

Fundamentals Level – Skills Module

# Audit and Assurance (Hong Kong)

Wednesday 4 June 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)

The ACCA logo consists of the letters 'ACCA' in a bold, white, sans-serif font, centered within a solid black square.

**ALL FIVE questions are compulsory and MUST be attempted**

**1 Introduction – audit firm**

You are an audit senior in Brennon & Co, a firm providing audit and assurance services. At the request of an audit partner, you are preparing the audit programme for the income and receivables systems of Seeley Co.

Audit documentation is available from the previous year’s audit, including internal control questionnaires and audit programmes for the despatch and sales system. The audit approach last year did not involve the use of computer-assisted audit techniques (CAATs); the same approach will be taken this year. As far as you are aware, Seeley’s system of internal control has not changed in the last year.

**Client background – sales system**

Seeley Co is a wholesaler of electrical goods such as kettles, televisions, MP3 players, etc. The company maintains one large warehouse in a major city. The customers of Seeley are always owners of small retail shops, where electrical goods are sold to members of the public. Seeley only sells to authorised customers; following appropriate credit checks, each customer is given a Seeley identification card to confirm their status. The card must be used to obtain goods from the warehouse.

**Despatch and sales system**

The despatch and sales system operates as follows:

1. Customers visit Seeley’s warehouse and load the goods they require into their vans after showing their Seeley identification card to the despatch staff.
2. A pre-numbered goods despatch note (GDN) is produced and signed by the customer and a member of Seeley’s despatch staff confirming goods taken.
3. One copy of the GDN is sent to the accounts department, the second copy is retained in the despatch department.
4. Accounts staff enter goods despatch information onto the computerised sales system. The GDN is signed.
5. The computer system produces the sales invoice, with reference to the inventory master file for product details and prices, maintains the sales day book and also the receivables ledger. The receivables control account is balanced by the computer.
6. Invoices are printed out and sent to each customer in the post with paper copies maintained in the accounts department. Invoices are compared to GDNs by accounts staff and signed.
7. Paper copies of the receivables ledger control account and list of aged receivables are also available.
8. Error reports are produced showing breaks in the GDN sequence.

**Information on receivables**

The chief accountant has informed you that receivables days have increased from 45 to 60 days over the last year. The aged receivables report produced by the computer is shown below:

Number of receivables	Range of debt	Total debt \$	Current \$	1 to 2 months old \$	More than 2 months old \$
15	Less than \$0	(87,253)	(87,253)		
197	\$0 to \$20,000	2,167,762	548,894	643,523	975,345
153	\$20,001 to 50,000	5,508,077	2,044,253	2,735,073	728,751
23	\$50,001 or more	1,495,498	750,235	672,750	72,513
<u>388</u>		<u>9,084,084</u>	<u>3,256,129</u>	<u>4,051,346</u>	<u>1,776,609</u>

In view of the deteriorating receivables situation, a direct confirmation of receivables will be performed this year.

**Required:**

- (a) Explain the steps necessary to check the accuracy of the previous year's internal control questionnaires. (4 marks)
  - (b) Using information from the scenario, list SIX tests of control that an auditor would normally carry out on the despatch and sales system at Seeley Co and explain the reason for each test. (12 marks)
  - (c) State and explain the meaning of FOUR assertions that relate to the direct confirmation of receivables. (4 marks)
  - (d) (i) Describe the procedures up to despatch of letters to individual receivables in relation to a direct confirmation of receivables. (5 marks)  
(ii) Discuss which particular categories of receivables might be chosen for the sample. (5 marks)
- (30 marks)**

- 2 (a) List and explain FOUR factors that will influence the auditor's judgement regarding the sufficiency of the evidence obtained. (4 marks)
- (b) HKSA 580 *Management Representations* provides guidance on the use of management representations as audit evidence.

**Required:**

List SIX items that could be included in a management representation letter. (3 marks)

- (c) After performing tests of controls, the auditor is of the opinion that audit evidence is not sufficient to support the audit opinion; in other words many control errors were found.

**Required:**

Explain THREE actions that the auditor may now take in response to this problem. (3 marks)

**(10 marks)**

3 (a) With reference to HKSA 520 *Analytical Procedures* explain

- (i) what is meant by the term 'analytical procedures'; (2 marks)
- (ii) the different types of analytical procedures available to the auditor; and (3 marks)
- (iii) the situations in the audit when analytical procedures can be used. (3 marks)

Zak Co sells garden sheds and furniture from 15 retail outlets. Sales are made to individuals, with income being in the form of cash and debit cards. All items purchased are delivered to the customer using Zak's own delivery vans; most sheds are too big for individuals to transport in their own motor vehicles. The directors of Zak indicate that the company has had a difficult year, but are pleased to present some acceptable results to the members.

The income statements for the last two financial years are shown below:

**Income statement**

	31 March 2008	31 March 2007
	\$000	\$000
Revenue	7,482	6,364
Cost of sales	(3,520)	(4,253)
Gross profit	3,962	2,111
Operating expenses		
Administration	(1,235)	(1,320)
Selling and distribution	(981)	(689)
Interest payable	(101)	(105)
Investment income	145	–
Profit/(loss) before tax	1,790	(3)
<b>Balance sheet extract</b>		
Cash and bank	253	(950)

**Required:**

- (b) As part of your risk assessment procedures for Zak Co, identify and provide a possible explanation for unusual changes in the income statement. (9 marks)
- (c) Confirmation of the end of year bank balances is an important audit procedure.

**Required:**

Explain the procedures necessary to obtain a bank confirmation letter from Zak Co's bank. (3 marks)

**(20 marks)**

4 (a) **Discuss the advantages and disadvantages of outsourcing an internal audit department.** (8 marks)

(b) MonteHodge Co has a sales income of \$253 million and employs 1,200 people in 15 different locations. MonteHodge Co provides various financial services from pension and investment advice to individuals, to maintaining cash books and cash forecasting in small to medium-sized companies. The company is owned by six shareholders, who belong to the same family; it is not listed on any stock-exchange and the shareholders have no intention of applying for a listing. However, an annual audit is required by statute and additional regulation of the financial services sector is expected in the near future.

Most employees are provided with on-line, real-time computer systems, which present financial and stock market information to enable the employees to provide up-to-date advice to their clients. Accounting systems record income, which is based on fees generated from investment advice. Expenditure is mainly fixed, being salaries, office rent, lighting and heating, etc. Internal control systems are limited; the directors tending to trust staff and being more concerned with making profits than implementing detailed controls.

Four of the shareholders are board members, with one member being the chairman and chief executive officer. The financial accountant is not qualified, although has many years experience in preparing financial statements.

**Required:**

**Discuss the reasons for and against having an internal audit department in MonteHodge Co.** (12 marks)

**(20 marks)**

5 Smithson Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.

The annual audit is nearly complete. As audit senior you have reported to the engagement partner that Smithson is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where Smithson's services to assist the prosecution were found to be in error. Not only did this provide adverse publicity for Smithson, but a number of clients withdrew their contracts. A senior employee then left Smithson, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company.

A cash flow forecast prepared internally shows Smithson requiring significant additional cash within the next 12 months to maintain even the current level of services. Smithson's auditors have been asked to provide a negative assurance report on this forecast.

**Required:**

(a) **Define 'going concern' and discuss the auditor's responsibilities in respect of going concern.** (4 marks)

(b) **State the audit procedures that may be carried out to try to determine whether or not Smithson Co is a going concern.** (8 marks)

(c) **Explain the audit procedures the auditor may take where the auditor has decided that Smithson Co is unlikely to be a going concern.** (4 marks)

(d) **In the context of the cash flow forecast, define the term 'negative assurance' and explain how this differs from the assurance provided by an audit report on statutory financial statements.** (4 marks)

**(20 marks)**

**End of Question Paper**