

Fundamentals Level – Skills Module

# Audit and Assurance (Hong Kong)

Wednesday 3 June 2009

**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)

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 Background information**

B-Star is a theme park based on a popular series of children's books. Customers pay a fixed fee to enter the park where they can participate in a variety of activities such as riding roller-coasters, playing on slides and purchasing themed souvenirs from gift shops.

The park is open all year and has been in operation for the last seven years. It is located in a country which has very little rainfall – the park is open-air so poor weather such as rain results in a significant fall in the number of customers for that day (normally by 50%). During the last seven years there have been on average 30 days each year with rain.

B-Star is now very successful; customer numbers are increasing at approximately 15% each year.

**Ticket sales**

Customers purchase tickets to enter the theme park from ticket offices located outside the park. Tickets are only valid on the day of purchase. Adults and children are charged the same price for admission to the park. Tickets are pre-printed and stored in each ticket office.

Tickets are purchased using either cash or credit cards.

Each ticket has a number comprising of two elements – two digits relating to the ticket office followed by six digits to identify the ticket. The last six digits are in ascending sequential order.

**Cash sales**

1. All ticket sales are recorded on a computer showing the amount of each sale and the number of tickets issued. This information is transferred electronically to the accounts office.
2. Cash is collected regularly from each ticket office by two security guards. The cash is then counted by two accounts clerks and banked on a daily basis.
3. The total cash from each ticket office is agreed to the sales information that has been transferred from each office.
4. Total cash received is then recorded in the cash book, and then the general ledger.

**Credit card sales**

1. Payments by credit cards are authorised online as the customers purchase their tickets.
2. Computers in each ticket office record the sales information, which is transferred electronically to the accounts office.
3. Credit card sales are recorded for each credit card company in a receivables ledger.
4. When payment is received from the credit card companies, the accounts clerks agree the total sales values to the amounts received from the credit card companies, less the commission payable to those companies. The receivables ledger is updated with the payments received.

You are now commencing the planning of the annual audit of B-Star. The date is 3 June and B-Star's year end is 30 June 2009.

**Required:**

- (a) List and explain the purpose of the main sections of an audit strategy document and for each section, provide an example relevant to B-Star. (8 marks)
- (b) (i) For the cash sales system of B-Star, identify the risks that could affect the assertion of completeness of sales and cash receipts; (4 marks)
- (ii) Discuss the extent to which tests of controls and substantive procedures could be used to confirm the assertion of completeness of income in B-Star. (6 marks)
- (c) (i) List the substantive analytical procedures that can be used to give assurance on the total income from ticket sales for one day in B-Star;
- (ii) List the substantive analytical procedures that can be used to give assurance on the total income from ticket sales for the year in B-Star. (8 marks)
- (d) List the audit procedures you would normally perform on the credit card receivables balance. (4 marks)

**(30 marks)**

- 2 (a) List and explain FOUR methods of selecting a sample of items to test from a population in accordance with HKSA 530 *Audit Sampling and Other Means of Testing*. (4 marks)
- (b) List and explain FOUR assertions from HKSA 500 *Audit Evidence* that relate to the recording of classes of transactions. (4 marks)
- (c) In terms of audit reports, explain the term 'modified'. (2 marks)

**(10 marks)**

- 3 Following a competitive tender, your audit firm Cal & Co has just gained a new audit client Tirrol Co. You are the manager in charge of planning the audit work. Tirrol Co's year end is 30 June 2009 with a scheduled date to complete the audit of 15 August. The date now is 3 June 2009.

Tirrol Co provides repair services to motor vehicles from 25 different locations. All inventory, sales and purchasing systems are computerised, with each location maintaining its own computer system. The software in each location is the same because the programs were written specifically for Tirrol Co by a reputable software house. Data from each location is amalgamated on a monthly basis at Tirrol Co's head office to produce management and financial accounts.

You are currently planning your audit approach for Tirrol Co. One option being considered is to re-write Cal & Co's audit software to interrogate the computerised inventory systems in each location of Tirrol Co (except for head office) as part of inventory valuation testing. However, you have also been informed that any computer testing will have to be on a live basis and you are aware that July is a major holiday period for your audit firm.

**Required:**

- (a) (i) Explain the benefits of using audit software in the audit of Tirrol Co; (4 marks)
- (ii) Explain the problems that may be encountered in the audit of Tirrol Co and for each problem, explain how that problem could be overcome. (10 marks)
- (b) Following a discussion with the management at Tirrol Co you now understand that the internal audit department are prepared to assist with the statutory audit. Specifically, the chief internal auditor is prepared to provide you with documentation on the computerised inventory systems at Tirrol Co. The documentation provides details of the software and shows diagrammatically how transactions are processed through the inventory system. This documentation can be used to significantly decrease the time needed to understand the computer systems and enable audit software to be written for this year's audit.

**Required:**

**Explain how you will evaluate the computer systems documentation produced by the internal audit department so you can place reliance on it during your audit.** (6 marks)

**(20 marks)**

**4 (a) Contrast the role of internal and external auditors.**

(8 marks)

- (b)** Conoy Co designs and manufactures luxury motor vehicles. The company employs 2,500 staff and consistently makes a net profit of between 10% and 15% of sales. Conoy Co is not listed; its shares are held by 15 individuals, most of them from the same family. The maximum shareholding is 15% of the share capital.

The executive directors are drawn mainly from the shareholders. There are no non-executive directors because the company legislation in Conoy Co's jurisdiction does not require any. The executive directors are very successful in running Conoy Co, partly from their training in production and management techniques, and partly from their 'hands-on' approach providing motivation to employees.

The board are considering a significant expansion of the company. However, the company's bankers are concerned with the standard of financial reporting as the financial director (FD) has recently left Conoy Co. The board are delaying provision of additional financial information until a new FD is appointed.

Conoy Co does have an internal audit department, although the chief internal auditor frequently comments that the board of Conoy Co do not understand his reports or provide sufficient support for his department or the internal control systems within Conoy Co. The board of Conoy Co concur with this view. Anders & Co, the external auditors have also expressed concern in this area and the fact that the internal audit department focuses work on control systems, not financial reporting. Anders & Co are appointed by and report to the board of Conoy Co.

The board of Conoy Co are considering a proposal from the chief internal auditor to establish an audit committee. The committee would consist of one executive director, the chief internal auditor as well as three new appointees. One appointee would have a non-executive seat on the board of directors.

**Required:**

**Discuss the benefits to Conoy Co of forming an audit committee.**

(12 marks)

**(20 marks)**

- 5 One of your audit clients is Tye Co, a company providing petrol, aviation fuel and similar oil based products to the government of the country it is based in. Although the company is not listed on any stock exchange, it does follow best practice regarding corporate governance regulations. The audit work for this year is complete, apart from the matter referred to below.

As part of Tye Co's service contract with the government, it is required to hold an emergency inventory reserve of 6,000 barrels of aviation fuel. The inventory is to be used if the supply of aviation fuel is interrupted due to unforeseen events such as natural disaster or terrorist activity.

This fuel has in the past been valued at its cost price of \$15 a barrel. The current value of aviation fuel is \$120 a barrel. Although the audit work is complete, as noted above, the directors of Tye Co have now decided to show the 'real' value of this closing inventory in the financial statements by valuing closing inventory of fuel at market value, which does not comply with relevant accounting standards. The draft financial statements of Tye Co currently show a profit of approximately \$500,000 with net assets of \$170 million.

**Required:**

- (a) **List the audit procedures and actions that you should now take in respect of the above matter.** (6 marks)
- (b) *For the purposes of this section assume from part (a) that the directors have agreed to value inventory at \$15/barrel.*

Having investigated the matter in part (a) above, the directors present you with an amended set of financial statements showing the emergency reserve stated not at 6,000 barrels, but reported as 60,000 barrels. The final financial statements now show a profit following the inclusion of another 54,000 barrels of oil in stock. When queried about the change from 6,000 to 60,000 barrels of inventory, the finance director stated that this change was made to meet expected amendments to emergency reserve requirements to be published in about six months time. The inventory will be purchased this year, and no liability will be shown in the financial statements for this future purchase. The finance director also pointed out that part of Tye Co's contract with the government requires Tye Co to disclose an annual profit and that a review of bank loans is due in three months. Finally the finance director stated that if your audit firm qualifies the financial statements in respect of the increase in inventory, the firm will not be recommended for re-appointment at the annual general meeting. The finance director refuses to amend the financial statements to remove this 'fictitious' inventory.

**Required:**

- (i) **State the external auditor's responsibilities regarding the detection of fraud;** (4 marks)
- (ii) **Discuss to which groups the auditors of Tye Co could report the 'fictitious' aviation fuel inventory;** (6 marks)
- (iii) **Discuss the safeguards that the auditors of Tye Co can use in an attempt to overcome the intimidation threat from the directors of Tye Co.** (4 marks)

**(20 marks)**

**End of Question Paper**