useful lives. The machines were sold for less than half of their carrying value. The Finance Director of Faurlin, James Paladini, is the majority owner of Tanglin Co.

The contracts that Faurlin Co has with its largest customers result in goods being shipped on a regular basis every three months. Since the sales are guaranteed by the contract, Faurlin Co recognises the revenue from each of these deliveries by spreading it evenly over the three month manufacturing process immediately before delivery of the goods. Goods are shipped on 1st March, 1st June, 1st September and 1st December to all customers who have such contracts, and customers have the right to return any goods that they fail to sell within a six month period after receiving the delivery. Faurlin Co sells any such returned items at a discount to a small local company which then sells them on cheaply on an internet auction site.

Faurlin Co carries out inventory counts every three months. At the two most recent counts, several hundred boxes containing cots were not located by the count teams. An initial investigation by company management has not been able to identify the cause of this discrepancy, and there are plans to bring forward the inventory count planned for 30th June by three weeks to identify if the problem is continuing.

Required:

(a) Explain what is meant by the term "preconditions for an audit" and discuss whether the "preconditions for an audit" exist for Helguson Co.

(5 marks)

(b) Assuming the acquisition of Helguson <u>DOES NOT</u> go ahead, identify and explain the audit risks that should be addressed when planning the final audit of Faurlin Co for the year ending 30th June 2017, producing your answer in the form of briefing notes to be used at the audit planning meeting. (15 marks)

Professional marks will be awarded in part (b) for the format of the answer, and for the clarity of the assessment provided.

(4 marks)

(c) Assuming the acquisition of Helguson <u>DOES</u> go ahead, describe the additional issues which will be relevant to the planning of the audit of Faurlin Group as a result of this acquisition.

(6 marks)

(d) Explain what is meant by the terms "forensic accountancy" and "forensic auditing" and explain their relevance to Faurlin Group.

(5 marks)

Assume today's date is 1st June 2017.

(35 marks)

2. Bobby Chang is a billionaire businessman who recently placed his main business empire onto a leading Stock Exchange. Whilst he retains a small stake in these businesses, he has stepped out from day-to-day management and no longer holds any executive positions, preferring to act as a non-executive director instead so that he can still play a small part in the strategy of the group of companies he founded. He is a huge football fan, and has been negotiating the acquisition of a leading European football club for several weeks. Mr Chang has approached your firm and invited you to perform a due diligence exercise on the football club.

The football club in question plays at a large stadium and also has two training grounds nearby. The training grounds are leased from the local council. The stadium is owned by a major bank. The football club had sold the stadium several years ago to a company called Stadium Holdings, and then leased the stadium back. Three months ago Stadium Holdings became insolvent as they were unable to pay back a major bank loan used to finance the purchase of the stadium from the football club, so the bank then became the legal owner of the stadium. Mr Chang has expressed his desire to buy the football stadium back for the football club, assuming a suitable price can be negotiated with the bank.

The club has a squad of 37 players under contracts of various lengths, and many of these players are very famous and represent their countries in international matches. All of the top players are represented by agents, and their contracts are therefore very detailed and complicated, with no two players having the same terms and conditions.

Having grown his own business empire "organically", Mr Chang has never acquired another company before and has therefore never been involved in a due diligence process before. He is keen to hear from you on how you plan to carry out the exercise, including examples of what you will focus on during your work. He is also keen to have an explanation of how much benefit he is likely to get from the due diligence exercise, as he is still not totally convinced of the need to pay for it when he could investigate the football club's finances himself.

Required:

(a) Define 'due diligence' and describe the likely benefits of your firm carrying out a due diligence review of the football club for Bobby Chang. (6 marks)

(b) Using the scenario above, write a memorandum to Bobby Chang, identifying and explaining the main matters you will focus on during the due diligence review (12 marks)

(c) Explain the likely level of assurance that your due diligence review will provide, contrasting this with the level of assurance provided in an audit of historical financial statements. (7 marks)

(25 marks)

Section B – TWO questions ONLY to be attempted

3. You are an audit manager in Warnock Ranger, a firm of Chartered Certified Accountants with five offices. You have specific responsibility for assisting the Ethics Partner in ethical matters which arise at the other four offices where you are not involved with any of the clients yourself. The following four matters have arisen:

(a) David Jones is an audit manager at Office A. During the audit of Wembar Properties for the year ended 31st October 2016, one of the audit seniors noted an invoice paid by the company to DJ Associates amounting to $34,000 for "financial consultancy services". One of the company's employees has confided to the audit senior that the consultancy work was done by David Jones, the audit manager. (5 marks)

(b) Biss Co is the largest audit client for Office B. The son of the company's CEO has recently left university and is keen to train as an accountant. Stephen Tan, the engagement partner for the Biss Co audit, offered some advice on accountancy as a choice of career, and after meeting the CEO's son has offered him a position as an audit trainee at Office B. (5 marks)

(c) Plato Co is a major client at Office C, and has grown rapidly in recent years. The company needs new finance to support its continued growth strategy and has invited local venture capital funds and banks to an evening reception at a local hotel, so that they can explain their business strategy in more detail and encourage some of those attending to provide more finance. The Finance Director of Plato Co, Doug Little, has asked the audit engagement partner Paul Lambert to attend the reception and sit at the front with the directors, so that he can answer any audit-related questions which might arise. (5 marks)

(d) Office D has an audit client called Melton Manufacturing whose Finance Director has been injured in a serious car crash and is expected to be unable to work for at least three months. The client's Board has asked if an experienced audit manager or partner could be seconded on a temporary three month assignment to the company in order to cover the Finance Director's absence, after which they would return to Office D. (5 marks)

Required:

Comment on the ethical and other professional issues raised by each of the above matters and advise on how Warnock Ranger should respond to them.

***Note*. The mark allocation is shown against each of the three issues.**

(20 marks)

4. You are the manager responsible for the audit of Taarabt Co. The company offers exam training courses for professional exams in accounting and other finance-related industries. The draft financial statements for the year ended 31st March 2017 show revenue of $134 million (2016 – $122 million), profit before taxation of $16 million (2016 – $15 million) and total assets of $78 million (2016 – $63 million).

The following issues arising during the final audit have been noted on a schedule of points for your attention:

(a) On 1st April 2016, Taarabt Co granted 200,000 share options to executives and senior employees of the company. The cost of the share option scheme is being recognized over the four-year vesting period of the scheme, with an expense of $9 million recognized during the year ended 31st March 2017. The expense has been calculated under the assumption that all of the options will vest. (6 marks)

(b) On 14th March 2017 Taarabt Co breached one of its loan covenants with its bank. The loan balance is $5.6 million and was due to be repaid in full in 2019, but under the terms of the loan agreement the bank is now entitled to demand immediate repayment because of the breach. On 18th May 2017 the company received a letter from the bank confirming that the bank would not demand immediate repayment, and that the original repayment date in 2019 would not be changed. (6 marks)

(c) On 12th March 2017, the board of Taarabt met to discuss the recent performance of the law training division. Several directors raised concerns over continued losses, and it was agreed that the matter should be discussed again at the next board meeting. On 13th April 2017, the board agreed that the law training division should be closed down, and the following day the staff were informed that they would be made redundant on 28th May 2017. With law exams in early June, all existing courses were finished before 28th May 2017 and no bookings had been taken for any future courses. The building in which law courses took place was vacated on 28th May 2017 and the lease, which had one year remaining, was terminated after Taarabt Co agreed to pay the lessor a $2m fee to terminate the lease early. The results of the law training division have been presented separately in the financial statements. (8 marks)

Required:

For each of the above issues:

(i) comment on the matters that you should consider; and

(ii) state the audit evidence that you should expect to find, in undertaking your review of the audit working papers and financial statements of Taarabt Co for the year ended 31st March 2017.

***Note*. The mark allocation is shown against each of the three issues.**

Assume today's date is 1st June 2017.

(20 marks)

5.

(a) Explain what is meant by the terms "emphasis of matter" and "other matter", in terms of additional paragraphs which might be required in an audit report on historical financial statements. (6 marks)

(b) You are an audit manager in the firm Bowles and Parkes, and you are conducting your review of the audit working papers for the audit of the financial statements of Queen Promotional Research Co (QPR Co) for the financial year ended 31st March 2017. QPR Co is listed on its country's stock exchange.

Two matters have been brought to your attention by your audit staff.

In the Chairman's Statement to be included at the front of the company's Annual Report the Chairman refers to a significant investment in new assets during the financial year just ended. Audit working papers on non-current assets show that there have been no acquisitions at all during the financial year just ended.

The company is being investigated for anti-competitive practices by Regulators in its home country. The investigation is at an early stage, and it is too early to know with any certainty whether the company has done anything illegal. If QPR Co were to be found guilty, there could be substantial fines payable and there is even a chance that the company could be forced to close down. The directors of QPR Co have disclosed the matter in full in a Note to the Financial Statements, making clear that there is a significant uncertainty regarding the company's ability to continue trading should the company be found guilty, and audit staff are satisfied that the disclosures are sufficient.

A note on the audit file from the audit senior says that no action is required on either of the two issues described above, because "as auditors we do not audit the Chairman's Statement, just the Financial Statements, and the regulator's investigation has been fully disclosed so the financial statements are true and fair and the audit report can therefore not mention this issue".

Required:
Explain the potential impact of the two matters above on your Firm's audit report on the Financial Statements of QPR Co for the year ended 31st December 2016, discussing to what extent the audit senior's comments are correct.

(14 marks)

Note. The marks in part (b) are split evenly between the two matters.

Assume today's date is 1st June 2017.

(20 marks)