

Fundamentals Level – Skills Module

Audit and Assurance

September/December 2015



Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This question paper is divided into two sections:

Section A – ALL 12 questions are compulsory and **MUST** be attempted

Section B – ALL SIX questions are compulsory and **MUST** be attempted

Do NOT open this question 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.

Do NOT record any of your answers on the question paper.

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

The Association of Chartered Certified Accountants

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Section B – ALL SIX questions are compulsory and MUST be attempted

Please write your answers to all parts of these questions on the lined pages of the Candidate Answer Booklet.

- 1** You are an audit manager of Pink Partners & Co (Pink) and are planning the audit of Golden Finance Co (Golden), a banking institution which provides a range of financial services including loans. Your firm has audited Golden for four years and the company's year end is 30 September 2015.

At the end of August, Golden's financial controller left and the new replacement is not due to start until approximately two months after the year end. The finance director, who is the sister-in-law of the audit engagement partner, has asked if a member of the audit team can be seconded to Golden for three months to act as the temporary financial controller.

You are aware that a number of the audit team members currently bank with Golden and two team members have significant loans owing to the company.

Pink's taxation department also provides services to Golden. They have been approached by Golden to represent them in negotiations to resolve some outstanding issues with the taxation authorities, for which the fees quoted are substantial.

The finance director has informed the audit engagement partner that when the audit is complete, she would like the whole team to attend an evening watching the national football team play a match followed by a luxury meal.

Required:

Using the information above:

- (i) Identify and explain FIVE ethical threats which may affect the independence of Pink Partners & Co's audit of Golden Finance Co; and**
- (ii) For each threat, explain how it might be reduced to an acceptable level.**

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

(10 marks)

- 2** ISA 210 *Agreeing the Terms of Audit Engagements* requires auditors to agree the terms of an engagement with those charged with governance and formalise these in an engagement letter.

Required:

- (a) Identify and explain TWO factors which would indicate that an engagement letter for an existing audit client should be revised.** (2 marks)
- (b) List SIX matters which should be included within an audit engagement letter.** (3 marks)
- (c) Your audit firm has just won a new audit client, Milky Way Technologies Co (Milky Way), and you have been asked by the audit engagement partner to gain an understanding about the new client as part of the planning process.**

Required:

Identify FIVE sources of information relevant to gaining an understanding of Milky Way Technologies Co and describe how this information will be used by the auditor. (5 marks)

(10 marks)

3 Mercury Motoring Co (Mercury) specialises in manufacturing engine parts for motor cars and the company has a diverse customer base but seven significant customers. The company's year end was 30 September 2015.

During the year, a number of the company's significant customers have experienced a fall in sales, and consequently they have purchased fewer items from Mercury. As a result, Mercury has paid a number of its suppliers later than usual and some of them have withdrawn credit terms meaning the company must pay cash on delivery. One of Mercury's main suppliers is threatening legal action to recover the sums owing. As a result of the increased level of payables, the company's current ratio has fallen below 1 to 0.9 for the first time.

Mercury has produced a cash flow forecast to 30 June 2016 and this shows net cash outflows until May 2016. Mercury has a loan of \$2.3 million which is due for repayment in full by 30 September 2016.

The finance director has just informed the audit manager that there is a possible change in legislation which will result in one of Mercury's top product lines becoming obsolete as it will not comply with the proposed law. The prepared cash flow forecasts do not reflect this possible event.

Required:

(a) Explain FIVE potential indicators that Mercury Motoring Co is NOT a going concern. (5 marks)

(b) Describe the audit procedures which you should perform in assessing whether or not Mercury Motoring Co is a going concern. (5 marks)

(10 marks)

4 You are an audit supervisor of Pluto & Co and are currently planning the audit of your client, Venus Magnets Co (Venus) which manufactures decorative magnets. Its year end is 31 December 2015 and the forecast profit before tax is \$9.6 million.

During the year, the directors reviewed the useful lives and depreciation rates of all classes of plant and machinery. This resulted in an overall increase in the asset lives and a reduction in the depreciation charge for the year.

Inventory is held in five warehouses and on 28 and 29 December a full inventory count will be held with adjustments for movements to the year end. This is due to a lack of available staff on 31 December. In October, there was a fire in one of the warehouses; inventory of \$0.9 million was damaged and this has been written down to its scrap value of \$0.2 million. An insurance claim has been submitted for the difference of \$0.7 million. Venus is still waiting to hear from the insurance company with regards to this claim, but has included the insurance proceeds within the statement of profit or loss and the statement of financial position.

The finance director has informed the audit manager that the October and November bank reconciliations each contained unreconciled differences; however, he considers the overall differences involved to be immaterial.

A directors' bonus scheme was introduced during the year which is based on achieving a target profit before tax. In order to finalise the bonus figures, the finance director of Venus would like the audit to commence earlier so that the final results are available earlier this year.

Required:

Describe FIVE audit risks, and explain the auditor's response to each risk, in planning the audit of Venus Magnets Co.

(10 marks)

- 5 You are an audit senior of Scarlet & Co and are in the process of reviewing the systems testing completed on the payroll cycle of Bronze Industries Co (Bronze), as well as preparing the audit programmes for the final audit.

Bronze operate several chemical processing factories across the country, it manufactures 24 hours a day, seven days a week and employees work a standard shift of eight hours and are paid for hours worked at an hourly rate. Factory employees are paid weekly, with approximately 80% being paid by bank transfer and 20% in cash; the different payment methods are due to employee preferences and Bronze has no plans to change these methods. The administration and sales teams are paid monthly by bank transfer.

Factory staff are each issued a sequentially numbered clock card which details their employee number and name. Employees swipe their cards at the beginning and end of the eight-hour shift and this process is not supervised. During the shift employees are entitled to a 30-minute paid break and employees do not need to clock out to access the dining area. Clock card data links into the payroll system, which automatically calculates gross and net pay along with any statutory deductions. The payroll supervisor for each payment run checks on a sample basis some of these calculations to ensure the system is operating effectively.

Bronze has a human resources department which is responsible for setting up new permanent employees and leavers. Appointments of temporary staff are made by factory production supervisors. Occasionally overtime is required of factory staff, usually to fill gaps caused by staff holidays. Overtime reports which detail the amount of overtime worked are sent out quarterly by the payroll department to production supervisors for their review.

To encourage staff to attend work on time for all shifts Bronze pays a discretionary bonus every six months to factory staff; the production supervisors determine the amounts to be paid. This is communicated in writing by the production supervisors to the payroll department and the bonus is input by a clerk into the system.

For employees paid by bank transfer, the payroll manager reviews the list of the payments and agrees to the payroll records prior to authorising the bank payment. If any changes are required, the payroll manager amends the records. For employees paid in cash, the pay packets are prepared in the payroll department and a clerk distributes them to employees; as she knows most of these individuals she does not require proof of identity.

Required:

- (a) **Identify and explain FIVE internal control STRENGTHS in Bronze Industries Co's payroll system.** (5 marks)
- (b) **Identify and explain SIX internal control DEFICIENCIES in Bronze Industries Co's payroll system and provide a RECOMMENDATION to address each of these deficiencies.** (12 marks)
- (c) **Describe substantive ANALYTICAL PROCEDURES you should perform to confirm Bronze Industries Co's payroll expense.** (3 marks)

(20 marks)

6 (a) Explain FOUR factors which influence the reliability of audit evidence. (4 marks)

Andromeda Industries Co (Andromeda) develops and manufactures a wide range of fast moving consumer goods. The company's year end is 31 December 2015 and the forecast profit before tax is \$8.3 million. You are the audit manager of Neptune & Co and the year-end audit is due to commence in January. The following information has been gathered during the planning process:

Inventory count

Andromeda's raw materials and finished goods inventory are stored in 12 warehouses across the country. Each of these warehouses is expected to contain material levels of inventory at the year end. It is expected that there will be no significant work in progress held at any of the sites. Each count will be supervised by a member of Andromeda's internal audit department and the counts will all take place on 31 December, when all movements of goods in and out of the warehouses will cease.

Research and development

Andromeda spends over \$2 million annually on developing new product lines. This year it incurred expenditure on five projects, all of which are at different stages of development. Once they meet the recognition criteria under IAS 38 *Intangible Assets* for development expenditure, Andromeda includes the costs incurred within intangible assets. Once production commences, the intangible assets are amortised on a straight line basis over five years.

Required:

(b) Describe audit procedures you would perform during the audit of Andromeda Industries Co:

(i) BEFORE and DURING the inventory counts; and (8 marks)

(ii) In relation to research and development expenditure. (4 marks)

(c) During the audit, the team discovers that one of the five development projects, valued at \$980,000 and included within intangible assets, does not meet the criteria for capitalisation. The finance director does not intend to change the accounting treatment adopted as she considers this an immaterial amount.

Required:

Discuss the issue and describe the impact on the audit report, if any, if the issue remains unresolved. (4 marks)

(20 marks)

End of Question Paper