Applied Skills

Audit and Assurance (AA)

March/June 2019 – Sample Questions

AA ACCA

AA

Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:

Section A – ALL 15 questions are compulsory and MUST be attempted

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

Do NOT open this question paper until instructed by the supervisor.

Do NOT record any of your answers on the question paper.

This question paper must not be removed from the examination hall.

Think Ahead ACCA

The Association of Chartered Certified Accountants

Section A – ALL 15 questions are compulsory and MUST be attempted

Please use the grid provided on page two of the Candidate Answer Booklet to record your answers to each multiple choice question. Do not write out the answers to the MCQs on the lined pages of the answer booklet.

Each question is worth 2 marks.

The following scenario relates to questions 1–5

You are an audit manager at Horti & Co and you are considering a number of ethical issues which have arisen on some of the firm's long-standing audit clients.

Tree Co
Horti & Co is planning its external audit of Tree Co. Yesterday, the audit engagement partner, Charlie Thrower, discovered that a significant fee for information security services, which were provided to Tree Co by Horti & Co, is overdue. Charlie hopes to be able to resolve the dispute amicably and has confirmed that he will discuss the matter with the finance director, Percy Marsh, at the weekend, as they are both attending a party to celebrate the engagement of Charlie's daughter and Percy's son.

Bush Co
Horti & Co is the external auditor of Bush Co and also provides other non-audit services to the company. While performing the audit for the year ended 31 October 20X8, the audit engagement partner was taken ill and took an indefinite leave of absence from the firm. The ethics partner has identified the following potential replacements and is keen that independence is maintained to the highest level:

Brian Smith	who is also the partner in charge of the tax services provided to Bush Co
Monty Nod	who was the audit engagement partner for the ten years ended 31 October 20X7
Cassie Dixon	who introduced Bush Co as a client when she joined the firm as an audit partner five years ago
Pete Russo	who is also the partner in charge of the payroll services provided to Bush Co

Plant Co
Plant Co is a large private company, with a financial year to 30 June, and has been an audit client of Horti & Co for several years. Alan Marshlow, a partner of Horti & Co, has acted as the engagement quality control reviewer (EQCR) on the last two audits to the year ended 30 June 20X8. At a recent meeting, he advised that he can no longer be EQCR on the engagement as he is considering accepting appointment as a non-executive director and will sit on the audit committee of Plant Co.

The board of directors has also asked Horti & Co if they would be able to provide internal audit services to the company.

Weed Co
Weed Co, a listed company, is one of Horti & Co's largest clients. Last year the fee for audit and other services was $1·2m and this year it is expected to be $1·3m which represents 16·6% and 18·1% of Horti & Co's total income respectively.

1 Which of the following statements correctly explains the possible threats to Horti & Co's independence and recommends an appropriate safeguard in relation to their audit of Tree Co?

(1) An intimidation threat exists due to the overdue fee and Tree Co should be advised that all fees must be paid prior to the auditor's report being signed
(2) A self-review threat exists due to the nature of the non-audit work which has been performed and an engagement quality control review should be carried out
(3) A self-interest threat exists due to the relationship between Charlie and Percy and Charlie should be removed as audit partner

A 1, 2 and 3
B 1 and 2 only
C 2 only
D 3 only

2 Taking into account the concern of the ethics partner, which of the partners identified as potential replacements should take over the audit of Bush Co for the year ended 31 October 20X8?

A Brian Smith
B Monty Nod
C Cassie Dixon
D Pete Russo

3 Which of the following correctly identifies the threats to Horti & Co's independence and proposes an appropriate course of action for the firm if Alan Marshlow accepts appointment as a non-executive director of Plant Co?

	Threats	Course of action
A	Self-interest and familiarity	Can continue with appropriate safeguards
B	Self-interest and self-review	Must resign as auditor
C	Self-review and familiarity	Must resign as auditor
D	Familiarity only	Can continue with appropriate safeguards

4 You are separately considering Plant Co's request to provide internal audit services and the remit of these services if they are accepted.

Which of the following would result in Horti & Co assuming a management responsibility in relation to the internal audit services?

(1) Taking responsibility for designing and maintaining internal control systems
(2) Determining which recommendations should take priority and be implemented
(3) Determining the reliance which can be placed on the work of internal audit for the external audit
(4) Setting the scope of the internal audit work to be carried out

A 1 and 3
B 2, 3 and 4
C 1, 2 and 4
D 3 and 4 only

5 Which of the following actions should Horti & Co take to maintain their objectivity in relation to the level of fee income from Weed Co?

(1) The level of fee income should be communicated to those charged with governance
(2) Separate teams should be used for the audit and non-audit work
(3) Request payment of the current year's audit fee in advance of any work being performed
(4) Request a pre-issuance review be conducted by an external accountant

A 1 and 4 only
B 3 and 4 only
C 2 and 3 only
D 1, 2, 3 and 4

The following scenario relates to questions 6–10

Chester Co manufactures and sells pet toys to the wholesale market. It has prepared its financial statements to 31 July 20X8. You are an audit assistant with Durham & Co and you have been assigned the current liabilities balances in the audit work plan.

You have calculated the payables payment period to be 66 days in 20X8 (45 days in 20X7) and have asked the directors of Chester Co to provide an explanation as to the increase in days.

Chester Co receives monthly statements from its main suppliers and performs regular supplier statement reconciliations. There were inconsistencies noted in respect of the following at 31 July 20X8:

Supplier	Balance per purchase ledger	Balance per supplier statement
	$	$
Oxford Co	151,480	296,120
Poole Co	(72,168)	84,235
Bath Co	82,348	92,340

Oxford Co
Chester Co has a credit agreement with Oxford Co under which it receives goods 14 days before the supplier raises the invoice. Chester Co received goods worth $144,640 on 18 July 20X8 for which the invoice was received shortly after the year end in accordance with the agreement. Chester Co entered the transaction into its accounting records at the date of invoice.

Poole Co
The difference on this balance has still to be investigated.

Bath Co
Chester Co's finance director has informed you that there was an error in closing the purchase ledger and it was closed three days early. Invoices received 29, 30 and 31 July 20X8 were posted to the 20X9 ledger. The directors of Chester Co have confirmed that following the discovery of this error, a manual adjustment was made using the journal book.

6 Which of the following supplier balances would indicate a high risk in relation to the COMPLETENESS of the liability recorded at the year end?

A A supplier with a high balance at the year end and with a low volume of transactions during the year
B A supplier with a low balance at the year end and with a high volume of transactions during the year
C A supplier with a low balance at the year end and with a low volume of transactions during the year
D A supplier with a high balance at the year end and with a high volume of transactions during the year

7 Which of the following would correctly explain why the payables payment period has increased from 45 days in 20X7 to 66 days in 20X8?

A Chester Co received a prompt payment discount from one of its suppliers for the first time in 20X8
B Chester Co obtained a trade discount from one of its biggest suppliers which has reduced the amount owed to that supplier by 10% in the year
C Chester Co purchased an unusually high level of goods in July 20X8 to satisfy a large order and had not paid for those goods by the year end
D Chester Co took advantage of extended credit terms offered by a new supplier in respect of a large order which it had fully settled by the year end

8 Which of the following is an appropriate action in respect of the inconsistency in the balance with Oxford Co?

A The auditor should take no further action as this is a timing difference which was resolved upon receipt and posting of the invoice

B The auditor should request that the purchase ledger balance is amended at the reporting date to reflect the recent invoice

C The auditor should contact the supplier and request a supplier statement as at the current date

D The auditor should request that an accrual is created in respect of the goods received but not yet invoiced

9 Which of the following would be a valid explanation for the difference in respect of Poole Co?

(1) An invoice for $156,403 has been paid twice

(2) An invoice for $156,403 has been posted as a debit note

(3) An invoice for $156,403 has been received and processed prior to receipt of the goods

A 1 only

B 1 and 2 only

C 2 and 3 only

D 1, 2 and 3

10 Which of the following would NOT provide sufficient and appropriate audit evidence over the COMPLETENESS of the purchase ledger balance in respect of Bath Co?

A Obtain the journal book and confirm that all invoices recorded as received from Bath Co dated 29–31 July have been manually adjusted for

B Review the accruals listing to ensure goods received from Bath Co post year end for which an invoice has not been received have been recorded in the correct period

C For post year-end cash book payments to Bath Co, confirm date of matching invoice and if pre year end agree to liability

D Review a sample of invoices received from Bath Co recorded post year end and match to GRN to determine if they should have been recorded at the year end

The following scenario relates to questions 11–15

Viola Co is a manufacturer of shoes. You are an audit manager with Cello & Co and you are performing an overall review of the financial statements for the year ended 30 September 20X8 prior to the issue of the auditor's report. Profit before tax for the year was $131·4m (20X7: $120·9m).

Analytical procedures
As part of your overall review, you have performed analytical procedures over the draft financial statements and have noted that the trade receivables collection period is lower than it was during the interim audit performed in July 20X8. You are aware that the credit controller of Viola Co left the company in August 20X8 and that the directors have said that, as a result, the company is experiencing difficulties in debt collection.

Disclosures
During the year, Viola Co revalued its head office and as part of your review, you are considering the detail which is disclosed in the property, plant and equipment note in the draft financial statements.

Uncorrected misstatements
Your review also includes an assessment of uncorrected misstatements. These have been recorded by the audit team as follows:

		$'000
(1)	Interest payable omitted in error	1,942
(2)	Additional allowance for receivables required	9,198
(3)	Error in sales invoice processing resulting in understatement of sales	8,541
(4)	Write off in respect of faulty goods	2,900

Faulty goods
The adjustment for faulty goods listed as an uncorrected misstatement above relates to an entire batch of shoes, which was produced on 12 September 20X8. The audit work concluded that the cost of this inventory exceeded its net realisable value by $2·9m. The directors dispute the audit team's figures and believe that the realisable value of the inventory still exceeds its cost.

11 Which of the following would form part of the auditor's overall review of the financial statements?

(1) Establishing whether the pre-conditions for an audit are present
(2) Assessing whether the information and explanations obtained during the audit are adequately reflected
(3) Performing a detailed review of the audit working papers to ensure the work has been properly performed
(4) Reviewing the adequacy of the disclosure of accounting policies

A 1 and 2
B 3 and 4
C 1 and 3
D 2 and 4

12 Which of the following is a valid explanation for the INCONSISTENCY between the results of the analytical procedures on trade receivables and the directors' statement regarding debt collection problems?

A A change in sales mix towards high value products
B An increase in the proportion of cash sales since August 20X8
C An increase in the rate of sales tax in September 20X8
D Sales growth of 1% per month over the year

13 Which of the following details should be disclosed in respect of the revaluation of the head office if the auditor is to conclude that the disclosures are adequate?

(1) Effective date of the revaluation
(2) Name of the valuer
(3) The amount of the revaluation increase
(4) Carrying amount of the head office under the cost model

A 1, 2 and 3 only
B 1, 3 and 4 only
C 2, 3 and 4 only
D 1, 2, 3 and 4

14 Which of the uncorrected misstatements numbered (1), (2) and (3) by the audit team MUST be adjusted for if the auditor is to issue an unmodified audit opinion?

A Misstatements 2 and 3 only
B Misstatements 1 and 3 only
C Misstatements 1, 2 and 3
D Misstatement 2 only

15 All adjustments required by the auditors have been made to the financial statements with the exception of adjustment (4) relating to the faulty goods.

Which of the following correctly describes the effect of this matter on the auditor's report?

A Unmodified opinion with no further disclosure
B Unmodified opinion with disclosure in an emphasis of matter paragraph
C Qualified opinion due to material misstatement
D Qualified opinion due to inability to obtain sufficient appropriate audit evidence

(30 marks)

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

Please write your answers to all parts of these questions on the lined pages within the Candidate Answer Booklet.

16 (a) Auditors are required to document a company's accounting and internal control systems as part of their audit process. Two methods available for documenting internal control systems are narrative notes and questionnaires.

Required:

For each of the two methods, NARRATIVE NOTES and QUESTIONNAIRES:

(i) Describe the method for documenting internal control systems; and
(ii) Explain an ADVANTAGE of using this method.

Note: The total marks will be split equally between each part. (4 marks)

Freesia Co is a company listed on a stock exchange. It manufactures furniture which it supplies to a wide range of retailers across the region. The company has an internal audit (IA) department and the company's year end is 30 June 20X9. You are an audit supervisor with Zinnia & Co, preparing the draft audit programmes and reviewing extracts from the internal controls documentation in preparation for the interim audit.

Sales

Freesia Co generates revenue through visits by its sales staff to customers' premises. Sales ledger clerks, who work at head office, carry out credit checks on new customers prior to being accepted and then set their credit limits. Sales staff visit retail customers' sites personally and orders are completed using a four-part pre-printed order form. One copy is left with the customer, a second copy is returned to the sales ordering department, the third is sent to the warehouse and the fourth to the finance department at head office. Each sales order number is based on the sales person's own identification number in order to facilitate monitoring of sales staff performance.

Retail customers are given payment terms of 30 days and most customers choose to pay their invoices by bank transfer. Each day Lily Shah, a finance clerk, posts the bank transfer receipts from the bank statements to the cash book and updates the sales ledger. On a monthly basis, she performs the bank reconciliation.

Purchases and inventory

Receipts of raw materials and goods from suppliers are processed by the warehouse team at head office, who agree the delivery to the purchase order, check the quantity and quality of goods and complete a sequentially numbered goods received note (GRN). The GRNs are sent to the finance department daily. On receipt of the purchase invoice from the supplier, Camilla Brown, the purchase ledger clerk, matches it to the GRN and order and the three documents are sent for authorisation by the appropriate individual. Once authorised, the purchase invoices are logged into the purchase ledger by Camilla, who utilises document count controls to ensure the correct number of invoices has been input.

The company values its inventory using standard costs, both for internal management reporting and for inclusion in the year-end financial statements. The basis of the standard costs was reviewed approximately 18 months ago.

Payroll

Freesia Co employs a mixture of factory staff, who work a standard shift of eight hours a day, and administration and sales staff who are salaried. All staff are paid monthly by bank transfer. Occasionally, overtime is required of factory staff. Where this occurs, details of overtime worked per employee is collated and submitted to the payroll department by a production clerk. The payroll department pays this overtime in the month it occurs. At the end of each quarter, the company's payroll department sends overtime reports which detail the amount of overtime worked to the production director for their review.

Freesia Co's payroll package produces a list of payments per employee which links into the bank system to produce a list of automatic bank transfer payments. The finance director reviews the total to be paid on the list of automatic payments and compares this to the total payroll amount to be paid for the month per the payroll records. If any issues arise, then the automatic bank transfer can be manually changed by the finance director.

Required:

(b) In respect of the internal controls of Freesia Co:

(i) Identify and explain SIX deficiencies;
(ii) Recommend a control to address each of these deficiencies; and
(iii) Describe a TEST OF CONTROL the external auditors should perform to assess if each of these controls, if implemented, is operating effectively to reduce the identified deficiency.

Note: Prepare your answer using three columns headed Control deficiency, Control recommendation and Test of control respectively. The total marks will be split equally between each part. (18 marks)

Freesia Co deducts employment taxes from its employees' wages and salaries 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 employment tax payable.

Required:

(c) Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in respect of Freesia Co's year-end accrual for employment tax payable. (4 marks)

The listing rules of the stock exchange require compliance with corporate governance principles and the directors of Freesia Co are confident that they are following best practice in relation to this. However, the chairman recently received correspondence from a shareholder, who is concerned that the company is not fully compliant. The company's finance director has therefore requested a review of the company's compliance with corporate governance principles.

Freesia Co has been listed for over eight years and its board comprises four executive and four independent non-executive directors (NEDs), excluding the chairman. An audit committee comprised of the NEDs and the finance director meets each quarter to review the company's internal controls.

The directors' remuneration is set by the finance director. NEDs are paid a fixed fee for their services and executive directors are paid an annual salary as well as a significant annual bonus based on Freesia Co's profits. The company's chairman does not have an executive role and so she has sole responsibility for liaising with the shareholders and answering any of their questions.

Required:

(d) Describe TWO corporate governance weaknesses faced by Freesia Co and provide a recommendation to address each weakness to ensure compliance with corporate governance principles.

Note: Prepare your answer using two columns headed Weakness and Recommendation respectively.

(4 marks)

(30 marks)

17 (a) Define and explain materiality and performance materiality. (4 marks)

You are an audit supervisor of Daffodil & Co and are planning the audit of Peony Co for the year ending 31 May 20X9. The company is a food retailer with a large network of stores across the country and four warehouses. The company has been a client of your firm for several years and the forecast profit before tax is $28·9m. The audit manager has attended a planning meeting with the finance director and has provided you with the following notes of the meeting.

Planning meeting notes

Peony Co has an internal audit (IA) department which undertakes controls testing across the network of stores. Each store is visited at least once every 18 months. The audit manager has discussed with the finance director that the external audit team may rely on the controls testing which is undertaken by IA.

During the meeting, the finance director provided some forecast financial information. Revenue for the year is expected to increase by 3% as compared to 20X8; the gross margin is expected to increase from 56% to 60%; and the operating margin is predicted to decrease from 21% to 18%.

Peony Co values inventory in line with industry practice, which is to use selling price less average profit margin. The directors consider this to be a close approximation to cost.

The company does not undertake a full year-end inventory count and instead undertakes monthly perpetual inventory counts, each of which covers one-twelfth of all lines in stores and the warehouses. As part of the interim audit which was completed in January, an audit junior attended a perpetual inventory count at one of the warehouses and noted that there were a large number of exceptions where the inventory records showed a higher quantity than the physical inventory which was present in the warehouse. When discussing these exceptions with the financial controller, the audit junior was informed that this had been a recurring issue.

During the year, IA performed a review of the non-current assets physically present in around one-third of the company's stores. A number of assets which had not been fully depreciated were identified as obsolete by this review.

The company launched a significant TV advertising campaign in January 20X9 in order to increase revenue. The directors have indicated that at the year end a current asset of $0·7m will be recognised, as they believe that the advertisements will help to boost future sales in the next 12 months. The last advertisement will be shown on TV in early May 20X9.

Peony Co decided to outsource its payroll function to an external service organisation. This service organisation handles all elements of the payroll cycle and sends monthly reports to Peony Co which detail wages and salaries and statutory obligations. Peony Co maintained its own payroll records until 31 December 20X8, at which point the records were transferred to the service organisation.

Peony Co is planning to expand the company by opening three new stores during July 20X9 and in order to finance this, in March 20X9 the company obtained a $3m bank loan. This is repayable in arrears over five years in quarterly instalments. In preparation for the expansion, the company is looking to streamline operations in the warehouses and is planning to make approximately 60 employees redundant after the year end. No decision has been made as to when this will be announced, but it is likely to be in May 20X9.

Required:

(b) Describe EIGHT audit risks and explain the auditor's response to each risk in planning the audit of Peony Co.

Note: Prepare your answer using two columns headed Audit risk and Auditor's response respectively.

(16 marks)

(20 marks)

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Question 18 begins on page 12.

18 Hyacinth Co develops and manufactures computer components and its year end was 31 December 20X8. The company has a large factory, and two warehouses, one of which is off-site. You are an audit supervisor of Tulip & Co and the final audit is due to commence shortly. Draft financial statements show total assets of $23·2m and profit before tax of $6·4m. The following three matters have been brought to your attention:

Inventory valuation

Your firm attended the year-end inventory count for Hyacinth Co and confirmed that the controls and processes for recording work in progress (WIP) and finished goods were acceptable. WIP and finished goods are both material to the financial statements and the audit team was able to confirm both the quantity and stage of completion of WIP.

Before goods are dispatched, they are inspected by the company's quality control department. Just prior to the inventory count, it was noted that a batch of product line 'Crocus', which had been produced to meet a customer's specific technical requirements, did not meet that customer's quality and technical standards. This inventory had a production cost of $450,000. Upon discussions with the production supervisor, the finance director believes that the inventory can still be sold to alternative customers at a discounted price of $90,000.

Research and development

Hyacinth Co includes expenditure incurred in developing new products within intangible assets once the recognition criteria under IAS® 38 *Intangible Assets* have been met. Intangible assets are amortised on a straight line basis over four years once production commences. The amortisation policy is based on past experience of the likely useful lives of the products. The opening balance of intangible assets is $1·9m.

In the current year, Hyacinth Co spent $0·8m developing three new products which are all at different stages of development.

Sales tax liability

Hyacinth Co is required by the relevant tax authority in the country in which it operates to charge sales tax at 15% on all products which it sells. This sales tax is payable to the tax authority. When purchasing raw materials and incurring expenses in the manufacturing process, the company pays 15% sales tax on any items purchased and this can be reclaimed from the tax authority. The company is required to report the taxes charged and incurred by completing a tax return on a quarterly basis, and the net amount owing to the tax authority must be remitted within four weeks of the quarter end. The draft financial statements contain a $1·1m liability for sales tax for the quarter ended 31 December 20X8.

Required:

(a) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the VALUATION of Hyacinth Co's inventory. (6 marks)

(b) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Hyacinth Co's research and development expenditure. (4 marks)

(c) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Hyacinth Co's year-end sales tax liability. (4 marks)

The audit is now almost complete and the auditor's report is due to be signed shortly. The following matter has been brought to your attention:

On 3 February 20X9, a flood occurred at the off-site warehouse. This resulted in some damage to inventory and property, plant and equipment. However, there have been no significant delays to customer deliveries or complaints from customers. Hyacinth Co's management has investigated the cause of the flooding and believes that the company is unlikely to be able to claim on its insurance. The finance director of Hyacinth Co has estimated that the value of damaged inventory and property, plant and equipment was $0·7m and that it now has no scrap value.

Required:

(d) (i) Explain whether the 20X8 financial statements of Hyacinth Co require amendment in relation to the flood; and

(ii) Describe audit procedures which should be performed in order to form a conclusion on any required amendment.

Note: The total marks will be split equally between each part. (6 marks)

(20 marks)

End of Question Paper