

Fundamentals Level – Skills Module

# Audit and Assurance (International)

Thursday 6 June 2013



**Time allowed**

Reading and planning: 15 minutes

Writing: 3 hours

ALL FIVE questions are compulsory and MUST be attempted.

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

**During reading and planning time only the question paper may be annotated. You must NOT write in your answer booklet until instructed by the supervisor.**

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

The Association of Chartered Certified Accountants

Paper F8 (INT)

**ACCA**

**ALL FIVE questions are compulsory and MUST be attempted**

- 1 (a) ISA 260 *Communication with Those Charged with Governance* provides guidance to auditors in relation to communicating with those charged with governance on matters arising from the audit of an entity's financial statements.

**Required:**

- (i) **Explain why it is important that auditors communicate throughout the audit with those charged with governance; and** (2 marks)
- (ii) **Describe THREE examples of matters that the auditors may communicate to those charged with governance.** (3 marks)

**Introduction**

Fox Industries Co (Fox) manufactures engineering parts. It has one operating site and a customer base spread across Europe. The company's year end was 30 April 2013. Below is a description of the purchasing and payments system.

**Purchasing system**

Whenever production materials are required, the relevant department sends a requisition form to the ordering department. An order clerk raises a purchase order and contacts a number of suppliers to see which can despatch the goods first. This supplier is then chosen. The order clerk sends out the purchase order. This is not sequentially numbered and only orders above \$5,000 require authorisation.

Purchase invoices are input daily by the purchase ledger clerk, who has been in the role for many years and, as an experienced team member, he does not apply any application controls over the input process. Every week the purchase day book automatically updates the purchase ledger, the purchase ledger is then posted manually to the general ledger by the purchase ledger clerk.

**Payments system**

Fox maintains a current account and a number of saving (deposit) accounts. The current account is reconciled weekly but the saving (deposit) accounts are only reconciled every two months.

In order to maximise their cash and bank balance, Fox has a policy of delaying payments to all suppliers for as long as possible. Suppliers are paid by a bank transfer. The finance director is given the total amount of the payments list, which he authorises and then processes the bank payments.

**Required:**

- (b) **As the external auditors of Fox Industries Co, write a report to management in respect of the purchasing and payments system described above which:**
  - (i) **Identifies and explains FOUR deficiencies in the system; and**
  - (ii) **Explains the possible implication of each deficiency; and**
  - (iii) **Provides a recommendation to address each deficiency.**

**A covering letter IS required.**

Note: Up to two marks will be awarded within this requirement for presentation and the remaining marks will be split equally between each part. (14 marks)

- (c) **Identify and explain FOUR application controls that should be adopted by Fox Industries Co to ensure the completeness and accuracy of the input of purchase invoices.** (4 marks)
- (d) **Describe substantive procedures the auditor should perform to confirm the bank and cash balance of Fox Industries Co at the year end.** (7 marks)

**(30 marks)**

- 2 (a) Compliance with the fundamental principles in ACCA's *Code of Ethics and Conduct* can be threatened in a number of ways.

**Required:**

**List the FIVE ethical threats to independence and objectivity and for EACH threat identify ONE example of a circumstance that may create the threat.** (5 marks)

- (b) In accordance with ISA 570 *Going Concern*, explain the responsibilities of auditors and management regarding going concern. (3 marks)

- (c) Describe the content of an emphasis of matter paragraph. (2 marks)

**(10 marks)**

**3 (a) Explain the concepts of materiality and performance materiality in accordance with ISA 320 *Materiality in Planning and Performing an Audit*.** (5 marks)

**(b)** You are the audit senior of Rhino & Co and you are planning the audit of Kangaroo Construction Co (Kangaroo) for the year ended 31 March 2013. Kangaroo specialises in building houses and provides a five-year building warranty to its customers. Your audit manager has held a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts:

Kangaroo has had a difficult year; house prices have fallen and, as a result, revenue has dropped. In order to address this, management has offered significantly extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in inventory where the selling price may be below cost. During the year, whilst calculating depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet a target profit before interest and taxation of \$0.5 million in order to be paid their annual bonus. In addition, to try and improve profits, Kangaroo changed their main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To help with operating cash flow, the directors borrowed \$1 million from the bank during the year. This is due for repayment at the end of 2013.

**Financial statement extracts for year ended 31 March**

|                                     | <b>DRAFT<br/>2013<br/>\$m</b> | <b>ACTUAL<br/>2012<br/>\$m</b> |
|-------------------------------------|-------------------------------|--------------------------------|
| Revenue                             | 12.5                          | 15.0                           |
| Cost of sales                       | (7.0)                         | (8.0)                          |
| Gross profit                        | 5.5                           | 7.0                            |
| Operating expenses                  | (5.0)                         | (5.1)                          |
| Profit before interest and taxation | 0.5                           | 1.9                            |
| Inventory                           | 1.9                           | 1.4                            |
| Receivables                         | 3.1                           | 2.0                            |
| Cash                                | 0.8                           | 1.9                            |
| Trade payables                      | 1.6                           | 1.2                            |
| Loan                                | 1.0                           | -                              |

**Required:**

**Using the information above:**

**(i) Calculate FIVE ratios, for BOTH years, which would assist the audit senior in planning the audit; and** (5 marks)

**(ii) Using the information provided and the ratios calculated, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Kangaroo Construction Co.** (10 marks)

**(20 marks)**

- 4 (a) (i) Describe FIVE types of procedures for obtaining audit evidence; and  
(ii) For each procedure, describe an example relevant to the audit of property, plant and equipment.

Note: The total marks will be split equally between each part. (10 marks)

Bush-Baby Hotels Co operates a chain of 18 hotels located across the country. Each hotel has bedrooms, a restaurant and leisure club facilities. Most visitors to the restaurant and leisure club are hotel guests; however, these facilities are open to the public as well. Hotel guests generally charge any costs to their room but other visitors must make payment directly to the hotel staff.

During the year, senior management noticed an increased level of cash discrepancies and inventory discrepancies, and they suspect that some employees have been stealing cash and goods from the hotels. They are keen to prevent this from reoccurring and are considering establishing an internal audit department to undertake a fraud investigation.

**Required:**

- (b) Explain how the new internal audit department of Bush-Baby Hotels Co could assist the directors in preventing and detecting fraud and error. (3 marks)
- (c) Describe the limitations of Bush-Baby Hotels Co establishing and maintaining an internal audit department. (2 marks)

The directors would like the internal audit department to have as broad a role as possible, as this will make the decision to recruit an internal audit department more cost effective.

**Required:**

- (d) Describe additional functions, other than fraud investigations, the directors of Bush-Baby Hotels Co could ask the internal audit department to undertake. (5 marks)

**(20 marks)**

5 (a) Explain the five elements of an assurance engagement. (5 marks)

(b) Panda Co manufactures chemicals and has a factory and four offsite storage locations for finished goods. Panda Co's year end was 30 April 2013. The final audit is almost complete and the financial statements and audit report are due to be signed next week. Revenue for the year is \$55 million and profit before taxation is \$5.6 million.

The following two events have occurred subsequent to the year end. No amendments or disclosures have been made in the financial statements.

**Event 1 – Defective chemicals**

Panda Co undertakes extensive quality control checks prior to despatch of any chemicals. Testing on 3 May 2013 found that a batch of chemicals produced in April was defective. The cost of this batch was \$0.85 million. In its current condition it can be sold at a scrap value of \$0.1 million. The costs of correcting the defect are too significant for Panda Co's management to consider this an alternative option.

**Event 2 – Explosion**

An explosion occurred at the smallest of the four offsite storage locations on 20 May 2013. This resulted in some damage to inventory and property, plant and equipment. Panda Co's management have investigated the cause of the explosion and believe that they are unlikely to be able to claim on their insurance. Management of Panda Co has estimated that the value of damaged inventory and property, plant and equipment was \$0.9 million and it now has no scrap value.

**Required:**

**For each of the two events above:**

- (i) Explain whether the financial statements require amendment; and
- (ii) Describe audit procedures that should be performed in order to form a conclusion on any required amendment.

Note: The total marks will be split equally between each event. (12 marks)

(c) The directors do not wish to make any amendments or disclosures to the financial statements for the explosion (event 2).

**Required:**

**Explain the impact on the audit report should this issue remain unresolved.** (3 marks)

**(20 marks)**

**End of Question Paper**