

Fundamentals Level – Skills Module

# Audit and Assurance

Monday 5 September 2016



**Time allowed:** 3 hours 15 minutes

This question paper is divided into two sections:

Section A – ALL 15 questions are compulsory and **MUST** be attempted

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

**Do NOT** open this question paper 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.

Think Ahead

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The Association of  
Chartered Certified  
Accountants

**Section A – ALL 15 questions are compulsory and MUST be attempted**

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question. Do not write out the answers to the MCQs on the lined pages of the answer booklet.

Each question is worth 2 marks.

The following scenario relates to questions 1–5

You are an audit senior of Viola & Co and are currently conducting the audit of Poppy Co for the year ended 30 June 20X6.

Materiality has been set at \$50,000, and you are carrying out the detailed substantive testing on the year-end payables balance. The audit manager has emphasised that understatement of the trade payables balance is a significant audit risk.

Below is an extract from the list of supplier statements as at 30 June 20X6 held by the company and corresponding payables ledger balances at the same date along with some commentary on the noted differences:

Supplier	Statement balance \$'000	Payables ledger balance \$'000
Carnation Co	70	50
Lily Co	175	105

**Carnation Co**

The difference in the balance is due to an invoice which is under dispute due to faulty goods which were returned on 29 June 20X6.

**Lily Co**

The difference in the balance is due to the supplier statement showing an invoice dated 28 June 20X6 for \$70,000 which was not recorded in the financial statements until after the year end. The payables clerk has advised the audit team that the invoice was not received until 2 July 20X6.

- 1 The audit manager has asked you to review the full list of trade payables and select balances on which supplier statement reconciliations will be performed.

**Which of the following items should you select for testing?**

- (1) Suppliers with material balances at the year end
- (2) Suppliers which have a high volume of business with Poppy Co
- (3) Major suppliers with nil balances at the year end
- (4) Major suppliers where the statement agrees to the ledger

- A** 1 only
- B** 1, 2 and 3 only
- C** 2 and 4 only
- D** 1, 2, 3 and 4

- 2 **Which of the following audit procedures should be performed in relation to the balance with Lily Co to determine if the payables balance is understated?**

- A** Inspect the goods received note to determine when the goods were received
- B** Inspect the purchase order to confirm it is dated before the year end
- C** Review the post year-end cashbook for evidence of payment of the invoice
- D** Send a confirmation request to Lily Co to confirm the outstanding balance

**3 Which of the following audit procedures should be carried out to confirm the balance owing to Carnation Co?**

- (1) Review post year-end credit notes for evidence of acceptance of return
- (2) Inspect pre year-end goods returned note in respect of the items sent back to the supplier
- (3) Inspect post year-end cash book for evidence that the amount has been settled

- A** 1, 2 and 3
- B** 1 and 3 only
- C** 1 and 2 only
- D** 2 and 3 only

**4 The audit manager has asked you to review the results of some statistical sampling testing, which resulted in 20% of the payables balance being tested.**

The testing results indicate that there is a \$45,000 error in the sample: \$20,000 which is due to invoices not being recorded in the correct period as a result of weak controls and additionally there is a one-off error of \$25,000 which was made by a temporary clerk.

**What would be an appropriate course of action on the basis of these results?**

- A** The error is immaterial and therefore no further work is required
- B** The effect of the control error should be projected across the whole population
- C** Poppy Co should be asked to adjust the payables figure by \$45,000
- D** A different sample should be selected as these results are not reflective of the population

**5 To help improve audit efficiency, Viola & Co is considering introducing the use of computer assisted audit techniques (CAATs) for some audits. You have been asked to consider how CAATs could be used during the audit of Poppy Co.**

**Which of the following is an example of using test data for trade payables testing?**

- A** Selecting a sample of supplier balances for testing using monetary unit sampling
- B** Recalculating the ageing of trade payables to identify balances which may be in dispute
- C** Calculation of trade payables days to use in analytical procedures
- D** Inputting dummy purchase invoices into the client system to see if processed correctly

**The following scenario relates to questions 6–10**

You are an audit manager at Blenkin & Co and are approaching the end of the audit of Sampson Co, which is a large listed retailer. The draft financial statements currently show a profit before tax of \$6.5m and revenue of \$66m for the financial year ended 30 June 20X6. You have been informed that the finance director left Sampson Co on 31 May 20X6.

As part of the subsequent events audit procedures, you reviewed post year-end board meeting minutes and discovered that a legal case for unfair dismissal has been brought against Sampson Co by the finance director. During a discussion with the Human Resources (HR) director of Sampson Co, you established that the company received notice of the proposed legal claim on 10 July 20X6.

The HR director told you that Sampson Co's lawyers believe that the finance director's claim is likely to be successful, but estimate that \$150,000 is the maximum amount of compensation which would be paid. However, management does not intend to make any adjustments or disclosures in the financial statements.

- 6** Blenkin & Co has a responsibility to perform procedures to obtain sufficient, appropriate evidence that subsequent events are appropriately reflected in the financial statements of Sampson Co.

**Subsequent events procedures should be performed between the date of the financial statements and WHICH DATE?**

- A** The date the subsequent events review is performed
- B** The date of approval of the financial statements
- C** The date of the auditor's report
- D** The date the financial statements are issued

- 7** If, after the financial statements have been issued, Blenkin & Co becomes aware of a fact which may have caused its report to be amended, the firm should consider several possible actions.

**Which of the following are appropriate actions for Blenkin & Co to take?**

- (1) Discuss the matter with management and, where appropriate, those charged with governance
- (2) Obtain a written representation from management
- (3) Consider whether the firm should resign from the engagement
- (4) Enquire how management intends to address the matter in the financial statements where appropriate

- A** 1 and 2
- B** 1 and 4
- C** 2 and 3
- D** 3 and 4

- 8** Which of the following audit procedures should be performed to form a conclusion as to whether the financial statements require amendment in relation to the unfair dismissal claim?

- (1) Inspect relevant correspondence with Sampson Co's lawyers
- (2) Write to the finance director to confirm the claim and level of damages
- (3) Review the post year-end cash book for evidence of payments to the finance director
- (4) Request that management confirm their views in a written representation

- A** 1, 2 and 3
- B** 1, 2 and 4
- C** 1, 3 and 4
- D** 2, 3 and 4

- 9 You are drafting the auditor's report for Sampson Co and the audit engagement partner has reminded you that the report will need to reflect the requirements of ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report*.

**According to ISA 701, which of the following should be included in the 'Key Audit Matters' paragraph in the auditor's report?**

- A Matters which required significant auditor attention
  - B Matters which result in a modification to the audit opinion
  - C All matters which were communicated to those charged with governance
  - D All matters which are considered to be material to the financial statements
- 10 Which of the following audit opinions will be issued if the unfair dismissal case is NOT adjusted for or disclosed within the financial statements?
- A A qualified audit opinion as the financial statements are materially misstated
  - B A qualified audit opinion as the auditor is unable to obtain sufficient appropriate evidence
  - C An unmodified opinion with an emphasis of matter paragraph
  - D An unmodified audit opinion

The following scenario relates to questions 11–15

Sycamore & Co is the auditor of Fir Co, a listed computer software company. The audit team comprises an engagement partner, a recently appointed audit manager, an audit senior and a number of audit assistants. The audit engagement partner has only been appointed this year due to the rotation of the previous partner who had been involved in the audit for seven years. Only the audit senior has experience of auditing a company in this specialised industry. The previous audit manager, who is a close friend of the new audit manager, left the firm before the completion of the prior year audit and is now the finance director of Fir Co.

The board of Fir Co has asked if Sycamore & Co can take on some additional work and have asked if the following additional non-audit services can be provided:

- (1) Routine maintenance of payroll records
- (2) Assistance with the selection of a new financial controller including the checking of references
- (3) Tax services whereby Sycamore & Co would liaise with the tax authority on Fir Co's behalf

Sycamore & Co has identified that the current year fees to be received from Fir Co for audit and other services will represent 16% of the firm's total fee income and totalled 15.5% in the prior year. The audit engagement partner has asked you to consider what can be done in relation to this self-interest threat.

**11 In relation to the composition of the current audit team, which of the following correctly identifies the fundamental principle which is at risk and provides an appropriate safeguard?**

	Fundamental principle	Safeguard
A	Professional competence	Reinstate previous partner
B	Confidentiality	Resign from the engagement
C	Confidentiality	Appoint a completely new audit team
D	Professional competence	Provide industry training for team members

**12 Which of the following identifies the threat which could arise as a result of the finance director's previous employment at Sycamore & Co and recommends an appropriate safeguard?**

- A A self-review threat; review the work performed by the previous audit manager
- B A familiarity threat; a different audit manager should be appointed
- C A self-review threat; change the existing audit plan
- D A familiarity threat; the firm should resign from the engagement

**13 Ignoring the potential effect on total fee levels, which of the following options correctly identifies the threats to independence from providing the above non-audit services?**

	Self-review	Self-interest	Advocacy
A	2	1	3
B	1	3	2
C	1	2	3
D	3	1	2

**14 Which of the following safeguards would NOT be relevant in mitigating the threat identified in relation to fees?**

- A Disclosure to those charged with governance that fees from Fir Co represent more than 15% of Sycamore & Co's total fee income
- B A pre-issuance review to be conducted by an external accountant
- C The use of separate teams to provide the audit and non-audit services
- D A post-issuance review to be conducted by an external accountant or regulatory body

- 15** During the course of the audit of Fir Co, a suspicious cash transfer has been identified. The audit team has reported this to the relevant firm representative as a potential money-laundering transaction.

**Which of the following statements is true regarding the confidentiality of this information?**

- A** Details of the transaction can only be disclosed with the permission of Fir Co
- B** If there is a legal requirement to report money-laundering, this overrides the principle of confidentiality
- C** Sycamore & Co is not permitted to disclose details of the suspicious transaction as the information has been obtained during the course of the audit
- D** In order to maintain confidentiality, Sycamore & Co should report their concerns anonymously

**(30 marks)**

## Section B – ALL THREE questions are compulsory and MUST be attempted

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

- 16** Heraklion Co is a manufacturer of footballs and is a new audit client for your firm. You are an audit supervisor of Spinalonga & Co and are currently preparing for the forthcoming interim and final audit for the year ending 31 October 20X6. You are required to document and assess the sales system, recommend control improvements to deal with a specific fraud issue as well as undertake substantive testing of revenue.

### **Sales ordering, goods despatched and invoicing**

Heraklion Co sells footballs to a range of large and small sports equipment retailers in several countries. Sales are made through a network of sales staff employed by Heraklion Co, but new customer leads are generated through a third party company. Sales staff are responsible for assessing new customers' creditworthiness and proposing a credit limit which is then authorised by the sales director. The sales staff have monthly sales targets and are able to use their discretion in granting sales discounts up to a maximum of 10%. They then record any discount granted in the customer master data file.

The sales staff visit customer sites personally and orders are completed using a two-part pre-printed order form. One copy is left with the customer and the other copy is retained by the sales person. The sales order number is based on the sales person's own identification (ID) number.

The company markets itself on being able to despatch all orders within three working days. Once the order is taken, the sales person emails the finance department and warehouse despatch team with the customer ID and the sales order details and from this a pick list is generated. Sequentially numbered goods despatched notes are completed and filed in the warehouse.

Sequentially numbered invoices are generated using the pick lists for quantities and the customer master data file for prices. Standard credit terms for customers are 30 days and on a monthly basis sales invoices which are over 90 days outstanding are notified to the relevant sales person to chase payment directly with the customer.

### **Payroll fraud**

The finance director, Montse Mirabelle, has informed you that a significant fraud took place during the year in the payroll department. A number of fictitious employees were set up on the payroll and wages were paid into one bank account. This bank account belonged to two supervisors, who were married, and were employed by Heraklion Co. One had sole responsibility for setting up new joiners in the payroll system and the other processed and authorised bank transfer requests for wages and supplier payments. These employees no longer work for the company and Montse has asked the audit firm for recommendations on how to improve controls in this area to prevent this type of fraud occurring again. Heraklion Co operates a Human Resources department.

### **Required:**

- (a) Describe TWO methods for documenting the sales system, and for each explain ONE advantage and ONE disadvantage of using this method.** (6 marks)
- (b) Identify and explain SEVEN deficiencies in the sales system of Heraklion Co and provide a recommendation to address each of these deficiencies.**  
  
Note: Prepare your answer using two columns headed Control deficiency and Control recommendation respectively. (14 marks)
- (c) In relation to the payroll fraud, identify and explain THREE controls Heraklion Co should implement to reduce the risk of this type of fraud occurring again and, for each control, describe how it would mitigate the risk.** (6 marks)
- (d) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Heraklion Co's revenue.** (4 marks)

**(30 marks)**

- 17** Elounda Co manufactures chemical compounds using a continuous production process. Its year end was 31 July 20X6 and the draft profit before tax is \$13.6 million. You are the audit supervisor and the year-end audit is due to commence shortly. The following matters have been brought to your attention.

**(i) Revaluation of property, plant and equipment (PPE)**

At the beginning of the year, management undertook an extensive review of Elounda Co's non-current asset valuations and as a result decided to update the carrying value of all PPE. The finance director, Peter Dullman, contacted his brother, Martin, who is a valuer and requested that Martin's firm undertake the valuation, which took place in August 20X5. (5 marks)

**(ii) Inventory valuation**

Your firm attended the year-end inventory count for Elounda Co and ascertained that the process for recording work in progress (WIP) and finished goods was acceptable. Both WIP and finished goods are material to the financial statements and the quantity and stage of completion of all ongoing production was recorded accurately during the count.

During the inventory count, the count supervisor noted that a consignment of finished goods, compound E243, with a value of \$720,000, was defective in that the chemical mix was incorrect. The finance director believes that compound E243 can still be sold at a discounted sum of \$400,000. (6 marks)

**(iii) Bank loan**

Elounda Co secured a bank loan of \$2.6 million on 1 October 20X4. Repayments of \$200,000 are due quarterly, with a lump sum of \$800,000 due for repayment in January 20X7. The company met all loan payments in 20X5 on time, but was late in paying the April and July 20X6 repayments. (4 marks)

**Required:**

- (a) Describe substantive procedures you should perform to obtain sufficient, appropriate audit evidence in relation to the above three matters.**

Note: The mark allocation is shown against each of the three matters above.

- (b) Describe the procedures which the auditor of Elounda Co should perform in assessing whether or not the company is a going concern.** (5 marks)

**(20 marks)**

- 18 (a)** ISA 300 *Planning an Audit of Financial Statements* provides guidance to assist auditors in planning an audit.

**Required:**

**Explain the benefits of audit planning.**

(4 marks)

You are an audit supervisor of Chania & Co and are planning the audit of your client, Sitia Sparkle Co which manufactures cleaning products. Its year end was 31 July 20X6 and the draft profit before tax is \$33.6 million. You are supervising a large audit team for the first time and will have specific responsibility for supervising and reviewing the work of the audit assistants in your team.

Sitia Sparkle Co purchases most of its raw materials from suppliers in Africa and these goods are shipped directly to the company's warehouse and the goods are usually in transit for up to three weeks. The company has incurred \$1.3 million of expenditure on developing a new range of cleaning products which are due to be launched into the market place in November 20X6. In September 20X5, Sitia Sparkle Co also invested \$0.9 million in a complex piece of plant and machinery as part of the development process. The full amount has been capitalised and this cost includes the purchase price, installation costs and training costs.

This year, the bonus scheme for senior management and directors has been changed so that rather than focusing on profits, it is instead based on the value of year-end total assets. In previous years an allowance for receivables, made up of specific balances, which equalled almost 1% of trade receivables was maintained. However, the finance director feels that this is excessive and unnecessary and has therefore not included it for 20X6 and has credited the opening balance to the profit or loss account.

A new general ledger system was introduced in May 20X6; the finance director has stated that the data was transferred and the old and new systems were run in parallel until the end of August 20X6. As a result of the additional workload on the finance team, a number of control account reconciliations were not completed as at 31 July 20X6, including the bank reconciliation. The finance director is comfortable with this as these reconciliations were completed successfully for both June and August 20X6. In addition, the year-end close down of the purchase ledger was undertaken on 8 August 20X6.

**Required:**

- (b) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Sitia Sparkle Co.**

Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively.

(12 marks)

- (c) In line with ISA 220 *Quality Control for an Audit of Financial Statements*, describe the audit supervisor's responsibilities in relation to supervising and reviewing the audit assistants' work during the audit of Sitia Sparkle Co.**

(4 marks)

**(20 marks)**

**End of Question Paper**