

**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) Define audit risk and the components of audit risk.**

(4 marks)

You are an audit supervisor of Caving & Co and you are planning the audit of Hurling Co, a listed company, for the year ending 31 March 20X7. The company manufactures computer components and forecast profit before tax is \$33.6m and total assets are \$79.3m.

Hurling Co distributes its products through wholesalers as well as via its own website. The website was upgraded during the year at a cost of \$1.1m. Additionally, the company entered into a transaction in February to purchase a new warehouse which will cost \$3.2m. Hurling Co's legal advisers are working to ensure that the legal process will be completed by the year end. The company issued \$5m of irredeemable preference shares to finance the warehouse purchase.

During the year the finance director has increased the useful economic lives of fixtures and fittings from three to four years as he felt this was a more appropriate period. The finance director has informed the engagement partner that a revised credit period has been agreed with one of its wholesale customers, as they have been experiencing difficulties with repaying the balance of \$1.2m owing to Hurling Co. In January 20X7, Hurling Co introduced a new bonus based on sales targets for its sales staff. This has resulted in a significant number of new wholesale customer accounts being opened by sales staff. The new customers have been given favourable credit terms as an introductory offer, provided goods are purchased within a two-month period. As a result, revenue has increased by 5% on the prior year.

The company has launched several new products this year and all but one of these new launches have been successful. Feedback on product Luge, launched four months ago, has been mixed, and the company has just received notice from one of their customers, Petanque Co, of intended legal action. They are alleging the product sold to them was faulty, resulting in a significant loss of information and an ongoing detrimental impact on profits. As a precaution, sales of the Luge product have been halted and a product recall has been initiated for any Luge products sold in the last four months.

The finance director is keen to announce the company's financial results to the stock market earlier than last year and in order to facilitate this, he has asked if the audit could be completed in a shorter timescale. In addition, the company is intending to propose a final dividend once the financial statements are finalised.

Hurling Co's finance director has informed the audit engagement partner that one of the company's non-executive directors (NEDs) has just resigned, and he has enquired if the partners at Caving & Co can help Hurling Co in recruiting a new NED. Specifically he has requested the engagement quality control reviewer, who was until last year the audit engagement partner on Hurling Co, assist the company in this recruitment. Caving & Co also provides taxation services for Hurling Co in the form of tax return preparation along with some tax planning advice. The finance director has recommended to the audit committee of Hurling Co that this year's audit fee should be based on the company's profit before tax. At today's date, 20% of last year's audit fee is still outstanding and was due to be paid three months ago.

**Required:**

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

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

(16 marks)

**(c) (i) Identify and explain FIVE ethical threats which may affect the independence of Caving & Co's audit of Hurling Co; and  
(ii) For each threat, suggest a safeguard to reduce the risk to an acceptable level.**

Note: The total marks will be split equally between each part. Prepare your answer using two columns headed Ethical threat and Possible Safeguard respectively.

(10 marks)

**(30 marks)**

- 17** Airsoft Co is a listed company which manufactures stationery products. The company's profit before tax for the year ended 31 December 20X6 is \$16.3m and total assets as at that date are \$66.8m. You are an audit supervisor of Biathlon & Co and you are currently finalising the audit programmes for the year-end audit of your existing client Airsoft Co. You attended a meeting with your audit manager where the following matters were discussed:

**Trade payables and accruals**

Airsoft Co purchases its raw materials from a large number of suppliers. The company's policy is to close the purchase ledger just after the year end and the financial controller is responsible for identifying goods which were received pre year-end but for which no invoice has yet been received. An accrual is calculated for goods received but not yet invoiced (GRNI) and is included within trade payables and accruals.

The audit strategy has identified a risk over the completeness of trade payables and accruals. The audit team will utilise computer assisted audit techniques (CAATs), in the form of audit software while auditing trade payables and accruals.

**Bank overdraft and savings accounts**

Airsoft Co's draft financial statements include a bank overdraft of \$2.6m, which relates to the company's main current account. In addition Airsoft Co maintains a number of savings accounts. The savings account balances are classified as cash and cash equivalents and are included in current assets. All accounts have been reconciled at the year end.

**Directors' remuneration**

Airsoft Co's board is comprised of eight directors. Their overall remuneration consists of two elements: an annual salary, paid monthly; and a significant annual discretionary bonus, which is paid in a separate payment run on 20 December. All remuneration paid to directors is included within wages and salaries. Local legislation requires disclosure of the overall total of directors' remuneration broken down by element and by director.

**Required:**

- (a) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the COMPLETENESS of Airsoft Co's trade payables and accruals.** (4 marks)

**Excluding procedures included in part (a):**

- (b) **Describe audit software procedures which could be carried out during the audit of Airsoft Co's trade payables and accruals.** (3 marks)
- (c) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Airsoft Co's year-end bank balances.** (5 marks)
- (d) **Describe substantive procedures the auditor should perform to confirm the directors' remuneration included in the financial statements at the year end.** (3 marks)

A member of your audit team has asked for information on ISA 701 *Communicating Key Audit Matters in the Independent Auditor's Report* as she has heard this standard is applicable to listed clients such as Airsoft Co.

**Required:**

- (e) **Identify what a key audit matter (KAM) is and explain how the auditor determines and communicates KAM.** (5 marks)

**(20 marks)**

- 18 (a)** ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* requires auditors to obtain an understanding of control activities relevant to the audit.

Control activities are the policies and procedures which help ensure that management directives are carried out.

**Required:**

**Describe FOUR different types of control activities and, for each type, provide an example control a company may implement.** (4 marks)

Equestrian Co manufactures smartphones and tablets. Its main customers are retailers who then sell to the general public. The company's manufacturing is spread across five sites and goods are stored in its nine warehouses located across the country. You are an audit supervisor of Baseball & Co and in preparation for the forthcoming audit for the year ending 30 June 20X7, you are reviewing the following notes your audit manager has provided you with in relation to the company's internal controls.

Equestrian Co has a small internal audit (IA) department. During the year, IA started a programme of physically verifying the company's assets and comparing the results to the non-current assets register, as this type of reconciliation had not occurred for some time. To date only 15% of assets have had their existence confirmed as IA has experienced significant staff shortages and several members of the current IA team are new to Equestrian Co.

During the year, Equestrian Co conducted an extensive reorganisation of its manufacturing process to improve efficiency. Due to the significant number of employee changes required, the human resources department (HR) has been very busy and to ease their workload during this period, the payroll department has assisted by setting up any new employees who have joined the company. In January 20X7, the wage rate paid to employees was increased by the HR director and he notified payroll by emailing the payroll supervisor.

A new sales ledger system was introduced in May 20X6 and will continue to be run in parallel with the old system until IA has completed its checks between the two systems. New customers obtained by the sales team are required to undergo a full credit check; on the basis of this, a credit limit is proposed by sales staff and approved by the sales director and these credit limits remain static in the sales system.

Monthly perpetual inventory counts are undertaken at each of the nine warehouses, as a full year-end inventory count is too disruptive for the company. High value items are stored in a secure area in each warehouse. Access is via a four digit code, which for convenience is the same across all sites. Due to the company's reorganisation programme, some of the monthly inventory counts were not performed.

Bank reconciliations are undertaken monthly by an accounts clerk and details of all reconciling items are included. Where the sum of the reconciling items is significant, the reconciliation is sent to the financial controller for review. In order to maximise cash balances, the finance director approves all purchase invoices for payment 75 days after receipt of the invoice.

**Required:**

- (b) Identify and explain EIGHT deficiencies in Equestrian Co's internal controls and provide a recommendation to address each of these deficiencies.**

**Note:** Prepare your answer using two columns headed Control deficiency and Control recommendation respectively. (16 marks)

**(20 marks)**

**End of Question Paper**