

Fundamentals Level – Skills Module

# Audit and Assurance (International)

Thursday 5 December 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** Minty Cola Co (Minty) manufactures fizzy drinks such as cola and lemonade as well as other soft drinks and its year end is 31 December 2013. You are the audit manager of Parsley & Co and are currently planning the audit of Minty. You attended the planning meeting with the engagement partner and finance director last week and recorded the minutes from the meeting shown below. You are reviewing these as part of the process of preparing the audit strategy.

**Minutes of planning meeting for Minty**

Minty's trading results have been strong this year and the company is forecasting revenue of \$85 million, which is an increase from the previous year. The company has invested significantly in the cola and fizzy drinks production process at the factory. This resulted in expenditure of \$5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; some are owned by Minty and some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at the year end.

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for a period of two months.

As a result of the increase in revenue, Minty has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of \$1.5 million.

In addition, Minty has incurred expenditure of \$4.5 million on developing a new brand of fizzy soft drinks. The company started this process in January 2013 and is close to launching their new product into the market place.

The finance director stated that there was a problem in November in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at cost of \$1 million at the year end.

As in previous years, the management of Minty is due to be paid a significant annual bonus based on the value of year-end total assets.

**Required:**

- (a) Explain audit risk and the components of audit risk. (5 marks)**
- (b) Using the minutes provided, identify and describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Minty Cola Co. (12 marks)**
- (c) Identify the main areas, other than audit risks, that should be included within the audit strategy document for Minty Cola Co; and for each area provide an example relevant to the audit. (4 marks)**
- (d) Describe substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence in relation to the following three matters:**
  - (i) The treatment of the \$5 million expenditure incurred on improving the factory production process;**
  - (ii) The release of the \$1.5 million allowance for receivables; and**
  - (iii) The damaged inventory.**

Note: The total marks will be split equally between each part. (9 marks)

**(30 marks)**

- 2 (a) (i) Define a 'test of control' and provide an example of a test of control in relation to the audit of wages and salaries; and  
(ii) Define a 'substantive procedure' and provide an example of a substantive procedure in relation to the audit of wages and salaries.

Note: The total marks will be split equally between each part. (4 marks)

- (b) ISA 500 *Audit Evidence* requires auditors to obtain sufficient and appropriate audit evidence. Appropriateness is a measure of the quality of audit evidence; that is, its relevance and its reliability.

**Required:**

**Identify and explain THREE factors which influence the reliability of audit evidence.** (3 marks)

- (c) Auditors are required to perform an overall review of the financial statements before they provide their audit opinion.

**Required:**

**Explain THREE procedures an auditor should perform in conducting their overall review of the financial statements.** (3 marks)

**(10 marks)**

- 3** You are a member of the recently formed internal audit department of Oregano Co (Oregano). The company manufactures tinned fruit and vegetables which are supplied to large and small food retailers. Management and those charged with governance of Oregano have concerns about the effectiveness of their sales and despatch system and have asked internal audit to document and review the system.

**Sales and despatch system**

Sales orders are mainly placed through Oregano's website but some are made via telephone. Online orders are automatically checked against inventory records for availability; telephone orders, however, are checked manually by order clerks after the call. A follow-up call is usually made to customers if there is insufficient inventory. When taking telephone orders, clerks note down the details on plain paper and afterwards they complete a three part pre-printed order form. These order forms are not sequentially numbered and are sent manually to both despatch and the accounts department.

As the company is expanding, customers are able to place online orders which will exceed their agreed credit limit by 10%. Online orders are automatically forwarded to the despatch and accounts department.

A daily pick list is printed by the despatch department and this is used by the warehouse team to despatch goods. The goods are accompanied by a despatch note and all customers are required to sign a copy of this. On return, the signed despatch notes are given to the warehouse team to file.

The sales quantities are entered from the despatch notes and the authorised sales prices are generated by the invoicing system. If a discount has been given, this has to be manually entered by the sales clerk onto the invoice. Due to the expansion of the company, and as there is a large number of sale invoices, extra accounts staff have been asked to help out temporarily with producing the sales invoices. Normally it is only two sales clerks who produce the sales invoices.

**Required:**

- (a) Describe TWO methods for documenting the sales and despatch system; and for each explain an advantage and a disadvantage of using this method.** (6 marks)
- (b) List TWO control objectives of Oregano Co's sales and despatch system.** (2 marks)
- (c) Identify and explain SIX deficiencies in Oregano Co's sales and despatch system and provide a recommendation to address each of these deficiencies.** (12 marks)

**(20 marks)**

**4** Salt & Pepper & Co (Salt & Pepper) is a firm of Chartered Certified Accountants which has seen its revenue decline steadily over the past few years. The firm is looking to increase its revenue and client base and so has developed a new advertising strategy where it has guaranteed that its audits will minimise disruption to companies as they will not last longer than two weeks. In addition, Salt & Pepper has offered all new audit clients a free accounts preparation service for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis. One of Salt & Pepper's existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.

Salt & Pepper has recently obtained a new audit client, Cinnamon Brothers Co (Cinnamon), whose year end is 31 December. Cinnamon requires their audit to be completed by the end of February; however, this is a very busy time for Salt & Pepper and so it is intended to use more junior staff as they are available. Additionally, in order to save time and cost, Salt & Pepper have not contacted Cinnamon's previous auditors.

**Required:**

**(a) Describe the steps that Salt & Pepper should take in relation to Cinnamon:**

- (i) Prior to accepting the audit; and** (5 marks)
- (ii) To confirm whether the preconditions for the audit are in place.** (3 marks)

**(b) State FOUR matters that should be included within an audit engagement letter.** (2 marks)

- (c) (i) Identify and explain FIVE ethical risks which arise from the above actions of Salt & Pepper & Co; and**
- (ii) For each ethical risk explain the steps which Salt & Pepper & Co should adopt to reduce the risks arising.**

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

**(20 marks)**

- 5 (a) ISA 510 *Initial Audit Engagements – Opening Balances* requires auditors to undertake additional audit procedures for confirming opening balances for new audit engagements. In addition, the ISA gives guidance on audit report implications if auditors are unable to confirm opening balances or if they contain misstatements.

**Required:**

- (i) Describe procedures the auditor should undertake to confirm opening balances for a new audit engagement; and  
(ii) Explain the impact on the audit report if the auditor is unable to confirm the opening balances, or if the opening balances contain misstatements.

Note: The total marks will be split equally between each part. (4 marks)

You are an audit manager in Brown & Co and you are nearing completion of the audit of Paprika & Co (Paprika). The audit senior has produced extracts below from the draft audit report for Paprika.

**Auditor's responsibility**

- (1) Our responsibility is to express an opinion on all pages of the financial statements based on our audit. We conducted our audit in accordance with most of the International Standards on Auditing.
- (2) Those standards require that we comply with ethical requirements and plan and perform the audit to obtain maximum assurance as to whether the financial statements are free from all misstatements whether caused by fraud or error.
- (3) We have a responsibility to prevent and detect fraud and error and to prepare the financial statements in accordance with International Financial Reporting Standards.
- (4) An audit involves performing procedures to obtain evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the availability and experience of audit team members. We considered internal controls relevant to the entity; and express an opinion on the effectiveness of these internal controls.
- (5) We did not evaluate the overall presentation of the financial statements, as this is management's responsibility. We considered the reasonableness of any new accounting estimates made by management. We did not review the appropriateness of accounting policies as these are the same as last year. In order to confirm raw material inventory quantities, we relied on the work undertaken by an independent expert.

The extracts are numbered to help you refer to them in your answer.

**Required:**

- (b) Describe the factors to consider and steps Brown & Co should take, prior to placing reliance on the work of the independent expert, in order to confirm raw material quantities. (4 marks)
- (c) For the above audit report extracts, identify and explain SIX elements of this report which require amendment. (12 marks)

Note: Redrafted audit report extracts are not required. (12 marks)

**(20 marks)**

**End of Question Paper**