

Audit and Internal Review

(International Stream)

PART 2

TUESDAY 12 DECEMBER 2006

QUESTION PAPER

Time allowed **3 hours**

This paper is divided into two sections

Section A ALL THREE questions are compulsory and MUST be answered

Section B TWO questions ONLY to be answered

Do not open this paper until instructed by the supervisor

This question paper must not be removed from the examination hall

The Association of Chartered Certified Accountants

Paper 2.6(INT)



Section A – ALL THREE questions are compulsory and MUST be attempted

- 1 (a) ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* states 'the auditor should perform . . . risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control.'

Required:

- (i) **Explain the purpose of risk assessment procedures.** (3 marks)
- (ii) **Outline the sources of audit evidence the auditor can use as part of risk assessment procedures.** (3 marks)

- (b) Mal & Co, an audit firm, has seven partners. The firm has a number of audit clients in different industrial sectors, with a wide range of fee income.

An audit partner of Mal & Co has just delegated to you the planning work for the audit of Serenity Co. This company provides a range of mobile communication facilities and this will be the second year your firm has provided audit services.

You have just met with the financial controller of Serenity prior to agreeing the engagement letter for this year. The controller has informed you that Serenity has continued to grow quickly, with financial accounting systems changing rapidly and appropriate control systems being difficult to maintain. Additional services in terms of review and implementation of control systems have been requested. An internal audit department has recently been established and the controller wants you to ensure that external audit work is limited by using this department.

You have also learnt that Serenity is to market a new type of mobile telephone, which is able to intercept messages from law enforcement agencies. The legal status of this telephone is unclear at present and development is not being publicised.

The granting of the licence to market the mobile telephone is dependent on the financial stability of Serenity. The financial controller has indicated that Mal & Co may be asked to provide a report to the mobile telephone licensing authority regarding Serenity's cash flow forecast for the year ending December 2007 to support the licence application.

Required:

As part of your risk assessment procedures for the audit of Serenity Co for the year ending 31 December 2006, identify and describe the issues to be considered when providing services to this client. (10 marks)

- (c) **When reporting on a cash flow forecast, explain the term 'negative assurance' and why this is used.** (4 marks)

(20 marks)

2 (a) Explain the purpose of the three 'Es' in relation to a value for money audit. (4 marks)

(b) You are an audit manager in the internal audit department of KLE Co. The internal audit department is auditing the company's procurement system in the company. Extracts from your system notes, which are correct and contain no errors, are provided below.

Details on ordering department:

- Six members of staff – one buyer and five purchasing clerks.
- Receives about 75 orders each day, many orders for duplicate items come from different departments in the organisation.
- Initial evaluation of internal controls is high.

Procurement systems

Ordering department

All orders are raised on pre-numbered purchase requisitions and sent to the ordering department.

In the ordering department, each requisition is signed by the chief buyer. A purchasing clerk transfers the order information onto an order form and identifies the appropriate supplier for the goods.

Part one of the two part order form is sent to the supplier and part two to the accounts department. The requisition is thrown away.

Goods inwards department

All goods received are checked for damage. Damaged items are returned to the supplier and a damaged goods note completed.

For undamaged items a two-part pre-numbered Goods Received Note (GRN) is raised.

- Part one is sent to the ordering department with the damaged goods notes.
- Part two is filed in order of the reference number for the goods being ordered (obtained from the supplier's goods despatched documentation), in the goods inwards department.

Ordering department

GRNs are separated from damaged goods notes, which are filed. The GRN is forwarded to the accounts department.

Accounts department

GRNs matched with the order awaiting the receipt of the invoice.

Required:

Using the system notes provided

(i) Identify and explain the internal control weaknesses and provide a recommendation to overcome each weakness. (10 marks)

(ii) Identify and explain the additional weaknesses that should be raised by a value for money audit and provide a suitable recommendation to overcome each weakness. (6 marks)

(20 marks)

- 3 (a) ISA 505, *External Confirmations*, states that 'the auditor should determine whether the use of external confirmations is necessary to obtain sufficient appropriate audit evidence at the assertion level'.

Required:

(i) List **FOUR** examples of external confirmations. (2 marks)

(ii) For **EACH** of the examples in (i) above explain:

ONE audit assertion that the external confirmation supports, and
ONE audit assertion that the external confirmation does **NOT** support. (8 marks)

- (b) Jayne Co has a significant number of cash transactions and recent non-current asset purchases have been financed by a bank loan. This loan is repayable in equal annual instalments for the next five years.

Required:

(i) Explain the procedures to obtain a bank report for audit purposes from Jayne Co's bank and the substantive procedures that should be carried out on that report. (5 marks)

(ii) List the further substantive procedures that should be carried out on the bank balances in Jayne Co's financial statements. (5 marks)

(20 marks)

Section B – TWO questions ONLY to be attempted

- 4 The FireFly Tennis Club owns 12 tennis courts. The club uses 'all weather' tarmac tennis courts, which have floodlights for night-time use. The club's year end is 30 September.

Members pay an annual fee to use the courts and participate in club championships. The club had 430 members as at 1 October 2005.

Income is derived from two main sources:

1. Membership fees. Each member pays a fee of \$200 per annum. Fees for the new financial year are payable within one month of the club year end. Approximately 10% of members do not renew their membership. New members joining during the year pay 50% of the total fees that would have been payable had they been members for a full year. During 2006, 50 new members joined the club. No members pay their fees before they are due.
2. Court hire fees: Non-members pay \$5 per hour to hire a court. Non-members have to sign a list in the club house showing courts hired. Money is placed in a cash box in the club house for collection by the club secretary.

All fees (membership and court hire) are paid in cash. They are collected by the club secretary and banked on a regular basis. The paying-in slip shows the analysis between fees and court hire income. The secretary provides the treasurer with a list of bankings showing member's names (for membership fees) and the amount banked. Details of all bankings are entered into the cash book by the treasurer.

Main items of expenditure are:

1. Court maintenance including repainting lines on a regular basis.
2. Power costs for floodlights.
3. Tennis balls for club championships. Each match in the championship uses 12 tennis balls.

The treasurer pays for all expenditure using the club's debit card. Receipts are obtained for all expenses and these are maintained in date order in an expenses file. The treasurer also prepares the annual financial statements.

Under the rules of the club, the annual accounts must be audited by an independent auditor. The date is now 13 December 2006 and the treasurer has just prepared the financial statements for audit.

Required:

- (a) Describe the audit work that should be performed to determine the completeness of income for the FireFly Tennis Club. (10 marks)
- (b) Describe the audit procedures that should be performed to check the completeness and accuracy of expenditure for the FireFly Tennis Club. (5 marks)
- (c) Discuss why internal control testing has limited value when auditing not-for-profit entities such as the FireFly Tennis Club. (5 marks)

(20 marks)

- 5 (a) (i) In the context of ISA 530 *Audit Sampling and Other Means of Testing*, explain and provide examples of the terms 'sampling risk' and 'non-sampling' risk. (4 marks)
- (ii) Briefly explain how sampling and non-sampling risk can be controlled by the audit firm. (2 marks)

- (b) Tam Co, is owned and managed by two brothers with equal shareholdings. The company specialises in the sale of expensive motor vehicles. Annual revenue is in the region of \$70,000,000 and the company requires an audit under local legislation. About 500 cars are sold each year, with an average value of \$140,000, although the range of values is from \$130,000 to \$160,000. Invoices are completed manually with one director signing all invoices to confirm the sales value is correct. All accounting and financial statement preparation is carried out by the directors. A recent expansion of the company's showroom was financed by a bank loan, repayable over the next five years.

The audit manager is starting to plan the audit of Tam Co. The audit senior and audit junior assigned to the audit are helping the manager as a training exercise.

Comments are being made about how to select a sample of sales invoices for testing. Audit procedures are needed to ensure that the managing director has signed them and then to trace details into the sales day book and sales ledger.

'We should check all invoices' suggests the audit manager.

'How about selecting a sample using statistical sampling techniques' adds the audit senior.

'Why waste time obtaining a sample?' asks the audit junior. He adds 'taking a random sample of invoices by reviewing the invoice file and manually choosing a few important invoices will be much quicker.'

Required:

Briefly explain each of the sample selection methods suggested by the audit manager, audit senior and audit junior, and discuss whether or not they are appropriate for obtaining a representative sample of sales invoices. (9 marks)

- (c) Define 'materiality' and explain why the auditors of Tam Co must form an opinion on whether the financial statements are free from material misstatement. (5 marks)

(20 marks)

- 6 Walsh Co sells motor vehicle fuel, accessories and spares to retail customers. The company owns 25 shops.

The company has recently implemented a new computerised wages system. Employees work a standard eight hour day. Hours are recorded using a magnetic card system; when each employee arrives for work, they hold their card close to the card reader; the reader recognises the magnetic information on the card identifying the employee as being 'at work'. When the employee leaves work at the end of the day the process is reversed showing that the employee has left work.

Hours worked are calculated each week by the computer system using the magnetic card information. Overtime is calculated as any excess over the standard hours worked. Any overtime over 10% of standard hours is sent on a computer generated report by e-mail to the financial accountant. If necessary, the accountant overrides overtime payments if the hours worked are incorrect.

Statutory deductions and net pay are also computer calculated with payments being made directly into the employee's bank account. The only other manual check is the financial accountant authorising the net pay from Walsh's bank account, having reviewed the list of wages to be paid.

Required:

- (a) **Using examples from Walsh Co, explain the benefits of using Computer-Assisted Audit Techniques to help the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the audit opinion.** (8 marks)
- (b) **List SIX examples of audit tests on Walsh Co's wages system using audit software.** (6 marks)
- (c) **Explain how using test data should help in the audit of Walsh Co's wages system, noting any problems with this audit technique.** (6 marks)

(20 marks)

End of Question Paper