

Fundamentals Level – Skills Module

# Audit and Assurance (Hong Kong)

Wednesday 3 December 2008

**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 Introduction**

Blake Co assembles specialist motor vehicles such as lorries, buses and trucks. The company owns four assembly plants to which parts are delivered and assembled into the motor vehicles.

The motor vehicles are assembled using a mix of robot and manual production lines. The 'human' workers normally work a standard eight hour day, although this is supplemented by overtime on a regular basis as Blake has a full order book. There is one shift per day; mass production and around the clock working are not possible due to the specialist nature of the motor vehicles being assembled.

**Wages system – shift workers**

Shift-workers arrive for work at about 7.00 am and 'clock in' using an electronic identification card. The card is scanned by the time recording system and each production shift-worker's identification number is read from their card by the scanner. The worker is then logged in as being at work. Shift-workers are paid from the time of logging in. The logging in process is not monitored as it is assumed that shift-workers would not work without first logging in on the time recording system.

Shift-workers are split into groups of about 25 employees, with each group under the supervision of a shift foreman. Each day, each group of shift-workers is allocated a specific vehicle to manufacture. At least 400 vehicles have to be manufactured each day by each work group. If necessary, overtime is worked to complete the day's quota of vehicles. The shift foreman is not required to monitor the extent of any overtime working although the foreman does ensure workers are not taking unnecessary or prolonged breaks which would automatically increase the amount of overtime worked. Shift-workers log off at the end of each shift by re-scanning their identification card.

**Payment of wages**

Details of hours worked each week are sent electronically to the payroll department, where hours worked are allocated by the computerised wages system to each employee's wages records. Staff in the payroll department compare hours worked from the time recording system to the computerised wages system, and enter a code word to confirm the accuracy of transfer. The code word also acts as authorisation to calculate net wages. The code word is the name of a domestic cat belonging to the department head and is therefore generally known around the department.

Each week the computerised wages system calculates:

- (i) gross wages, using the standard rate and overtime rates per hour for each employee,
- (ii) statutory deductions from wages, and
- (iii) net pay.

The list of net pay for each employee is sent over Blake's internal network to the accounts department. In the accounts department, an accounts clerk ensures that employee bank details are on file. The clerk then authorises and makes payment to those employees using Blake's online banking systems. Every few weeks the financial accountant reviews the total amount of wages made to ensure that the management accounts are accurate.

**Termination of employees**

Occasionally, employees leave Blake. When this happens, the personnel department sends an e-mail to the payroll department detailing the employee's termination date and any unclaimed holiday pay. The receipt of the e-mail by the payroll department is not monitored by the personnel department.

**Salaries system – shift managers**

All shift managers are paid an annual salary; there are no overtime payments.

Salaries were increased in July by 3% and an annual bonus of 5% of salary was paid in November.

**Required:**

(a) List **FOUR** control objectives of a wages system. (2 marks)

(b) As the external auditors of Blake Co, write a management letter to the directors in respect of the shift-workers wages recording and payment systems which:

- (i) Identifies and explains **FOUR** weaknesses in that system;
- (ii) Explains the possible effect of each weakness;
- (iii) Provides a recommendation to alleviate each weakness.

Note: up to two marks will be awarded within this requirement for presentation. (14 marks)

(c) List **THREE** substantive analytical procedures you should perform on the shift managers' salary system. For each procedure, state your expectation of the result of that procedure. (6 marks)

(d) Audit evidence can be obtained using various audit procedures, such as inspection.

**APART FROM THIS PROCEDURE**, in respect of testing the accuracy of the time recording system at Blake Co, explain **FOUR** procedures used in collecting audit evidence and discuss whether the auditor will benefit from using each procedure. (8 marks)

**(30 marks)**

2 (a) HKSA 620 *Using the Work of an Expert* explains how an auditor may use an expert to obtain audit evidence.

**Required:**

Explain **THREE** factors that the external auditor should consider when assessing the competence and objectivity of the expert. (3 marks)

(b) Auditors have various duties to perform in their role as auditors, for example, to assess the truth and fairness of the financial statements.

**Required:**

Explain **THREE** rights that enable auditors to carry out their duties. (3 marks)

(c) List **FOUR** assertions relevant to the audit of tangible non-current assets and state one audit procedure which provides appropriate evidence for each assertion. (4 marks)

**(10 marks)**

- 3** You are a manager in the audit firm of Ali & Co; and this is your first time you have worked on one of the firm's established clients, Stark Co. The main activity of Stark Co is providing investment advice to individuals regarding saving for retirement, purchase of shares and securities and investing in tax efficient savings schemes. Stark is regulated by the relevant financial services authority.

You have been asked to start the audit planning for Stark Co, by Mr Son, a partner in Ali & Co. Mr Son has been the engagement partner for Stark Co, for the previous nine years and so has excellent knowledge of the client. Mr Son has informed you that he would like his daughter Zoe to be part of the audit team this year; Zoe is currently studying for her first set of fundamentals papers for her ACCA qualification. Mr Son also informs you that Mr Far, the audit senior, received investment advice from Stark Co during the year and intends to do the same next year.

In an initial meeting with the finance director of Stark Co, you learn that the audit team will not be entertained on Stark Co's yacht this year as this could appear to be an attempt to influence the opinion of the audit. Instead, he has arranged a balloon flight costing less than one-tenth of the expense of using the yacht and hopes this will be acceptable. The director also states that the fee for taxation services this year should be based on a percentage of tax saved and trusts that your firm will accept a fixed fee for representing Stark Co in a dispute regarding the amount of sales tax payable to the taxation authorities.

**Required:**

- (a) (i) Explain the ethical threats which may affect the auditor of Stark Co. (6 marks)
- (ii) For each ethical threat, discuss how the effect of the threat can be mitigated. (6 marks)
- (b) Discuss the benefits of Stark Co establishing an internal audit department. (8 marks)

**(20 marks)**

- 4 (a) Explain the term 'audit risk' and the three elements of risk that contribute to total audit risk. (4 marks)**

The EuKaRe charity was established in 1960. The charity's aim is to provide support to children from disadvantaged backgrounds who wish to take part in sports such as tennis, badminton and football.

EuKaRe has a detailed constitution which explains how the charity's income can be spent. The constitution also notes that administration expenditure cannot exceed 10% of income in any year.

The charity's income is derived wholly from voluntary donations. Sources of donations include:

- (i) Cash collected by volunteers asking the public for donations in shopping areas,
- (ii) Cheques sent to the charity's head office,
- (iii) Donations from generous individuals. Some of these donations have specific clauses attached to them indicating that the initial amount donated (capital) cannot be spent and that the income (interest) from the donation must be spent on specific activities, for example, provision of sports equipment.

The rules regarding the taxation of charities in the country EuKaRe is based are complicated, with only certain expenditure being allowable for taxation purposes and donations of capital being treated as income in some situations.

**Required:**

- (b) Identify areas of inherent risk in the EuKaRe charity and explain the effect of each of these risks on the audit approach. (12 marks)
- (c) Explain why the control environment may be weak at the charity EuKaRe. (4 marks)

**(20 marks)**

- 5 The date is 3 December 2008. The audit of ZeeDiem Co is nearly complete and the financial statements and the audit report are due to be signed next week. However, the following additional information on two material events has just been presented to the auditor. The company's year end was 30 September 2008.

Event 1 – Occurred on 10 October 2008

The springs in a new type of mattress have been found to be defective making the mattress unsafe for use. There have been no sales of this mattress; it was due to be marketed in the next few weeks. The company's insurers estimate that inventory to the value of \$750,000 has been affected. The insurers also estimate that the mattresses are now only worth \$225,000. No claim can be made against the supplier of springs as this company is in liquidation with no prospect of any amounts being paid to third parties. The insurers will not pay ZeeDiem for the fall in value of the inventory as the company was underinsured. All of this inventory was in the finished goods store at the end of the year and no movements of inventory have been recorded post year-end.

Event 2 – Occurred on 5 November 2008

Production at the ShamEve factory was halted for one day when a truck carrying dye used in colouring the fabric on mattresses reversed into a metal pylon, puncturing the vehicle allowing dye to spread across the factory premises and into a local river. The Environmental Agency is currently considering whether the release of dye was in breach of environmental legislation. The company's insurers have not yet commented on the event.

**Required:**

**(a) For each of the two events above:**

- (i) Explain whether the events are adjusting or non-adjusting according to HKAS 10 *Events After the Reporting Period*.** (4 marks)
- (ii) Explain the auditors' responsibility and the audit procedures and actions that should be carried out according to HKSA 560 (Revised) *Subsequent Events*.** (12 marks)

**(b)** Assume that the date is now 20 December 2008, the financial statements and the audit report have just been signed, and the annual general meeting is to take place on 10 January 2009. The Environmental Agency has issued a report stating that ZeeDiem Co is in breach of environmental legislation and a fine of \$900,000 will now be levied on the company. The amount is material to the financial statements.

**Required:**

**Explain the additional audit work the auditor should carry out in respect of this fine.** (4 marks)

**(20 marks)**

**End of Question Paper**