Section A – ALL THREE questions are compulsory and MUST be attempted

1 Geno Vesa Farm (GVF), a limited liability company, is a cheese manufacturer. Its principal activity is the production of a traditional ‘Farmhouse’ cheese that is retailed around the world to exclusive shops, through mail order and web sales. Other activities include the sale of locally produced foods through a farm shop and cheese-making demonstrations and tours.

The farm’s herd of 700 goats is used primarily for the production of milk. Kids (i.e. goat offspring), which are a secondary product, are selected for herd replacement or otherwise sold. Animals held for sale are not usually retained beyond the time they reach optimal size or weight because their value usually does not increase thereafter.

There are two main variations of the traditional farmhouse cheese; ‘Rabida Red’ and ‘Bachas Blue’. The red cheese is coloured using Innittu, which is extracted from berries found only in South American rain forests. The cost of Innittu has risen sharply over the last year as the collection of berries by local village workers has come under the scrutiny of an international action group. The group is lobbying the South American government to ban the export of Innittu, claiming that the workers are being exploited and that sustaining the forest is seriously under threat.

Demand for Bachas Blue, which is made from unpasteurised milk, fell considerably in 2003 following the publication of a research report that suggested a link between unpasteurised milk products and a skin disorder. The financial statements for the year ended 30 September 2004 recognised a material impairment loss attributable to the equipment used exclusively for the manufacture of Bachas Blue. However, as the adverse publicity is gradually being forgotten, sales of Bachas Blue are now showing a steady increase and are currently expected to return to their former level by the end of September 2005.

Cheese is matured to three strengths – mild, medium and strong – depending on the period of time it is left to ripen, which is six, 12 and 18 months respectively. When produced, the cheese is sold to a financial institution, Abingdon Bank, at cost. Under the terms of sale, GVF has the option to buy the cheese on its maturity at cost plus 7% for every six months which has elapsed.

All cheese is stored to maturity on wooden boards in GVF’s cool and airy sheds. However, recently enacted health and safety legislation requires that the wooden boards be replaced with stainless steel shelves with effect from 1 July 2005. The management of GVF has petitioned the government health department that to comply with the legislation would interfere with the maturing process and the production of medium and strong cheeses would have to cease.

In 2003, GVF applied for and received a substantial regional development grant for the promotion of tourism in the area. GVF’s management has deferred its plan to convert a disused barn into holiday accommodation from 2004 until at least 2006.

Required:

(a) Identify and explain the principal audit risks to be considered when planning the final audit of GVF for the year ending 30 September 2005. (14 marks)

(b) Describe the audit work to be performed in respect of the carrying amount of the following items in the balance sheet of GVF as at 30 September 2005:

(i) goat herd; (4 marks)

(ii) equipment used in the manufacture of Bachas Blue; and (4 marks)

(iii) cheese. (4 marks)

(26 marks)
Plaza, a limited liability company, is a major food retailer. Further to the success of its national supermarkets in the late 1990s it has extended its operations throughout Europe and most recently to Asia, where it is expanding rapidly.

You are a manager in Andando, a firm of Chartered Certified Accountants. You have been approached by Duncan Seymour, the chief finance officer of Plaza, to advise on a bid that Plaza is proposing to make for the purchase of MCM. You have ascertained the following from a briefing note received from Duncan.

MCM provides training in management, communications and marketing to a wide range of corporate clients, including multi-nationals. The ‘MCM’ name is well regarded in its areas of expertise. MCM is currently wholly-owned by Frontiers, an international publisher of textbooks, whose shares are quoted on a recognised stock exchange. MCM has a National and an International business.

The National business comprises 11 training centres. The audited financial statements show revenue of $12·5 million and profit before taxation of $1·3 million for this geographic segment for the year to 31 December 2004. Most of the National business’s premises are owned or held on long leases. Trainers in the National business are mainly full-time employees.

The International business has five training centres in Europe and Asia. For these segments, revenue amounted to $6·3 million and profit before tax $2·4 million for the year to 31 December 2004. Most of the International business’s premises are held on operating leases. International trade receivables at 31 December 2004 amounted to $3·7 million. Although the International centres employ some full-time trainers, the majority of trainers provide their services as freelance consultants.

Required:

(a) Define ‘due diligence’ and describe the nature and purpose of a due diligence review. (4 marks)

(b) Explain the matters you should consider before accepting an engagement to conduct a due diligence review of MCM. (10 marks)

(c) Illustrate how:

(i) inquiry; and (4 marks)

(ii) analytical procedures, (6 marks)

might appropriately be used in the due diligence review of MCM. (24 marks)
You are the manager responsible for the audit of Volcan, a long-established limited liability company. Volcan operates a national supermarket chain of 23 stores, five of which are in the capital city, Urvina. All the stores are managed in the same way with purchases being made through Volcan's central buying department and product pricing, marketing, advertising and human resources policies being decided centrally. The draft financial statements for the year ended 31 March 2005 show revenue of $303 million (2004 – $282 million), profit before taxation of $9·5 million (2004 – $7·3 million) and total assets of $178 million (2004 – $173 million).

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

(a) On 1 May 2005, Volcan announced its intention to downsize one of the stores in Urvina from a supermarket to a ‘City Metro’ in response to a significant decline in the demand for supermarket-style shopping in the capital. The store will be closed throughout June, re-opening on 1 July 2005. Goodwill of $5·5 million was recognised three years ago when this store, together with two others, was bought from a national competitor. It is Volcan's policy to write off goodwill over five years. (7 marks)

(b) On 1 April 2004 Volcan introduced a ‘reward scheme’ for its customers. The main elements of the reward scheme include the awarding of a ‘store point’ to customers' loyalty cards for every $1 spent, with extra points being given for the purchase of each week’s special offers. Customers who hold a loyalty card can convert their points into cash discounts against future purchases on the basis of $1 per 100 points. (6 marks)

(c) In October 2004, Volcan commenced the development of a site in a valley of ‘outstanding natural beauty’ on which to build a retail ‘megastore’ and warehouse in late 2005. Local government planning permission for the development, which was received in April 2005, requires that three 100-year-old trees within the valley be preserved and the surrounding valley be restored in 2006. Additions to property, plant and equipment during the year include $4·4 million for the estimated cost of site restoration. This estimate includes a provision of $0·4 million for the relocation of the 100-year-old trees.

In March 2005 the trees were chopped down to make way for a car park. A fine of $20,000 per tree was paid to the local government in May 2005. (7 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 Volcan for the year ended 31 March 2005.

NOTE: The mark allocation is shown against each of the three issues.

(20 marks)
4. (a) Explain the auditor’s responsibilities for other information in documents containing audited financial statements. (5 marks)

(b) You are an audit manager with specific responsibility for reviewing other information in documents containing audited financial statements before your firm’s auditor’s report is signed. The financial statements of Hegas, a privately-owned civil engineering company, show total assets of $120 million, revenue of $261 million, and profit before tax of $9·2 million for the year ended 31 March 2005. Your review of the Annual Report has revealed the following:

(i) The statement of changes in equity includes $4·5 million under a separate heading of ‘miscellaneous item’ which is described as ‘other difference not recognized in income’. There is no further reference to this amount or ‘other difference’ elsewhere in the financial statements. However, the Management Report, which is required by statute, is not audited. It discloses that ‘changes in shareholders’ equity not recognized in income includes $4·5 million arising on the revaluation of investment properties’.

The notes to the financial statements state that the company has implemented IAS 40 ‘Investment Property’ for the first time in the year to 31 March 2005 and also that ‘the adoption of this standard did not have a significant impact on Hegas’s financial position or its results of operations during 2005’.

(ii) The chairman’s statement asserts ‘Hegas has now achieved a position as one of the world’s largest generators of hydro-electricity, with a dedicated commitment to accountable ethical professionalism’. Audit working papers show that 14% of revenue was derived from hydro-electricity (2004: 12%). Publicly available information shows that there are seven international suppliers of hydro-electricity in Africa alone, which are all at least three times the size of Hegas in terms of both annual turnover and population supplied.

Required:
Identify and comment on the implications of the above matters for the auditor’s report on the financial statements of Hegas for the year ended 31 March 2005. (10 marks)
You are an audit manager in Bartolome, a firm of Chartered Certified Accountants. You have specific responsibility
for undertaking annual reviews of existing clients and advising whether an engagement can be properly continued.
The following matters have arisen in connection with recent assignments:

(a) Leon Dormido is the senior in charge of the audit of the financial statements of Moreno, a limited liability
company, for the year ending 30 June 2005. Moreno’s Chief Executive Officer, James Bay, has just sent you an
e-mail to advise you that Leon has been short-listed for the position of Finance Director. You were not previously
aware that Leon had applied for the position. (5 marks)

(b) Chatam, a limited liability company, is a long-standing client. One of its subsidiaries, Ayora, has made losses
for several years. At your firm’s request, Chatam’s management has made a written representation that goodwill
arising on the acquisition of Ayora is not impaired. Your firm’s auditor’s report on the consolidated financial
statements of Chatam for the year ended 31 March 2005 is unmodified. Your firm’s auditor’s report on the
financial statements of Ayora is similarly unmodified. Chatam’s Chief Executive, Charles Barrington, is due to
retire in 2006 when his share options mature. (6 marks)

(c) Pinzon, a limited liability company and audit client, is threatening to sue your firm in respect of audit fees charged
for the year ended 31 December 2004. Pinzon is alleging that Bartolome billed the full rate on air fares for audit
staff when substantial discounts had been obtained by Bartolome. (4 marks)

Required:
Comment on the ethical and other professional issues raised by each of the above matters and their implications,
if any, for the continuation of each assignment.

NOTE: The mark allocation is shown against each of the three issues. (15 marks)

6 (a) Explain the term ‘money laundering’. (3 marks)

(b) Comment on the need for ethical guidance for accountants on money laundering. (4 marks)

(c) The OECD’s Financial Action Task Force on Money Laundering (FATF) recommends preventative measures to be
taken by independent legal professionals and accountants (including sole practitioners, partners and employed
professionals within professional firms).

Required:
Describe FOUR measures that assist in preventing professional accountants from being used for money
laundering purposes. (8 marks)

(15 marks)

End of Question Paper