Faculty of Business & Enterprise

Higher Education Division

HBC225/HBC 225N

Assignment

ADELPHI HEALTH CARE LTD:

CONTINUOUS CASE STUDY IN AUDITING

(Week 5 – Week 11)

Semester 1, 2012

SWINBURNE UNIVERSITY OF TECHNOLOGY

ADELPHI HEALTH CARE LTD:
CONTINUOUS CASE STUDY IN AUDITING

You need to start work on this online based continuous case study from W/B 26th March. You need to work in pairs (can choose member from other tutorials) and must participate (individually) in online discuss board (please check Blackboard discussion page).

You should be able to answer each week's requirements after you attended lecture, tutorial and read relevant chapters. Need to put together your case study answers and submit them as your final assignment (ONE pdf or word file) by due date, Monday 14th May, 2012 5pm (don't submit on a weekly basis!).

Part 1: Week 5 (Chapter 6)

Adelphi Health Care Ltd listed on the Australian Securities Exchange in 2004. Prior to listing, it was a privately held company managing medical centers in New South Wales. The founders of Adelphi are John Simpson and Eddie Gallagher who are both medical practitioners by profession. At the time of going public, John held the position of Chief Executive Officer (CEO) and Eddie was the Chief Operating Officer (COO). The company raised $50 million and moved into research and development of the flu vaccine.

The company's main product Fluvacs was commercialized in 2007 and it is now sold across Australia. Since 2009, this vaccine is also being distributed in Singapore, Malaysia and the Philippines. The marketing director Anne Tanner has been instrumental in putting in place the local and overseas distribution agreements. Adelphi has agreements with one distributor in each Australian state and one distributor in each of its offshore locations.

In January 2010, John Simpson resigned as CEO and took on the role of Board Chairman. He was replaced as CEO by Ray Wilson who was the CEO of a listed mining group prior to joining Adelphi. Ray has a proven track record of expanding into new projects and markets but has no experience in the health care industry. Eddie Gallagher continues in his COO role but spends more time on the golf course these days. The company has retained the same Chief Financial Officer, Jenny Maxwell. Jenny was offered a 30% increase in salary and a lucrative bonus in the current year as part of the Board's plan to retain her. Jenny has been with Adelphi since its listing and has put into place extensive processes and controls over the past seven years. She is a perfectionist and prefers to handle important matters on her own, seldom delegating to her finance team.

Since taking over Ray Wilson has decided that the company's future lies in developing a vaccine for avian (bird) flu. He is of the view that the company is well placed to market the product in Asia with its existing distributor base. A dedicated research team has been hired to work on this vaccine. Management has indicated that initial lab results are promising and are confident that clinical trials can be commenced within the next 12 months. As a result, a significant proportion of research and development costs have been capitalized in the current financial year.

In late 2008, the company bought a piece of land in Sydney's inner west and constructed a purpose built building with offices and research labs. Prior to this, the company was renting premises. The land cost $6.5 million and the building cost $3.5 million. Jenny recently asked a friend who is a real estate agent for an informal valuation and was advised that the property market has lost its momentum and the company's land and buildings were currently worth about $9 million. Jenny did not mention this to any of the company directors.

You are the audit manager in charge of the audit of Adelphi Health Care Ltd. Your firm has been the auditor for the past three years. Adelphi has been provided with an unqualified opinion since your firm has been the company auditor. You are currently carrying out the audit planning for the financial year end audit.

The client has provided you with the following draft financial information in respect of the year ended 30 June 2011.

Adelphi Healthcare Ltd
Draft Statement of Comprehensive Income
for the year ended 30 June, 2011

	2011	2010
	$'000	$'000
Revenue	28,715	37,280
Cost of sales	10,880	12,640
Gross profit	17,835	24,640
Operating expenses		
Research & development	2,930	11,210
Advertising	1,180	925
Distribution	1,010	1,370
Shipping and handling	465	550
Salaries and wages	7,985	4,840
Depreciation	795	675
Interest	825	725
Other expenses	1,325	180
Profit before income tax	1,320	4,165

Income tax expense	395	1,250
Profit after income tax	925	2,915

Draft Statement of Financial Position
as at 30 June, 2011

	Notes	2011 $'000	2010 $'000
CURRENT ASSETS			
Cash and cash equivalents		1,040	11,500
Receivables	2	8,615	5,880
Inventories		3,560	1,335
Other current assets		440	565
Total current assets		13,655	19,280
NON-CURRENT ASSETS			
Intangibles	3	6,570	-
Property, plant and equipment	4	10,280	10,475
Total non-current assets		16,850	10,475
TOTAL ASSETS		30,505	29,755
CURRENT LIABILITIES			
Accounts payable		1,845	2,390
Provisions	5	1,015	775
Total current liabilities		2,860	3,165
NON-CURRENT LIABILITIES			
Borrowings	6	10,000	10,000
Provisions	5	365	235
Total non-current liabilities		10,365	10,235
TOTAL LIABILITIES		13,225	13,400
NET ASSETS		17,280	16,355

EQUITY		
Contributed equity	50,000	50,000
General Reserve	10,000	10,000
Accumulated losses	(42,720)	(43,645)
TOTAL EQUITY	17,280	16,355

Notes to the financial statements

Note 1 Summary of significant accounting policies

Receivables

Trade receivables are carried at original invoice value less any provision for doubtful debts. Debts, which are known to be uncollectible, are written off. A provision for doubtful debts is recognized when collection of the full amount is no longer probable.

Inventories

Inventories are measured at the lower of cost and net realizable value. Costs incurred in bringing the product to its present location and condition, are accounted for as follows:

- Raw materials – purchase cost on a first in first out basis; and
- Finished goods and work-in-progress – cost of direct material, direct labour and a proportion of manufacturing overhead based on normal operating capacity

Property, plant and equipment

Cost and valuation

All property, plant and equipment are brought to account at cost.

Depreciation

Depreciation is calculated on a straight line basis to write off the depreciable amount of each item of property, plant and equipment (excluding land) over its expected useful life to the company.

Depreciation periods are:

Buildings	20 years
Plant and equipment	2.5 – 10 years

Intangible assets

Research and development

Costs incurred on research and development projects are expensed as incurred, unless future recoverability is assured beyond a reasonable doubt, to exceed those costs. Where research and development costs are capitalized, such costs are amortised over future periods on a basis related to expected benefits. Unamortised costs are reviewed at each reporting date to determine the amount (if any) that is no longer recoverable and any amount identified is written off.

		2011	2010
		$'000	$'000
Note 2	**Receivables**		
	Accounts receivable	9,015	6,235
	less Provision for doubtful debts	(400)	(355)
		8,615	5,880
Note 3	**Intangibles**		
	Research and development	6,570	-
Note 4	**Property, plant and equipment**		
	Freehold Land	6,500	6,500
	Buildings	3,500	3,500
	Accumulated depreciation	(700)	(525)
		2,800	2,975
	Plant and equipment - at cost	2,600	2,000
	Accumulated depreciation	(1,620)	(1,000)
		980	1,000
	Total property, plant and equipment	10,280	10,475
Note 5	**Provisions**		
	Current		
	Provision for annual leave	1,015	775
	Non-current		

	Provision for long service leave	365	235
Note 6	**Borrowings**		
	Secured bank loan	10,000	10,000

Required

Carry out preliminary analytical procedures based on the draft financial information provided and discuss the impact of your findings on the audit plan.

Part 2: Week 6 (Chapter 7)

This is a continuation of question in Chapter 6, relating to Adelphi Health Care Ltd. However, it may be completed independently of that question. Refer to the background information contained there.

Required

(a) Outline the factors that would affect your assessment of inherent risk associated with the audit of Adelphi Health Care Ltd.

(b) For each of the inherent risk factors you outlined in (a) above, indicate:

(i) whether it increases or decreases audit risk; and

(ii) its effect on your audit procedures.

(c) Your audit partner has asked you to set a preliminary materiality level for the audit of Adelphi Health Care Ltd to be discussed at the planning meeting. The audit partner has asked you to consider and justify the base you think is appropriate in setting planning materiality. You should take into account your assessment of the inherent risk factors in determining planning materiality. Outline how the materiality level will influence the nature and extent of audit procedures planned.

Part 3: Week 7 (Chapter 8)

This is a continuation of questions in Chapter 6 and Chapter 7, relating to Adelphi Health Care Ltd. However, it may be completed independently of those questions.

You are currently planning the audit of Adelphi Health Care Ltd, a listed company involved in the manufacture and sale of the flu vaccine. The company has a balance date of 30 June. The following notes were drafted as part of the audit plan two years ago and describe the procedures performed by the employees of the company in relation to the purchases cycle. Control risk around purchases was assessed as low during the audit two years ago. The audit plan this year includes testing controls around purchases.

Audit file note: Understanding the purchases cycle and control procedures implemented by management:

The head of the manufacturing department has the authority to approve purchases up to $50,000. The computerized inventory management system generates requisition orders when inventory levels fall below re-order levels. All purchase requisitions are processed through the centralized purchasing department. The role of the purchasing department is to ensure that purchase requisitions are duly approved, approved suppliers are used and where there are no pre-approved suppliers for a particular item, competitive quotes are sought if the cost exceeds $5,000 per item. The purchasing department then prepares a purchase order which is sent to the relevant supplier.

All goods are delivered to the central warehouse. The warehouse supervisor is responsible for checking that the goods received are in good order and that the quantities received and description of items matches the purchase order. The warehouse clerk then updates the inventory management system to reflect the receipt of the goods. If an order is only partially filled, a note is made on the purchase order and the purchasing department follows up with the supplier.

Supplier invoices are received by the accounts payable clerk who checks the invoices for mathematical accuracy and also agrees the details and quantities on the invoices to the goods received report and purchase order. Once these checks are done, the accounts payable clerk signs off on the invoice and sends it to the financial accountant for final approval. A register is maintained of all invoices received so as to avoid paying duplicate invoices. Once the accountant approves the invoices, they are batched and sent back to the accounts payable clerk for posting to the accounting system.

At each month end, the accounting system generates a payment report along with a remittance advice providing a break-down of the balances owing. The financial accountant reconciles the totals to each weekly batch summary. Once the balances are reconciled, the accountant approves the payment. The system then initiates electronic transfer of funds to all suppliers and sends either an email copy or hard copy of the remittance advice.

Conclusion: Control risk around purchases is assessed as LOW.

Required

(a) List the control procedures implemented by Adelphi over the purchases cycle.

(b) Discuss the appropriateness of using the audit notes from two years ago and the associated control risk assessment.

(c) Outline further work that would be required to assess control risk in the current audit.

Part 3: Week 7 (Chapter 9)

This is a continuation of question in Chapter 8. However, it may be completed independently of that question.

You are currently involved in the audit of Adelphi Health Care Ltd, a listed company involved in the manufacture and sale of the flu vaccine. The company has a balance date of 30 June. One of the key audit risks identified in the audit plan relates to credit sales and the collectability of trade receivables. The reliance on single distributors in each local and overseas jurisdiction as well as their geographical spread heightens the risk in this area.

An initial evaluation of control risk in the planning stage indicates that management has sound controls around approving the distributors, recording sales accurately and diligently following up outstanding accounts.

The following are the control objectives identified in the audit plan:

1. Ensure that Adelphi evaluates each potential distributor's credit history prior to approving them as an authorized distributor.
2. Ensure there is adequate segregation of duties between authorizing sales, delivering the finished product and recording sales.
3. Ensure there are adequate controls to ensure sales are recorded in the correct financial period.
4. Ensure there are adequate controls around the estimation of provision for doubtful debts.

Required

Identify appropriate tests of controls for each of the above control objectives.

Part 4: Week 8 (Chapter 10)

This is a continuation of question in Chapter 9, with additional background information from question in Chapter 6. However, it may be completed independently of those questions.

You are currently involved in the audit of Adelphi Health Care Ltd, a listed company involved in the manufacture and sale of the flu vaccine. The company has a balance date of 30 June. The following information was gathered by your audit senior in discussions with management.

1. Research and development expenses

The audit senior noted that research and development expenses had decreased significantly during the year. Adelphi expensed more than $11 million in research and development costs while in the current year they have only expensed close to $3 million. It was brought to the attention of the audit senior that the CFO in discussions with the Board decided to capitalize about $6.5 million in research and development costs in the current year. The CFO advised the audit senior that "while we are still in the early stages of developing the avian flu vaccine, initial testing is showing some promising results and we believe that the current research program will contribute significantly to the commercial outcomes of our new product".

2. Land and buildings

While reading the minutes of the Board meetings, the audit senior came across an item discussing the valuation of land and buildings. Board members were concerned with the recent slowdown in the property market and what impact that may have on the valuation of land and buildings. The CFO was asked to follow up on this matter and to arrange an independent valuation of land and buildings. There was no evidence of a follow up in the subsequent minutes.

3. Accounts payable

In reviewing liabilities, the audit senior noticed that trade and other payables had decreased compared to the prior year. This did not appear reasonable given the level of spending on operating costs and research and development activities. The audit senior approached the financial accountant to seek clarification. “We have made a concerted effort this year to make prompt payments to all suppliers. We have ensured that trade payables have been reconciled to all supplier invoices and to the payment summary”, reassured the financial accountant.

Required

(a) Identify the key financial report assertions relevant to the audit of the above account balances.

(b) For each of the assertions identified in (a) above, describe two procedures that could be used to gather sufficient and appropriate audit evidence.

Part 5: Week 9 (Chapter 11)

This is a continuation of question in Chapter 10. However, it may be completed independently of that question.

You are reviewing your audit assistant’s work for Adelphi Health Care Ltd for the year ended 30 June 2011, and note the following issues.

(a) Your audit assistant’s work papers on the trade payables testing conclude the following: *“In testing trade payables, twenty balances were randomly selected and vouched to suppliers’ invoices and receiving reports. The sample selected amounted to $832,000. Total trade payables is $1,760,000.Results of the testing revealed two invoices with a total of $24,900 had been incorrectly recorded on the trade payables ledger, as the goods were only received in July 2011.The error found relates to 3 per cent of trade payables tested. This results in a total error of $52,673 of the total trade payables balance. As total error is only 3 per cent of trade payables, it is not considered material and, therefore, no further work has been performed. I conclude that the trade payables balance of Adelphi Health Care Ltd is not materially misstated.”*

(b) The audit assistant performed tests of controls on 30 purchases transactions. This testing resulted in the discovery of three errors. A tolerable error of 5 per cent had been set during the audit planning. The audit assistant concluded that the controls were reliable on the basis that none of the errors found were considered to be material.

Required

Do you consider your audit assistant’s conclusions in each of the above situations appropriate? Justify your response.

Part 6: Week 11 (Chapter 12)

This is a continuation of question in Chapter 11, and the background information provided in question in Chapter 6. However, it may be completed independently of those questions.

You are the audit senior currently involved in the audit of Adelphi Health Care Ltd, a listed company involved in the manufacture and sale of the flu vaccine. The audit is drawing to a close and the timeline below applies. The following matters come to your attention.

- Balance date: 30 June 2011
- Directors' declaration and audit report signed: 22 August 2011
- Financial report and audit report mailed to shareholders: 29 August 2011
- Annual general meeting of shareholders: 17 October 2011

(i) The Board of Directors were growing increasingly concerned with recent media reports about falling property values in Australia and in June 2011, the Board commissioned an independent property consultant to prepare a valuation report on the land and buildings. On 18 July 2011, the property valuation report was received by the Board. The land and buildings collectively were valued at $8.5 million.

(ii) In May 2011, Adelphi received correspondence from SHC Distributors Pte Ltd (SHC), its distributor in Singapore advising that it was having difficulty paying its monthly invoices. As at 30 June, 2011 SHC owed Adelphi $1.2 million. As at balance date, the financial accountant had posted a provision for doubtful debts of $300,000 against the balance owing by SHC. On 15 August, Adelphi received correspondence from company administrators advising that SHC is under voluntary liquidation. Initial estimates are that creditors are likely to receive 15 cents in the dollar once SHC is liquidated.

(iii) In early August 2011, Adelphi received reports from its distributor in the Philippines that a few patients administered with the flu vaccine had complained of serious side effects. An investigation by the distributor revealed that these complaints were attributed to a batch of the flu vaccine that was shipped out in early July 2011. The distributor has recalled the affected batch and is seeking compensation from Adelphi for the cost of the recall. On 18 August 2011, Adelphi received correspondence from a legal firm representing a patient whose health has deteriorated significantly since receiving the flu vaccine. Compensation of $2 million is being sought.

(iv) On 4 July 2011, there was some isolated flooding in Adelphi's warehouse caused by a damaged water pipe. Most of the inventory stored was unaffected but after the warehouse has been cleaned up, warehouse staff determined that about $350,000 worth of inventory was damaged in the flooding and had to be destroyed as it was unfit for sale.

Consider each of these independent issues to be material when determining your response to the following requirements.

Required

(a) For each of the events (i) to (iv) select the appropriate advise you would give your client from the actions listed below, and **justify your choice**:

(1) Adjust the 30 June 2011 financial report.
(2) Disclose the information in a note to the 30 June 2011 financial report.
(3) Request the client to recall the 30 June 2011 financial report for revision.
(4) No further action required.

(b) What additional audit evidence would you obtain in relation to each of the events (i) to (iv) to ensure a sound basis for forming the audit opinion?

Part 7: Week 11 (Chapter 13)

This is a continuation of question in Chapter 12, and of the background information contained in question in Chapter 6. However, it may be completed independently of those questions.

The audit of Adelphi Health Care Ltd is now complete, and as the audit manager on the engagement you have been tasked with drafting the audit report. The Board of directors has accepted the advice of the audit partner and has updated the financial report to appropriately reflect the impact of all the subsequent events identified in question 12.xx. You receive a phone call from the CEO just as you are about to finalize the audit report.

“We’ve got some fantastic news! I have been discussing our new vaccine with a private equity firm and they are really excited about its prospects and have verbally assured us that they would be willing to invest up to $20 million over the next two years given how promising the preliminary results have been. This will help tremendously with our cash flow and get us back on track given the recent issues we have had. Based on this news, I think we can sign off the accounts on a going concern basis and look forward to an unqualified opinion from your firm”

You assured the CEO that you would consider this information along with the audit evidence gathered thus far in arriving at the appropriate audit opinion.

Required

(a) Do you think Adelphi Health Care Ltd is a going concern risk? Identify the relevant factors in forming and justifying your conclusion. Also identify any mitigating factors you may have considered.

(b) If you conclude that there is a going concern risk and management decide not to include a disclosure note detailing the going concern issue, identify the type of audit opinion you would issue and explain the basis of your decision.