Audit and Assurance (International)

Thursday 5 June 2014

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.
Trombone Co (Trombone) operates a chain of hotels across the country. Trombone employs in excess of 250 permanent employees and its year end is 31 August 2014. You are the audit supervisor of Viola & Co and are currently reviewing the documentation of Trombone’s payroll system, detailed below, in preparation for the interim audit.

Trombone’s payroll system

Permanent employees work a standard number of hours per week as specified in their employment contract. However, when the hotels are busy, staff can be requested by management to work additional shifts as overtime. This can either be paid on a monthly basis or taken as days off.

Employees record any overtime worked and days taken off on weekly overtime sheets which are sent to the payroll department. The standard hours per employee are automatically set up in the system and the overtime sheets are entered by clerks into the payroll package, which automatically calculates the gross and net pay along with relevant deductions. These calculations are not checked at all. Wages are increased by the rate of inflation each year and the clerks are responsible for updating the standing data in the payroll system.

Employees are paid on a monthly basis by bank transfer for their contracted weekly hours and for any overtime worked in the previous month. If employees choose to be paid for overtime, authorisation is required by department heads of any overtime in excess of 30% of standard hours. If employees choose instead to take days off, the payroll clerks should check back to the ‘overtime worked’ report; however, this report is not always checked.

The ‘overtime worked’ report, which details any overtime recorded by employees, is run by the payroll department weekly and emailed to department heads for authorisation. The payroll department asks department heads to only report if there are any errors recorded. Department heads are required to arrange for overtime sheets to be authorised by an alternative responsible official if they are away on annual leave; however, there are instances where this arrangement has not occurred.

The payroll package produces a list of payments per employee; this links into the bank system to produce a list of automatic payments. The finance director reviews the total list of bank transfers and compares this to the total amount to be paid per the payroll records; if any issues arise then the automatic bank transfer can be manually changed by the finance director.

Required:

(a) In respect of the payroll system of Trombone Co:

(i) Identify and explain FIVE deficiencies;
(ii) Recommend a control to address each of these deficiencies; and
(iii) Describe a test of control Viola & Co should perform to assess if each of these controls is operating effectively.

Note: The total marks will be split equally between each part. (15 marks)

(b) Explain the difference between an interim and a final audit. (5 marks)

(c) Describe substantive procedures you should perform at the final audit to confirm the completeness and accuracy of Trombone Co’s payroll expense. (6 marks)

Trombone deducts employment taxes from its employees’ wages on a monthly basis and pays these to the local taxation authorities in the following month. At the year end the financial statements will contain an accrual for income tax payable on employment income. You will be in charge of auditing this accrual.

Required:

(d) Describe the audit procedures required in respect of the year end accrual for tax payable on employment income. (4 marks)

(30 marks)
2 (a) Define the ‘three Es’ of a value for money audit. (3 marks)

(b) ISA 230 *Audit Documentation* requires auditors to prepare audit documentation for an audit of financial statements on a timely basis.

**Required:**

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

(c) ISA 530 *Audit Sampling* applies when the auditor has decided to use sampling to obtain sufficient and appropriate audit evidence.

**Required:**

Define what is meant by ‘audit sampling’ and explain the need for this. (3 marks)

(10 marks)
Recorder Communications Co (Recorder) is a large mobile phone company which operates a network of stores in countries across Europe. The company’s year end is 30 June 2014. You are the audit senior of Piano & Co. Recorder is a new client and you are currently planning the audit with the audit manager. You have been provided with the following planning notes from the audit partner following his meeting with the finance director.

Recorder purchases goods from a supplier in South Asia and these goods are shipped to the company’s central warehouse. The goods are usually in transit for two weeks and the company correctly records the goods when received. Recorder does not undertake a year-end inventory count, but carries out monthly continuous (perpetual) inventory counts and any errors identified are adjusted in the inventory system for that month.

During the year the company introduced a bonus based on sales for its sales persons. The bonus target was based on increasing the number of customers signing up for 24-month phone line contracts. This has been successful and revenue has increased by 15%, especially in the last few months of the year. The level of receivables is considerably higher than last year and there are concerns about the creditworthiness of some customers.

Recorder has a policy of revaluing its land and buildings and this year has updated the valuations of all land and buildings.

During the year the directors have each been paid a significant bonus, and they have included this within wages and salaries. Separate disclosure of the bonus is required by local legislation.

Required:

(a) Describe FIVE audit risks, and explain the auditor’s response to each risk, in planning the audit of Recorder Communications Co. (10 marks)

(b) Explain the audit procedures you should perform in order to place reliance on the continuous (perpetual) counts for year-end inventory. (3 marks)

(c) Describe substantive procedures you should perform to confirm the directors’ bonus payments included in the financial statements. (3 marks)

The finance director of Recorder informed the audit partner that the reason for appointing Piano & Co as auditors was because they audit other mobile phone companies, including Recorder’s main competitor. The finance director has asked how Piano & Co keeps information obtained during the audit confidential.

Required:

(d) Explain the safeguards which your firm should implement to ensure that this conflict of interest is properly managed. (4 marks)

(20 marks)
Saxophone Enterprises Co (Saxophone) has been trading for 15 years selling insurance and has recently become a listed company. In accordance with corporate governance principles Saxophone maintains a small internal audit department. The directors feel that the team needs to increase in size and specialist skills are required, but they are unsure whether to recruit more internal auditors, or to outsource the whole function to their external auditors, Cello & Co.

Saxophone is required to comply with corporate governance principles in order to maintain its listed status; hence the finance director has undertaken a review of whether or not the company complies.

Bill Bassoon is the chairman of Saxophone, until last year he was the chief executive. Bill is unsure if Saxophone needs more non-executive directors as there are currently three non-executive directors out of the eight board members. He is considering appointing one of his close friends, who is a retired chief executive of a manufacturing company, as a non-executive director.

The finance director, Jessie Oboe, decides on the amount of remuneration each director is paid. Currently all remuneration is in the form of an annual bonus based on profits. Jessie is considering setting up an audit committee, but has not undertaken this task yet as she is very busy. A new sales director was appointed nine months ago. He has yet to undertake his board training as this is normally provided by the chief executive and this role is currently vacant.

There are a large number of shareholders and therefore the directors believe that it is impractical and too costly to hold an annual general meeting of shareholders. Instead, the board has suggested sending out the financial statements and any voting resolutions by email; shareholders can then vote on the resolutions via email.

Required:

(a) Explain the advantages and disadvantages for each of Saxophone Enterprises Co AND Cello & Co of outsourcing the internal audit department.

Note: The total marks will be split as follows:

Saxophone Enterprises Co (8 marks)
Cello & Co (2 marks)

(10 marks)

(b) In respect of the corporate governance of Saxophone Enterprises Co:

(i) Identify and explain FIVE corporate governance weaknesses; and
(ii) Provide a recommendation to address each weakness.

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

(20 marks)
Clarinet Co (Clarinet) is a computer hardware specialist and has been trading for over five years. The company is funded partly through overdrafts and loans and also by several large shareholders; the year end is 30 April 2014. Clarinet has experienced significant growth in previous years; however, in the current year a new competitor, Drums Design Co (Drums), has entered the market and through competitive pricing has gained considerable market share from Clarinet. One of Clarinet’s larger customers has stopped trading with them and has moved its business to Drums. In addition, a number of Clarinet’s specialist developers have left the company and joined Drums. Clarinet has found it difficult to replace these employees due to the level of their skills and knowledge. Clarinet has just received notification that its main supplier who provides the company with specialist electrical equipment has ceased to trade. Clarinet is looking to develop new products to differentiate itself from the rest of its competitors. It has approached its shareholders to finance this development; however, they declined to invest further in Clarinet. Clarinet’s loan is long term and it has met all repayments on time. The overdraft has increased significantly over the year and the directors have informed you that the overdraft facility is due for renewal next month, and they are confident it will be renewed. The directors have produced a cash flow forecast which shows a significantly worsening position over the coming 12 months. They are confident with the new products being developed, and in light of their trading history of significant growth, believe it is unnecessary to make any disclosures in the financial statements regarding going concern.

At the year end, Clarinet received notification from one of its customers that the hardware installed by Clarinet for the customers’ online ordering system has not been operating correctly. As a result, the customer has lost significant revenue and has informed Clarinet that they intend to take legal action against them for loss of earnings. Clarinet has investigated the problem post year end and discovered that other work-in-progress is similarly affected and inventory should be written down. The finance director believes that as this misstatement was identified after the year end, it can be amended in the 2015 financial statements.

Required:

(a) Describe the procedures the auditors of Clarinet Co should undertake in relation to the uncorrected inventory misstatement identified above. (4 marks)

(b) Explain SIX potential indicators that Clarinet Co is not a going concern. (6 marks)

(c) Describe the audit procedures which you should perform in assessing whether or not Clarinet Co is a going concern. (6 marks)

(d) The auditors have been informed that Clarinet’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 some going concern disclosures.

Required:

Describe the impact on the audit report of Clarinet Co if the auditor believes the company is a going concern but that this is subject to a material uncertainty. (4 marks)

(20 marks)