

Fundamentals Level – Skills Module

# Audit and Assurance (International)

Wednesday 8 December 2010

**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) Auditors have a responsibility under ISA 265 *Communicating Deficiencies in Internal Control to those Charged with Governance and Management*, to communicate deficiencies in internal controls. In particular SIGNIFICANT deficiencies in internal controls must be communicated in writing to those charged with governance.

**Required:**

**Explain examples of matters the auditor should consider in determining whether a deficiency in internal controls is significant.** (5 marks)

Greystone Co is a retailer of ladies clothing and accessories. It operates in many countries around the world and has expanded steadily from its base in Europe. Its main market is aimed at 15 to 35 year olds and its prices are mid to low range. The company's year end was 30 September 2010.

In the past the company has bulk ordered its clothing and accessories twice a year. However, if their goods failed to meet the key fashion trends then this resulted in significant inventory write downs. As a result of this the company has recently introduced a just in time ordering system. The fashion buyers make an assessment nine months in advance as to what the key trends are likely to be, these goods are sourced from their suppliers but only limited numbers are initially ordered.

Greystone Co has an internal audit department but at present their only role is to perform regular inventory counts at the stores.

**Ordering process**

Each country has a purchasing manager who decides on the initial inventory levels for each store, this is not done in conjunction with store or sales managers. These quantities are communicated to the central buying department at the head office in Europe. An ordering clerk amalgamates all country orders by specified regions of countries, such as Central Europe and North America, and passes them to the purchasing director to review and authorise.

As the goods are sold, it is the store manager's responsibility to re-order the goods through the purchasing manager; they are prompted weekly to review inventory levels as although the goods are just in time, it can still take up to four weeks for goods to be received in store.

It is not possible to order goods from other branches of stores as all ordering must be undertaken through the purchasing manager. If a customer requests an item of clothing, which is unavailable in a particular store, then the customer is provided with other branch telephone numbers or recommended to try the company website.

**Goods received and Invoicing**

To speed up the ordering to receipt of goods cycle, the goods are delivered directly from the suppliers to the individual stores. On receipt of goods the quantities received are checked by a sales assistant against the supplier's delivery note, and then the assistant produces a goods received note (GRN). This is done at quiet times of the day so as to maximise sales. The checked GRNs are sent to head office for matching with purchase invoices.

As purchase invoices are received they are manually matched to GRNs from the stores, this can be a very time consuming process as some suppliers may have delivered to over 500 stores. Once the invoice has been agreed then it is sent to the purchasing director for authorisation. It is at this stage that the invoice is entered onto the purchase ledger.

**Required:**

- (b) As the external auditors of Greystone Co, write a report to management in respect of the purchasing system which:
- (i) Identifies and explains **FOUR** deficiencies in that system;
  - (ii) Explains the possible implication of each deficiency;
  - (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. (14 marks)

- (c) Describe substantive procedures the auditor should perform on the year-end trade payables of Greystone Co. (5 marks)
- (d) Describe additional assignments that the internal audit department of Greystone Co could be asked to perform by those charged with governance. (6 marks)

**(30 marks)**

- 2 (a) Explain the concept of TRUE and FAIR presentation. (4 marks)
- (b) Explain the status of International Standards on Auditing. (2 marks)
- (c) ISA 230 *Audit Documentation* deals with the auditor's responsibility to prepare audit documentation for an audit of financial statements.

**Required:**

**State FOUR benefits of documenting audit work.** (4 marks)

**(10 marks)**

- 3 (a) In agreeing the terms of an audit engagement, the auditor is required to agree the basis on which the audit is to be carried out. This involves establishing whether the preconditions for an audit are present and confirming that there is a common understanding between the auditor and management of the terms of the engagement.

**Required:**

**Describe the process the auditor should undertake to assess whether the PRECONDITIONS for an audit are present.** (3 marks)

- (b) **List FOUR examples of matters the auditor may consider when obtaining an understanding of the entity.** (2 marks)

- (c) You are the audit senior of White & Co and are planning the audit of Redsmith Co for the year ended 30 September 2010. The company produces printers and has been a client of your firm for two years; your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Redsmith's management were disappointed with the 2009 results and so in 2010 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Redsmith has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related. He is happy with the 2010 results and feels that they are a good reflection of the improved trading levels.

Financial statement extracts for year ended 30 September	DRAFT 2010 \$m	ACTUAL 2009 \$m
Revenue	23.0	18.0
Cost of Sales	(11.0)	(10.0)
Gross profit	12.0	8.0
Operating expenses	(7.5)	(4.0)
Profit before interest and taxation	4.5	4.0
Inventory	2.1	1.6
Receivables	4.5	3.0
Cash	–	2.3
Trade payables	1.6	1.2
Overdraft	0.9	–

**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) **From a review of the above information and the ratios calculated, explain the audit risks that arise and describe the appropriate response to these risks.** (10 marks)

**(20 marks)**

4 (a) Explain the purpose of a value for money audit. (4 marks)

(b) Bluesberry hospital is located in a country where healthcare is free, as the taxpayers fund the hospitals which are owned by the government. Two years ago management reviewed all aspects of hospital operations and instigated a number of measures aimed at improving overall 'value for money' for the local community. Management have asked that you, an audit manager in the hospital's internal audit department, perform a review over the measures which have been implemented.

Bluesberry has one centralised buying department and all purchase requisition forms for medical supplies must be forwarded here. Upon receipt the buying team will research the lowest price from suppliers and a purchase order is raised. This is then passed to the purchasing director, who authorises all orders. The small buying team receive in excess of 200 forms a day.

The human resources department has had difficulties with recruiting suitably trained staff. Overtime rates have been increased to incentivise permanent staff to fill staffing gaps, this has been popular, and reliance on expensive temporary staff has been reduced. Monitoring of staff hours had been difficult but the hospital has implemented time card clocking in and out procedures and these hours are used for overtime payments as well.

The hospital has invested heavily in new surgical equipment, which although very expensive, has meant that more operations could be performed and patient recovery rates are faster. However, currently there is a shortage of appropriately trained medical staff. A capital expenditure committee has been established, made up of senior managers, and they plan and authorise any significant capital expenditure items.

**Required:**

(i) Identify and explain **FOUR STRENGTHS** within Bluesberry's operating environment; and (6 marks)

(ii) For each strength identified, describe how Bluesberry might make further improvements to provide the best value for money. (4 marks)

(c) Describe **TWO** substantive procedures the external auditor of Bluesberry should adopt to verify **EACH** of the following assertions in relation to an entity's property, plant and equipment;

(i) Valuation;

(ii) Completeness; and

(iii) Rights and obligations.

Note: Assume that the hospital adopts International Financial Reporting Standards. (6 marks)

**(20 marks)**

- 5** Greenfields Co specialises in manufacturing equipment which can help to reduce toxic emissions in the production of chemicals. The company has grown rapidly over the past eight years and this is due partly to the warranties that the company gives to its customers. It guarantees its products for five years and if problems arise in this period it undertakes to fix them, or provide a replacement product.

You are the manager responsible for the audit of Greenfields and you are performing the final review stage of the audit and have come across the following two issues.

**Receivable balance owing from Yellowmix Co**

Greenfields has a material receivable balance owing from its customer, Yellowmix Co. During the year-end audit, your team reviewed the ageing of this balance and found that no payments had been received from Yellowmix for over six months, and Greenfields would not allow this balance to be circularised. Instead management has assured your team that they will provide a written representation confirming that the balance is recoverable.

**Warranty provision**

The warranty provision included within the statement of financial position is material. The audit team has performed testing over the calculations and assumptions which are consistent with prior years. The team has requested a written representation from management confirming the basis and amount of the provision are reasonable. Management has yet to confirm acceptance of this representation.

**Required:**

- (a) **Describe the audit procedures required in respect of accounting estimates.** (5 marks)
- (b) **For each of the two issues above:**
- (i) **Discuss the appropriateness of written representations as a form of audit evidence; and** (4 marks)
- (ii) **Describe additional procedures the auditor should now perform in order to reach a conclusion on the balance to be included in the financial statements.** (6 marks)

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

- (c) The directors of Greenfields have decided not to provide the audit firm with the written representation for the warranty provision as they feel that it is unnecessary.

**Required:**

**Explain the steps the auditor of Greenfields Co should now take and the impact on the audit report in relation to the refusal to provide the written representation.** (5 marks)

**(20 marks)**

**End of Question Paper**