Answers

Section A

Question	Answer	See Note Below
1	**D**	**1**
2	**C**	**2**
3	**B**	**3**
4	**A**	**4**
5	**C**	**5**
6	**D**	**6**
7	**B**	**7**
8	**C**	**8**
9	**A**	**9**
10	**C**	**10**

NOTES

(1) Confirmation of completeness of recording in the company's accounting records is a particular problem for an auditor, where the internal controls are weak. This is because lack of adequate controls leads to systems objectives not being met and there is often a lack of an audit trail to evidence the inception of transactions through to completion.

(2) As the auditors of Three Co have concluded that the internal controls of the company are unreliable they cannot rely on them and will have to adopt a substantive procedures approach when conducting the final audit of the company's financial statements. This will involve extensive testing of transactions for the whole accounting period in addition to the verification of the items in the statement of financial position and a review of the financial statements. Options (A) (B) and (D) do not allow the necessary substantive testing to be carried out.

(3) The main purpose of the engagement letter is to clearly define the extent of the responsibilities of the auditor and so minimise the possibility of any misunderstanding between the client company and the auditor in this respect.

(4) Analytical procedures must be applied as a risk assessment tool at the planning stage of the audit and to assist in understanding the business. They must also be used in the overall review stage at the end of the audit when forming an overall conclusion as to whether the financial statements are consistent with the auditor's knowledge of the business. Analytical procedures can also prove to be very beneficial when used as substantive procedures to reduce detection risk.

(5) A management representation letter contains confirmations from management on matters relevant only to the audit of the financial statements subject to audit. It should therefore be retained on the current file.

(6) Internal Control Evaluation Questionnaires contain key control questions which focus on the objectives of the system under review. Questions (2), (3) and (4) all focus on the objectives of a payroll system, whilst question (1) focuses on a control procedure only.

(7) The auditor is not an employee of the client company and should therefore take no active part in the inventory count. Having observed the inventory count the auditor can judge the extent to which (s)he will rely on the inventory count records as a basis for verifying the inventory as reported in the company's financial statements.

(8) Sales commissions should not be accounted for in the trading account and thus should not affect reported gross profit. Sales volumes combined with other factors could also be accompanied by an increased gross profit percentage. Any settlement discounts received should not be accounted for in the trading account and thus should not affect reported gross profit. An increase in the cost of sales as explained in option (C) would be consistent with the noted decrease in gross profit.

(9) The limitation on the scope of the auditors' work has created material uncertainty with regard to one particular aspect of the company's financial statements. However, whilst the matter is considered to be material (if it was immaterial then it would be ignored by the auditors), it is not considered to be pervasive to the financial statements. Consequently the auditors should express an 'except for' opinion in the financial statements. If the auditors did consider the matter under review to be pervasive to the financial statements then they should express a 'disclaimer' of opinion.

(10) Whilst options (A), (B) and (D) may provide corroborative evidence as to the ownership of the freehold office building, the evidence they provide is insufficient and not as reliable as that provided by inspecting the title deeds to the building. The deeds provide independent reliable confirmation of ownership.

Section B

1 ACE CO

(a) The objectives of a sales and trade receivables system are to ensure that:

(i) Customer orders are executed promptly and efficiently.

(ii) All goods and services provided by the company are invoiced.

(iii) Sales invoices are raised promptly.

(iv) Sales invoice prices are correct.

(v) Customers are credited for authorised returns and faulty services.

(vi) Sales transactions are recorded promptly, accurately and completely in the company's accounting records.

(vii) Invoices are paid in accordance with the trading terms of the company.

(viii) Bad debts are minimised.

(ix) There is early recognition of bad debts together with prompt, accurate and complete recording of these in the company's accounting records.

(Full marks will be awarded for stating five of the above or other appropriate objectives)

(b) (i) Weakness
Sales representatives are responsible for actioning all aspects of credit control.

Implications of Weakness
There is an increased risk that Ace Co will incur bad debts. This is because sales representatives have a conflict of interest in maximising sales to customers whilst being responsible for minimising the risk of bad debts arising. The problem is compounded by the fact that sales representatives receive bonus payments based on sales figures achieved.

Recommendation
Sales representatives should not be integral to the company's credit control function. The function should be managed and controlled by a responsible official employed by Ace Co (a credit controller), and the appointee should be independent of both the sales and the sales accounting functions.

(ii) Weakness
Purchase orders are accepted from prospective customers on the basis of a simple e-mail confirmation to Ace Co.

Implications of Weakness
There is an increased risk of customer disputes over orders despatched and consequential losses to Ace Co. There is also an increased risk of loss to the company as a consequence of goods being delivered against fraudulent orders placed with the company.

Recommendation
The company should introduce robust procedures to facilitate clarity and certainty in the customer ordering process. This should include a requirement to forward to Ace Co a fully detailed authorised purchase order either electronically or by delivery to the company's premises. For exceptionally large or unusual orders, procedures should be modified to ensure checking and authorisation by the sales manager as a means of additional control, prior to order acceptance.

(iii) Weakness
Invoices are forwarded to the customers merely on receipt of a customer order.

Implications of Weakness
There is a very high risk that sales revenues will be recognised incorrectly, prior to the receipt of goods sold being received by customers. Consequently, there is a similar risk that reported profits will be overstated.

Recommendation
Sales invoices should be forwarded to customers only on confirmation of receipt of goods by customers. To facilitate ease and efficiency of communication in this regard, a copy of the completed goods delivery note should be forwarded by the warehouse to the sales department as a basis for invoicing following confirmation of delivery to customers.

(iv) Weakness
Sales bonuses are paid against invoices raised, with invoices being sent without evidence of the receipt of goods by customers.

Implications of Weakness
There is a high risk of the company making bonus payments in respect of non-completed sales transactions.

Recommendation
Sales bonuses should be paid against sales invoices duly authorised by the sales manager, with invoices being authorised and forwarded for processing only after proof of receipt of goods as ordered by customers. To facilitate internal

checking, bonus calculations should be calculated independently of the sales department and then authorised by an independent responsible official. Authorised bonus payments should then be forwarded to Ace Co's wages department for processing through the company's payroll.

(v) Weakness
There are inadequate controls over the opening of customer accounts in the trade receivables ledger.

Implications of Weakness
There is an increased risk of Ace Co incurring losses as a consequence of bad debts arising on sales to un-creditworthy customers and a risk of loss as a consequence of deliveries to fictitious customers.

Recommendation
Rigorous control procedures should be exercised over the opening of customer accounts. These should include thorough credit checks, the obtaining of trade/bank references and the setting of appropriate credit limits for customers. Strict control should be maintained over the updating of the trade receivables master file, with appropriate segregation of duties for sales and accounts staff and the authorisation of new customer accounts by a responsible official of the company (for example the accountant or financial director of Ace Co).

(vi) Weakness
There is an inadequate audit trail of sales transactions in Ace Co's accounts department. Revenue pertaining to sales transactions should be recognised at the point of delivery of machines ordered by customers. The signed delivery notes acknowledging receipt by customers are therefore key to Ace Co's accounting function in determining the date that sales transactions should be recognised in the company's accounting records. Currently, the accounts department is not notified of the date of delivery.

Implications of Weakness
There is an increased risk that the company's accounting records will be incomplete and inaccurate with regard to sales transactions.

Recommendation
The signed copy of the delivery note should be forwarded to the accounts department for subsequent matching with customer orders and copy sales invoices. Accounts department staff should constantly monitor the sequence numbers of copy delivery notes and sales invoices received and processed, to ensure completeness of processing of sales transactions.

(vii) Weakness
Sales invoice transactions are entered in Ace Co's accounting records without prior authorisation from a responsible official of the company.

Implications of Weakness
Unauthorised transactions could be entered into the company's accounting records, resulting in inaccurate reporting of financial information, unnecessary disputes with customers and loss of customer goodwill.

Recommendation
Accounts staff should match copies of authorised sales invoices with delivery notes and customer orders and forward to an appropriate authorised official (for example Ace Co's accountant or financial director), for checking and authorisation prior to posting into the company's accounting records.

(c) It is apparent that the inventory held by Ace Co consisting of approximately 1,000 machines, represents a high volume of relatively high value items. Consequently the total inventory holding has significant value.

It is also apparent that individual machine units are desirable assets and the risk of loss by intentional misappropriation or otherwise is high. Additionally, due to the fragile nature of the product range of machines it is likely that there is a significant risk of damage or breakage in the transportation and storage of machines.

In order to reduce the risks of damage identified above and to facilitate early recognition and mitigation of losses, Ace Co should have implemented a continuous (perpetual) system of inventory counting.

2 AUDIT RISK

(a) (i) (1) Audit Risk is the risk that an auditor will give an inappropriate opinion on the financial statements.

(2) Inherent Risk is the susceptibility of an assertion or misstatement which could be material (individually or when aggregated with other misstatements) assuming there were no related internal controls.

(3) Control Risk is the risk that a misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal controls.

(4) Detection Risk is the risk that the firm's audit procedures will not detect a misstatement that exists in an assertion that could be material (individually or when aggregated with other misstatements).

(Full marks will be awarded for the definitions as above or for similar definitions)

(ii) Auditors use the audit risk model to direct audit resources to the performance of additional substantive procedures in areas of the financial statement where audit risk is deemed to be high.

The formula for the audit risk model is:

$$\text{Audit Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Detection Risk}$$

It follows from the above that if risk percentage values can be assessed for both inherent risk and control risk (financial statement risk), then for a desired level of acceptable audit risk, a prescribed level of detection risk can be set. Thus the extent of required substantive procedures (and the level of audit resource to carry out those procedures) can be determined.

Using the example of the area of purchases as reported in the financial statements of a company, we may assume that the auditor auditing the company's financial statements works to a desired audit risk level of 5%. Assuming also that the auditor assesses the inherent risk associated with purchases as 80% and that control risk is set at 25%, then the required level of detection risk would be set at 25% (i e. 0·05 = 0·8 x 0·25 x 0·25).

Having set the prescribed level of detection risk, the auditor may then use manual tables and/or dedicated computer software packages to determine the size of samples to be tested, thus dictating the amount of audit resource to direct towards purchases – being the area of the financial statements under review. In the illustrated example above with a required detection risk level set at only 25%, sample sizes would be relatively high with obvious repercussions for the auditor in setting aside time and resources to carry out the required substantive procedures.

(Full marks will be awarded for answers containing similar points to those above with appropriate descriptions of how the auditor would actually determine inherent risk and control risk)

(b) Three factors that would contribute to the assessment of high inherent risk in determining the car hire income:

1 Recording of Sale Values for Car Hire Transactions

The very nature of car hire services presents difficulties in ensuring that all car hire transactions are recorded and that the value of each hire transaction is accurately recorded in the company's accounting records. Unlike consumer goods, where each sales transaction represents the transfer of ownership of a tangible item and therefore the physical transfer of goods; car hire charges are normally based on daily hire rates and mileage charges.

2 Recording of Sales Values Attributed to the Hire of Accessories and Insurance Premiums

As with car hire transactions, there is a high inherent risk associated with income from the hire of car seats and satellite navigation systems and also from excess damage waiver insurance premiums. This is because the hire transactions involve only the temporary transfer of custody of the company's assets in exchange for payment. As with damage waiver insurance premiums, there is a strong possibility of transactions being erroneously or purposefully undercharged to customers in this regard.

3 Geographical Spread of Car Hire Depots

The scale of the company's operations indicate that the company is relatively large and as such it is likely that there will be a high number of mixed car hire transactions. This fact, combined with the likelihood that there will be a relatively high number of employees engaged in transacting with customers on behalf of Deuce Car Hire Co from remote car depot locations, means that the likelihood of error or omission is high in the transmission of car hire transaction data for entry into the company's centralised accounting records.

4 Cash Transactions

The company accepts cash payments in settlement of car hire transactions, and it is inevitable that a material proportion of the transactions will be settled in this manner. By its nature, cash is a desirable asset subject to temptation and for this reason there is a relatively high risk that cash received from customers will be misappropriated by dishonest employees of the company or by other individuals. In order to reduce the possibility of their misdemeanours being detected in this regard, it is likely that relevant individuals would seek to extinguish all trace of such transactions from the company's records.

(Full marks will be awarded for identifying three of the above or other relevant factors)

3 AUDIT EVIDENCE

(a) Audit evidence is all the information used by the auditor in arriving at the conclusion on which the audit opinion is based. It is necessary to support that opinion and the auditor's report (See SSA 500 – *Audit Evidence*).

(b) Examples of third party confirmations pertaining to the audit of a large manufacturing company include:

(i) Bank Letter – confirming evidence of bank balances, overdrafts, loans, mortgaged properties and deposits and securities held by the bank on behalf of the company.
(ii) Inventory Certificates – confirming levels of inventory held by third parties on behalf of the company.
(iii) Trade Receivables Circularisation Letters – confirming trade debts owed by customers to the company.

(iv) Trade Payables Circularisation Letters – confirming trade debts owed to suppliers by the company.
(v) Loan Certificates – confirming the amounts owed by/to the company to/from third parties.
(vi) Investment Confirmation Letters – confirming the nature of investment certificates held for safekeeping by a third party custodian (for example, shares certificates held by a solicitor).
(vii) Pending Litigation Confirmation – from legal representatives of the company confirming the likelihood of future litigation involving the company and possible outcomes.

(Full marks will be awarded for identifying four of the above or other appropriate examples of third party confirmations)

(c) **(i)** The period of time under review when an auditor is considering 'subsequent events' is that between the period end and the date of the auditor's report.

(ii) Examples of subsequent events that may provide confirming evidence (in support of assertions) when auditing the financial statements of a large manufacturing company include:

(1) The receipt of payments from trade receivable customers owing amounts at the year end date.
(2) The sale of goods which represented inventory items in existence at the year end date.
(3) Payments to trade payable customers in existence at the year end date.
(4) The existence of a cash balance, facilitating the reconciliation of the cash held at the year end date after considering subsequent receipts and payments.

(Full marks will be awarded for providing two of the above or any other appropriate example of subsequent events which provide confirming evidence)

4 QJK CO

(a) The following factors could cast doubt on the going concern status of QJK Co as at 30 April 2009.

Financial Indicators
- Net liability or net current liability position.
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long-term assets.
- Adverse key financial ratios.
- Substantial operating losses.
- Arrears or discontinuance of dividends.
- Inability to pay payables on due dates.
- Difficulty in complying with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

Operating Indicators
- Loss of key management without replacement.
- Loss of major market, franchise, licence, or principal supplier.
- Labour difficulties or shortages of important supplies.

Other Indicators
- Non-compliance with capital or other statutory requirements.
- Pending legal proceedings against the entity that may, if successful result in judgements that could not be met.
- Changes in legislation or government policy.

(Full marks will be given for providing nine of the above or other relevant indicators)

(b) The purpose of the review is to ensure that work is being performed as required and that audit objectives are being met. As such, the audit manager will examine the working papers prepared to ensure that audit procedures have been carried out as planned, that the scope of the work is sufficient and that any problems encountered or findings which may be of concern are resolved and actioned as appropriate. In carrying out the review, the audit manager will be in a position to ascertain the sufficiency and appropriateness of audit evidence to support the audit opinion and be able to offer guidance to audit staff in this respect.

A further aspect of the review is to offer advice and guidance to members of the audit team, in areas of weakness, for example in the presentation of scheduled information, such that these may be improved for the remainder of the audit assignment and on future assignments.

In Section A questions 1 to 10, each multi-choice question carries 2 marks.
Full marks are awarded for choosing the correct option. No marks will be awarded where an incorrect option is selected or where more than one option is selected.

In Section B for all questions the marking scheme generally indicates that up to $1^1/_2$ marks may be awarded for relevant points. Consideration should be given to the depth and relevance given by each candidate when answering the question; for example if only a brief explanation is given then it may only be worth $^1/_2$ mark whilst a detailed discussion could be worth up to a maximum of $1^1/_2$ marks.

Marks are not allocated to specific points as the candidate may include a valid point within their answer which is not included in the model answer; the candidate should be given full credit for such points.

The majority of the questions require several points to be included within the answer, so if a candidate concentrates on a few points then they should not be given as much recognition, and their overall mark should be lower than a candidate who provides a range of points.

In conclusion, it is important that the overall standard of the candidate's answers is considered in terms of whether it is above or below a pass grade. After marking each question, the total mark awarded should be evaluated to assess whether it is fair. If it is decided that the total mark is not a proper reflection of the standard of the candidate's answer then the answer should be reviewed again, and the marks adjusted to ensure that the total awarded is fair. If the answer is of a pass standard then it should be awarded a minimum of 50%; if it is below a pass standard then it should be awarded less than 50%.

QUESTIONS 1–10 Multi-Choice

2 marks for each correct answer with an overall maximum of (2 x 10) **(20 marks)**

1 – Ace Co

(a) Stating five objectives of internal controls that should be exercised over a sales and trade receivables system.

Generally 1 mark per objective up to a maximum of (5 marks)

(b) (1) Identifying the weaknesses in Ace Co's sales and trade receivables system.

Generally 1 mark per weakness up to a maximum of (4 marks)

(2) Describing the implications of each weakness.

Generally $1^1/_2$ marks per implication up to a maximum of (6 marks)

(3) Recommending improvements to address each weakness identified.

Generally $1^1/_2$ marks per improvement up to a maximum of (6 marks)

(c) Stating reasons why Ace Co should have implemented a continuous (perpetual) system of counting in preference to a year end count as a means of controlling its inventory of machines.

Generally up to 1 mark per point, up to a maximum of (4 marks)

(25 marks)

(*Full marks will be awarded for identifying the weaknesses as identified above or other existing weaknesses, for stating implications of weaknesses and for making appropriate recommendations)*

2 – Audit Risk

(a) **(i)** Defining audit risk and its components.

Generally up to $1^1/_2$ marks for each term identified up to a maximum of (6 marks)

(ii) Illustration of how auditors use the audit risk model to determine sample sizes for substantive testing and the level of resource required.

For setting out the formula for the audit risk model up to (2 marks)

Then generally up to 1 mark per point up to a maximum of (8 marks)

(b) Identifying three factors that would contribute to the assessment of a high inherent risk applying to the car hire income of Deuce Car Hire Co.

1 mark per factor identified and generally up to 1 mark per explanatory point to a maximum of 4 marks per factor with an overall maximum of (9 marks)

(25 marks)

3 – Audit Evidence

(a) Explaining the meaning of the term audit evidence and stating why it is necessary.

Generally 1 mark per point up to a maximum of (2 marks)

(b) Describing four different examples of third party confirmations that an auditor may choose to rely on.

Generally up to 2 marks per example up to a maximum of (2 x 4) (8 marks)

(c) **(i)** Stating the period of time that is under review when an auditor is considering 'subsequent events' up to (2 marks)

(ii) Stating two examples of subsequent events that may provide confirming evidence when auditing the financial statements of a large manufacturing company.

Generally up to $1^1/_2$ marks for each example provided up to a maximum of ($1^1/_2$ x 2) (3 marks)

(15 marks)

4 – QKJ Co

(a) Stating nine indicators of risk that the continuance of QKJ Co as a going concern may be questionable.

Generally up to 1 mark per indicator up to a maximum of (9 marks)

(b) Explaining the purpose of the review of audit work by the audit manager.

Generally up to 1 mark per point up to a maximum of (6 marks)

(15 marks)