



# AUDIT PRACTICE & ASSURANCE SERVICES

## PROFESSIONAL 2 EXAMINATION – JULY 2019

### NOTES:

**Answer the Question in Section A**

**Answer only 2 Questions in Section B**

### TIME ALLOWED:

3 hours plus **20 minutes** to read the paper

### INSTRUCTIONS:

During the reading time you may write on the examination paper, but you may not commence writing in your answer book. **Please read each Question carefully.**

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

**Start your answer to each question on a new page.**

You are reminded to pay particular attention to your communication skills, and care must be taken regarding the format and literacy of your solutions. The marking system will take into account the content of your answers and the extent to which answers are supported with relevant legislation, case law or examples, where appropriate.

List of the cover of each answer booklet, in the space provided, the number of each question attempted.

## **SECTION A QUESTION 1 – THIS QUESTION IS COMPULSORY AND MUST BE ATTEMPTED**

Serendip PLC (Serendip) operates a chain of hotels across the country. Serendip employs in excess of 250 permanent employees and its year end is 31 March 2019. You are the audit supervisor of KWC audit firm and are currently reviewing the documentation of Serendip's payroll system, detailed below, in preparation for the interim audit.

### **Serendip'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 Serendip Co:

- (i) Identify and explain FIVE deficiencies;
- (ii) Recommend a control to address each of these deficiencies; and

(iii) Describe a test of control KWC should perform to assess if each of these controls is operating effectively.

Note: The total marks will be split equally between each part. **(24 marks)**

(b) Explain the difference between an interim and a final audit. **(6 marks)**

(c) Describe substantive procedures you should perform at the final audit to confirm the completeness and accuracy of Serendip Co's payroll expense. **(10 marks)**

Serendip 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. **(10 marks)**

**(Total 50 marks)**

## SECTION B – ANSWER ONLY TWO QUESTIONS

### Question 2

Nano Motor Cars Co (Nano) manufactures a range of motor cars and its year end is 31 March 2019. You are the audit supervisor of SSMG & Co and are currently preparing the audit programmes for the year-end audit of Nano. You have had a meeting with your audit manager and he has notified you of a number of issues identified during the audit risk assessment process.

#### Land and buildings

Nano have a policy of revaluing land and buildings, this is undertaken on a rolling basis over a five-year period. During the year Nano requested an external valuer to revalue a number of properties, including a warehouse purchased in May 2018. Depreciation is charged on a pro rata basis.

#### Work in progress

Nano undertakes continuous production of cars, 24 hours a day, seven days a week. An inventory count is to be undertaken at the year end and SSMG & Co will attend. You are responsible for the audit of work in progress (WIP) and will be part of the team attending the count as well as the final audit. WIP constitutes the partly assembled cars at the year end and this balance is likely to be material. Nano values WIP according to percentage of completion, and standard costs are then applied to these percentages.

#### Required:

(a) Explain the factors SSMG & Co should consider when placing reliance on the work of the independent valuer. **(7 marks)**

(b) Describe the substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to:

(i) The revaluation of land and buildings and the recently purchased warehouse; and **(6 marks)**

(ii) The valuation of work in progress. **(5 marks)**

(c) During the audit, your team has identified an error in the valuation of work in progress, as a number of the assumptions contain out of date information. The directors of Nano have indicated that they do not wish to amend the financial statements.

**Required:** Explain the steps SSMG & Co should now take and the impact on the audit report in relation to the directors' refusal to amend the financial statements. **(7 marks)**

**(Total 25 marks)**

### Question 3

You are the audit supervisor of Silva & Co and are currently planning the audit of an existing client, Ginasena Limited (Ginasena), whose year end was 31 March 2019. Ginasena is a pharmaceutical company, which manufactures and supplies a wide range of medical supplies. The draft financial statements show revenue of SLR 3.6 billion and profit before tax of SLR 500.9 million.

Ginasena's previous finance director left the company in December 2018 after it was discovered that he had been claiming fraudulent expenses from the company for a significant period of time. A new finance director was appointed in January 2019 who was previously a financial controller of a bank, and she has expressed surprise that Maple & Co had not uncovered the fraud during last year's audit.

During the year Ginasena has spent SLR 100.8 million on developing several new products. These projects are at different stages of development and the draft financial statements show the full amount of SLR 100.8 million within intangible assets. In order to fund this development, SLR 200 million was borrowed from the bank and is due for repayment over a ten-year period. The bank has attached minimum profit targets as part of the loan covenants.

The new finance director has informed the audit partner that since the year end there has been an increased number of sales returns and that in the month of April over SLR 50 million of goods sold in March were returned.

Silva & Co attended the year-end inventory count at Ginasena's warehouse. The auditor present raised concerns that during the count there were movements of goods in and out the warehouse and this process did not seem well controlled.

During the year, a review of plant and equipment in the factory was undertaken and surplus plant was sold, resulting in a profit on disposal of SLR 30.7m

#### **Required:**

- (a) State Silva & Co's responsibilities in relation to the prevention and detection of fraud and error. **(7 marks)**
- (b) Describe SIX audit risks, and explain the auditor's response to each risk, in planning the audit of Ginasena Science Co. **(12 marks)**
- (c) Ginasena's new finance director has read about review engagements and is interested in the possibility of Maple & Co undertaking these in the future. However, she is unsure how these engagements differ from an external audit and how much assurance would be gained from this type of engagement.

**Required:**

- (i) Explain the purpose of review engagements and how these differ from external audits; and **(3 marks)**
- (ii)** (ii) Describe the level of assurance provided by external audits and review engagements. **(3 marks)**

**(Total 25 marks)**

#### Question 4

Harbots Ltd manufactures chemical compounds using a continuous production process. Its year end was 31 March 2019 and the draft profit before tax is SLR 130.6 million. You are the audit supervisor and the year-end audit is due to commence shortly. The following matters have been brought to your attention.

- (i) Revaluation of property, plant and equipment (PPE)

At the beginning of the year, management undertook an extensive review of Harbots Ltd's non-current asset valuations and as a result decided to update the carrying value of all PPE. The finance director, Peter Dullman, contacted his brother, Martin, who is a valuer and requested that Martin's firm undertake the valuation, which took place in August 2018. **(6 marks)**

- (ii) Inventory valuation Your firm attended the year-end inventory count for Harbots Ltd and ascertained that the process for recording work in progress (WIP) and finished goods was acceptable. Both WIP and finished goods are material to the financial statements and the quantity and stage of completion of all ongoing production was recorded accurately during the count. During the inventory count, the count supervisor noted that a consignment of finished goods, compound E243, with a value of SLR 7.2m, was defective in that the chemical mix was incorrect. The finance director believes that compound E243 can still be sold at a discounted sum of SLR 4m. **(8 marks)**

- (iii) Bank loan

Harbots Ltd secured a bank loan of SLR 20.6 million on 1 October 2018. Repayments of SLR 2m are due quarterly, with a lump sum of SLR 8m due for repayment in January 2020. The company met all loan payments in 2018 on time, but was late in paying the January and March 20X6 repayments. **(6 marks)**

#### Required

- (a) Describe substantive procedures you should perform to obtain sufficient, appropriate audit evidence in relation to the above three matters. Note: The mark allocation is shown against each of the three matters above.
- (b) Describe the procedures which the auditor of Harbots Co should perform in assessing whether or not the company is a going concern. **(5 marks)**

**(Total 25 marks)**

**End of Question Paper**