

Fundamentals Level – Skills Module

Audit and Assurance (Hong Kong)

Thursday 6 December 2012



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 (HKG)

ACCA

ALL FIVE questions are compulsory and MUST be attempted

- 1** Lily Window Glass Co (Lily) is a glass manufacturer, which operates from a large production facility, where it undertakes continuous production 24 hours a day, seven days a week. Also on this site are two warehouses, where the company's raw materials and finished goods are stored. Lily's year end is 31 December.

Lily is finalising the arrangements for the year-end inventory count, which is to be undertaken on 31 December 2012. The finished windows are stored within 20 aisles of the first warehouse. The second warehouse is for large piles of raw materials, such as sand, used in the manufacture of glass. The following arrangements have been made for the inventory count:

The warehouse manager will supervise the count as he is most familiar with the inventory. There will be ten teams of counters and each team will contain two members of staff, one from the finance and one from the manufacturing department. None of the warehouse staff, other than the manager, will be involved in the count.

Each team will count an aisle of finished goods by counting up and then down each aisle. As this process is systematic, it is not felt that the team will need to flag areas once counted. Once the team has completed counting an aisle, they will hand in their sheets and be given a set for another aisle of the warehouse. In addition to the above, to assist with the inventory counting, there will be two teams of counters from the internal audit department and they will perform inventory counts.

The count sheets are sequentially numbered, and the product codes and descriptions are printed on them but no quantities. If the counters identify any inventory which is not on their sheets, then they are to enter the item on a separate sheet, which is not numbered. Once all counting is complete, the sequence of the sheets is checked and any additional sheets are also handed in at this stage. All sheets are completed in ink.

Any damaged goods identified by the counters will be too heavy to move to a central location, hence they are to be left where they are but the counter is to make a note on the inventory sheets detailing the level of damage.

As Lily undertakes continuous production, there will continue to be movements of raw materials and finished goods in and out of the warehouse during the count. These will be kept to a minimum where possible.

The level of work-in-progress in the manufacturing plant is to be assessed by the warehouse manager. It is likely that this will be an immaterial balance. In addition, the raw materials quantities are to be approximated by measuring the height and width of the raw material piles. In the past this task has been undertaken by a specialist; however, the warehouse manager feels confident that he can perform this task.

Required:

(a) For the inventory count arrangements of Lily Window Glass Co:

- (i) Identify and explain SIX deficiencies; and**
- (ii) Provide a recommendation to address each deficiency.**

The total marks will be split equally between each part

(12 marks)

You are the audit senior of Daffodil & Co and are responsible for the audit of inventory for Lily. You will be attending the year-end inventory count on 31 December 2012.

In addition, your manager wishes to utilise computer-assisted audit techniques for the first time for controls and substantive testing in auditing Lily Window Glass Co's inventory.

Required:

- (b) Describe the procedures to be undertaken by the auditor DURING the inventory count of Lily Window Glass Co in order to gain sufficient appropriate audit evidence.** (6 marks)
- (c) For the audit of the inventory cycle and year-end inventory balance of Lily Window Glass Co:**
 - (i) Describe FOUR audit procedures that could be carried out using computer-assisted audit techniques (CAATS);**
 - (ii) Explain the potential advantages of using CAATS; and**
 - (iii) Explain the potential disadvantages of using CAATS.**

The total marks will be split equally between each part (12 marks)

(30 marks)

- 2 (a) In order for auditors to operate effectively and to provide an opinion on an entity's financial statements, they are given certain rights.

Required:

State THREE rights of an auditor, excluding those related to resignation and removal. (3 marks)

- (b) HKSA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires auditors to obtain an understanding of control activities relevant to the audit.

Control activities are the policies and procedures that help ensure that management directives are carried out; and which are designed to prevent and detect fraud and error occurring. An example of a control activity is the maintenance of a control account.

Required:

Apart from maintenance of a control account, explain FOUR control activities a company may undertake to prevent and detect fraud and error. (4 marks)

- (c) **Describe THREE limitations of external audits.** (3 marks)

(10 marks)

- 3** Sunflower Stores Co (Sunflower) operates 25 food supermarkets. The company's year end is 31 December 2012. The audit manager and partner recently attended a planning meeting with the finance director and have provided you with the planning notes below.

You are the audit senior, and this is your first year on this audit. In order to familiarise yourself with Sunflower, the audit manager has asked you to undertake some research in order to gain an understanding of Sunflower, so that you are able to assist in the planning process. He has then asked that you identify relevant audit risks from the notes below and also consider how the team should respond to these risks.

Sunflower has spent \$1.6 million in refurbishing all of its supermarkets; as part of this refurbishment programme their central warehouse has been extended and a smaller warehouse, which was only occasionally used, has been disposed of at a profit. In order to finance this refurbishment, a sum of \$1.5 million was borrowed from the bank. This is due to be repaid over five years.

The company will be performing a year-end inventory count at the central warehouse as well as at all 25 supermarkets on 31 December. Inventory is valued at selling price less an average profit margin as the finance director believes that this is a close approximation to cost.

Prior to 2012, each of the supermarkets maintained their own financial records and submitted returns monthly to head office. During 2012 all accounting records have been centralised within head office. Therefore at the beginning of the year, each supermarket's opening balances were transferred into head office's accounting records. The increased workload at head office has led to some changes in the finance department and in November 2012 the financial controller left. His replacement will start in late December.

Required:

- (a) List FIVE sources of information that would be of use in gaining an understanding of Sunflower Stores Co, and for each source describe what you would expect to obtain.** (5 marks)
- (b) Using the information provided, describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Sunflower Stores Co.** (10 marks)
- (c) The finance director of Sunflower Stores Co is considering establishing an internal audit department.**

Required:

Describe the factors the finance director should consider before establishing an internal audit department. (5 marks)

(20 marks)

4 (a) Identify and explain each of the FIVE fundamental principles contained within ACCA's *Code of Ethics and Conduct*. (5 marks)

(b) Rose Leisure Club Co (Rose) operates a chain of health and fitness clubs. Its year end was 31 October 2012. You are the audit manager and the year-end audit is due to commence shortly. The following three matters have been brought to your attention.

(i) Trade payables and accruals

Rose's finance director has notified you that an error occurred in the closing of the purchase ledger at the year end. Rather than it closing on 1 November, it accidentally closed one week earlier on 25 October. All purchase invoices received between 25 October and the year end have been posted to the 2013 year-end purchase ledger. (6 marks)

(ii) Receivables

Rose's trade receivables have historically been low as most members pay monthly in advance. However, during the year a number of companies have taken up group memberships at Rose and hence the receivables balance is now material. The audit senior has undertaken a receivables circularisation for the balances at the year end; however, there are a number who have not responded and a number of responses with differences. (5 marks)

(iii) Reorganisation

The company recently announced its plans to reorganise its health and fitness clubs. This will involve closing some clubs for refurbishment, retraining some existing staff and disposing of some surplus assets. These plans were agreed at a board meeting in October and announced to their shareholders on 29 October. Rose is proposing to make a reorganisation provision in the financial statements. (4 marks)

Required:

Describe substantive procedures you would perform to obtain sufficient and appropriate audit evidence in relation to the above three matters.

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

(20 marks)

- 5 (a) Explain the purpose of, and procedures for, obtaining written representations. (5 marks)
- (b) The directors of a company have provided the external audit firm with an oral representation confirming that the bank overdraft balances included within current liabilities are complete.

Required:

Describe the relevance and reliability of this oral representation as a source of evidence to confirm the completeness of the bank overdraft balances. (3 marks)

- (c) You are the audit manager of Violet & Co and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues:

Daisy Designs Co (Daisy)

Daisy's year end is 30 September, however, subsequent to the year end the company's sales ledger has been corrupted by a computer virus. Daisy's finance director was able to produce the financial statements prior to this occurring; however, the audit team has been unable to access the sales ledger to undertake detailed testing of revenue or year-end receivables. All other accounting records are unaffected and there are no backups available for the sales ledger. Daisy's revenue is \$15.6m, its receivables are \$3.4m and profit before tax is \$2m.

Fuchsia Enterprises Co (Fuchsia)

Fuchsia has experienced difficult trading conditions and as a result it has lost significant market share. The cash flow forecast has been reviewed during the audit fieldwork and it shows a significant net cash outflow. Management are confident that further funding can be obtained and so have prepared the financial statements on a going concern basis with no additional disclosures; the audit senior is highly sceptical about this. The prior year financial statements showed a profit before tax of \$1.2m; however, the current year loss before tax is \$4.4m and the forecast net cash outflow for the next 12 months is \$3.2m.

Required:

For each of the two issues:

- (i) Discuss the issue, including an assessment of whether it is material;
- (ii) Recommend procedures the audit team should undertake at the completion stage to try to resolve the issue; and
- (iii) Describe the impact on the audit report if the issue remains unresolved.

Notes: 1 The total marks will be split equally between each issue.

2 Audit report extracts are NOT required.

(12 marks)

(20 marks)

End of Question Paper