Fundamentals Level – Skills Module

Audit and Assurance (International)

Thursday 8 December 2011

Paper F8 (INT)

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

ACCA

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1 Introduction and client background

You are the audit senior of Blair & Co and your team has just completed the interim audit of Chuck Industries Co, whose year end is 31 January 2012. You are in the process of reviewing the systems testing completed on the payroll cycle, as well as preparing the audit programmes for the final audit.

Chuck Industries Co manufactures lights and the manufacturing process is predominantly automated; however there is a workforce of 85 employees, who monitor the machines, as well as approximately 50 employees who work in sales and administration. The company manufactures 24 hours a day seven days a week.

Below is a description of the payroll system along with deficiencies identified by the audit team:

Factory workforce

The company operates three shifts every day with employees working eight hours each. They are required to clock in and out using an employee swipe card, which identifies the employee number and links into the hours worked report produced by the computerised payroll system. Employees are paid on an hourly basis for each hour worked. There is no monitoring/supervision of the clocking in/out process and an employee was witnessed clocking in several employees using their employee swipe cards.

The payroll department calculates on a weekly basis the cash wages to be paid to the workforce, based on the hours worked report multiplied by the hourly wage rate, with appropriate tax deductions. These calculations are not checked by anyone as they are generated by the payroll system. During the year the hourly wage was increased by the Human Resources (HR) department and this was notified to the payroll department verbally.

Each Friday, the payroll department prepares the pay packets and physically hands these out to the workforce, who operate the morning and late afternoon shifts, upon production of identification. However, for the night shift workers, the pay packets are given to the factory supervisor to distribute. If any night shift employees are absent on pay day then the factory supervisor keeps these wages and returns them to the payroll department on Monday.

Sales and administration staff

The sales and administration staff are paid monthly by bank transfer. Employee numbers do fluctuate and during July two administration staff joined; however, due to staff holidays in the HR department, they delayed informing the payroll department, resulting in incorrect salaries being paid out.

Required:

(a) For the deficiencies already identified in the payroll system of Chuck Industries Co:

(i) explain the possible implications of these; and
(ii) suggest a recommendation to address each deficiency. (12 marks)

(b) Describe substantive procedures you should now perform to confirm the accuracy and completeness of Chuck Industries' payroll charge. (6 marks)

(c) Last week the company had a visit from the tax authorities who reviewed the wages calculations and discovered that incorrect levels of tax had been deducted by the payroll system, as the tax rates from the previous year had not been updated. The finance director has queried with the audit team why they did not identify this non-compliance with tax legislation during last year's audit.

Required:

Explain the responsibilities of management and auditors of Chuck Industries Co in relation to compliance with law and regulations under ISA 250 *Consideration of Laws and Regulations in an Audit of Financial Statements*. (4 marks)

(d) Chuck Industries has decided to outsource its sales ledger department and as a result it is making 14 employees redundant. A redundancy provision, which is material, will be included in the draft accounts.

Required:

Describe substantive procedures you should perform to confirm the redundancy provision at the year end. (4 marks)

(e) Chuck Industries is considering establishing an internal audit (IA) department next year. The finance director has asked whether the work performed by the IA department can be relied upon by Blair & Co.

Required:

Explain the factors that should be considered by an external auditor before reliance can be placed on the work performed by a company's internal audit department. (4 marks)

(30 marks)

2 **(a)** ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires auditors to understand the entity's internal control. An entity's internal control is made up of several components.

Required:

State the FIVE components of an entity's internal control and give a brief explanation of each component.
(5 marks)

(b) ISA 700 *Forming an Opinion and Reporting on Financial Statements* provides guidance on the form and content of the auditor's report and should contain a number of elements.

Required:

Describe FIVE elements of an unmodified auditor's report. (5 marks)

(10 marks)

3 (a) Explain the components of audit risk and, for each component, state an example of a factor which can result in increased audit risk. (6 marks)

Abrahams Co develops, manufactures and sells a range of pharmaceuticals and has a wide customer base across Europe and Asia. You are the audit manager of Nate & Co and you are planning the audit of Abrahams Co whose financial year end is 31 January. You attended a planning meeting with the finance director and engagement partner and are now reviewing the meeting notes in order to produce the audit strategy and plan. Revenue for the year is forecast at $25 million.

During the year the company has spent $2·2 million on developing several new products. Some of these are in the early stages of development whilst others are nearing completion. The finance director has confirmed that all projects are likely to be successful and so he is intending to capitalise the full $2·2 million.

Once products have completed the development stage, Abrahams begins manufacturing them. At the year end it is anticipated that there will be significant levels of work in progress. In addition the company uses a standard costing method to value inventory; the standard costs are set when a product is first manufactured and are not usually updated. In order to fulfil customer orders promptly, Abrahams Co has warehouses for finished goods located across Europe and Asia; approximately one third of these are third party warehouses where Abrahams just rents space.

In September a new accounting package was introduced. This is a bespoke system developed by the information technology (IT) manager. The old and new packages were not run in parallel as it was felt that this would be too onerous for the accounting team. Two months after the system changeover the IT manager left the company; a new manager has been recruited but is not due to start work until January.

In order to fund the development of new products, Abrahams has restructured its finance and raised $1 million through issuing shares at a premium and $2·5 million through a long-term loan. There are bank covenants attached to the loan, the main one relating to a minimum level of total assets. If these covenants are breached then the loan becomes immediately repayable. The company has a policy of revaluing land and buildings, and the finance director has announced that all land and buildings will be revalued as at the year end.

The reporting timetable for audit completion of Abrahams Co is quite short, and the finance director would like to report results even earlier this year.

Required:

(b) Using the information provided, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Abrahams Co. (10 marks)

(c) Describe substantive procedures you should perform to obtain sufficient appropriate evidence in relation to:

(i) Inventory held at the third party warehouses; and
(ii) Use of standard costs for inventory valuation. (4 marks)

(20 marks)

4 (a) Explain what is meant by 'corporate governance' and why it is important. (3 marks)

(b) Serena VDW Co has been trading for over 20 years and obtained a listing on a stock exchange five years ago. It provides specialist training in accounting and finance.

The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are fairly confident that they are following best practice in relation to this. However, they have recently received an email from a significant shareholder, who is concerned that Serena VDW Co does not comply with corporate governance principles.

Serena VDW Co's board is comprised of six directors; there are four executives who originally set up the company and two non-executive directors who joined Serena VDW Co just prior to the listing. Each director has a specific area of responsibility and only the finance director reviews the financial statements and budgets.

The chief executive officer, Daniel Brown, set up the audit committee and he sits on this sub-committee along with the finance director and the non-executive directors. As the board is relatively small, and to save costs, Daniel Brown has recently taken on the role of chairman of the board. It is the finance director and the chairman who make decisions on the appointment and remuneration of the external auditors. Again, to save costs, no internal audit function has been set up to monitor internal controls.

The executive directors' remuneration is proposed by the finance director and approved by the chairman. They are paid an annual salary as well as a generous annual revenue related bonus.

Since the company listed, the directors have remained unchanged and none have been subject to re-election by shareholders.

Required:

Describe SIX corporate governance weaknesses faced by Serena VDW Co and provide recommendations to address each weakness, to ensure compliance with corporate governance principles. (12 marks)

(c) Explain the auditor's ethical responsibilities with regard to client confidentiality and when they have an:

(i) obligatory responsibility; and
(ii) voluntary responsibility to disclose client information. (5 marks)

(20 marks)

5 (a) Describe the auditor's responsibility for subsequent events occurring between:

(i) The year-end date and the date the auditor's report is signed; and

(ii) The date the auditor's report is signed and the date the financial statements are issued. (5 marks)

(b) Humphries Co operates a chain of food wholesalers across the country and its year end was 30 September 2011. The final audit is nearly complete and it is proposed that the financial statements and audit report will be signed on 13 December. Revenue for the year is $78 million and profit before taxation is $7·5 million. The following events have occurred subsequent to the year end.

Receivable

A customer of Humphries Co has been experiencing cash flow problems and its year-end balance is $0·3 million. The company has just become aware that its customer is experiencing significant going concern difficulties. Humphries believe that as the company has been trading for many years, they will receive some, if not full, payment from the customer; hence they have not adjusted the receivable balance.

Lawsuit

A key supplier of Humphries Co is suing them for breach of contract. The lawsuit was filed prior to the year end, and the sum claimed by them is $1 million. This has been disclosed as a contingent liability in the notes to the financial statements; however correspondence has just arrived from the supplier indicating that they are willing to settle the case for a payment by Humphries Co of $0·6 million. It is likely that the company will agree to this.

Warehouse

Humphries Co has three warehouses; following extensive rain on 20 November significant rain and river water flooded the warehouse located in Bass. All of the inventory was damaged and has been disposed of. The insurance company has already been contacted. No amendments or disclosures have been made in the financial statements.

Required:

For each of the three events above:

(i) discuss whether the financial statements require amendment;

(ii) describe audit procedures that should be performed in order to form a conclusion on the amendment; and

(iii) explain the impact on the audit report should the issue remain unresolved. (15 marks)

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

(20 marks)

End of Question Paper