

Fundamentals Level – Skills Module

# Audit and Assurance (International)

Wednesday 9 June 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)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black rectangular background.

## **ALL FIVE questions are compulsory and MUST be attempted**

### **1 Introduction and client background**

You are an audit senior in Staple and Co and you are commencing the planning of the audit of Smoothbrush Paints Co for the year ending 31 August 2010.

Smoothbrush Paints Co is a paint manufacturer and has been trading for over 50 years, it operates from one central site, which includes the production facility, warehouse and administration offices.

Smoothbrush sells all of its goods to large home improvement stores, with 60% being to one large chain store Homewares. The company has a one year contract to be the sole supplier of paint to Homewares. It secured the contract through significantly reducing prices and offering a four-month credit period, the company's normal credit period is one month.

#### **Goods in/purchases**

In recent years, Smoothbrush has reduced the level of goods directly manufactured and instead started to import paint from South Asia. Approximately 60% is imported and 40% manufactured. Within the production facility is a large amount of old plant and equipment that is now redundant and has minimal scrap value. Purchase orders for overseas paint are made six months in advance and goods can be in transit for up to two months. Smoothbrush accounts for the inventory when it receives the goods.

To avoid the disruption of a year end inventory count, Smoothbrush has this year introduced a continuous/perpetual inventory counting system. The warehouse has been divided into 12 areas and these are each to be counted once over the year. The counting team includes a member of the internal audit department and a warehouse staff member. The following procedures have been adopted;

1. The team prints the inventory quantities and descriptions from the system and these records are then compared to the inventory physically present.
2. Any discrepancies in relation to quantities are noted on the inventory sheets, including any items not listed on the sheets but present in the warehouse area.
3. Any damaged or old items are noted and they are removed from the inventory sheets.
4. The sheets are then passed to the finance department for adjustments to be made to the records when the count has finished.
5. During the counts there will continue to be inventory movements with goods arriving and leaving the warehouse.

At the year end it is proposed that the inventory will be based on the underlying records. Traditionally Smoothbrush has maintained an inventory provision based on 1% of the inventory value, but management feels that as inventory is being reviewed more regularly it no longer needs this provision.

#### **Finance Director**

In May 2010 Smoothbrush had a dispute with its finance director (FD) and he immediately left the company. The company has temporarily asked the financial controller to take over the role while they recruit a permanent replacement. The old FD has notified Smoothbrush that he intends to sue for unfair dismissal. The company is not proposing to make any provision or disclosures for this, as they are confident the claim has no merit.

**Required:**

- (a) Identify and explain the audit risks identified at the planning stage of the audit of Smoothbrush Paints Co. (10 marks)
- (b) Discuss the importance of assessing risks at the planning stage of an audit. (4 marks)
- (c) List and explain suitable controls that should operate over the continuous/perpetual inventory counting system, to ensure the completeness and accuracy of the existing inventory records at Smoothbrush Paints Co. (10 marks)
- (d) Describe **THREE** substantive procedures the auditor of Smoothbrush Paints Co should perform at the year end in confirming each of the following:
- (i) The valuation of inventory; (3 marks)
  - (ii) The completeness of provisions or contingent liabilities. (3 marks)
- (30 marks)**

- 2 (a) Auditors are frequently required to provide assurance for a range of non-audit engagements.

**Required:**

**List and explain the elements of an assurance engagement.** (5 marks)

- (b) ISA 320 *Materiality in Planning and Performing an Audit* provides guidance on the concept of materiality in planning and performing an audit.

**Required:**

**Define materiality and determine how the level of materiality is assessed.** (5 marks)

**(10 marks)**

- 3 (a) (i) **Define a 'test of control' and a 'substantive procedure';** (2 marks)  
(ii) **State ONE test of control and ONE substantive procedure in relation to sales invoicing.** (2 marks)

- (b) Shiny Happy Windows Co (SHW) is a window cleaning company. Customers' windows are cleaned monthly, the window cleaner then posts a stamped addressed envelope for payment through the customer's front door.

SHW has a large number of receivable balances and these customers pay by cheque or cash, which is received in the stamped addressed envelopes in the post. The following procedures are applied to the cash received cycle:

1. A junior clerk from the accounts department opens the post and if any cheques or cash have been sent, she records the receipts in the cash received log and then places all the monies into the locked small cash box.
2. The contents of the cash box are counted each day and every few days these sums are banked by which ever member of the finance team is available.
3. The cashier records the details of the cash received log into the cash receipts day book and also updates the sales ledger.
4. Usually on a monthly basis the cashier performs a bank reconciliation, which he then files, if he misses a month then he catches this up in the following month's reconciliation.

**Required:**

**For the cash cycle of SHW:**

- (i) **Identify and explain THREE deficiencies in the system;** (3 marks)  
(ii) **Suggest controls to address each of these deficiencies; and** (3 marks)  
(iii) **List tests of controls the auditor of SHW would perform to assess if the controls are operating effectively.** (3 marks)
- (c) **Describe substantive procedures an auditor would perform in verifying a company's bank balance.** (7 marks)

**(20 marks)**

4 (a) **State the FIVE threats contained within ACCA's Code of Ethics and Conduct and for each threat list ONE example of a circumstance that may create the threat.** (5 marks)

(b) You are the audit manager of Jones & Co and you are planning the audit of LV Fones Co, which has been an audit client for four years and specialises in manufacturing luxury mobile phones.

During the planning stage of the audit you have obtained the following information. The employees of LV Fones Co are entitled to purchase mobile phones at a discount of 10%. The audit team has in previous years been offered the same level of staff discount.

During the year the financial controller of LV Fones was ill and hence unable to work. The company had no spare staff able to fulfil the role and hence a qualified audit senior of Jones & Co was seconded to the client for three months. The audit partner has recommended that the audit senior work on the audit as he has good knowledge of the client. The fee income derived from LV Fones was boosted by this engagement and along with the audit and tax fee, now accounts for 16% of the firm's total fees.

From a review of the correspondence files you note that the partner and the finance director have known each other socially for many years and in fact went on holiday together last summer with their families. As a result of this friendship the partner has not yet spoken to the client about the fee for last year's audit, 20% of which is still outstanding.

**Required:**

(i) **Explain the ethical threats which may affect the independence of Jones & Co's audit of LV Fones Co;** and (5 marks)

(ii) **For each threat explain how it might be avoided.** (5 marks)

(c) **Describe the steps an audit firm should perform prior to accepting a new audit engagement.** (5 marks)

**(20 marks)**

**5 (a) Define the going concern assumption.**

(2 marks)

Medimade Co is an established pharmaceutical company that has for many years generated 90% of its revenue through the sale of two specific cold and flu remedies. Medimade has lately seen a real growth in the level of competition that it faces in its market and demand for its products has significantly declined. To make matters worse, in the past the company has not invested sufficiently in new product development and so has been trying to remedy this by recruiting suitably trained scientific staff, but this has proved more difficult than anticipated.

In addition to recruiting staff the company also needed to invest \$2m in plant and machinery. The company wanted to borrow this sum but was unable to agree suitable terms with the bank; therefore it used its overdraft facility, which carried a higher interest rate. Consequently, some of Medimade's suppliers have been paid much later than usual and hence some of them have withdrawn credit terms meaning the company must pay cash on delivery. As a result of the above the company's overdraft balance has grown substantially.

The directors have produced a cash flow forecast and this shows a significantly worsening position over the coming 12 months.

The directors have informed you that the bank overdraft facility is due for renewal next month, but they are confident that it will be renewed. They also strongly believe that the new products which are being developed will be ready to market soon and hence trading levels will improve and therefore that the company is a going concern. Therefore they do not intend to make any disclosures in the accounts regarding going concern.

**Required:**

- (b) Identify any potential indicators that the company is not a going concern and describe why these could impact upon the ability of the company to continue trading on a going concern basis.** (8 marks)
- (c) Explain the audit procedures that the auditor of Medimade should perform in assessing whether or not the company is a going concern.** (6 marks)
- (d) The auditors have been informed that Medimade's bankers will not make a decision on the overdraft facility until after the audit report is completed. The directors have now agreed to include going concern disclosures.**

**Required:**

**Describe the impact on the audit report of Medimade if the auditor believes the company is a going concern but a material uncertainty exists.** (4 marks)

**(20 marks)**

**End of Question Paper**