

Fundamentals Level – Skills Module

Audit and Assurance

Specimen Exam applicable from
December 2014



Time allowed

Reading and planning: 15 minutes

Writing: 3 hours

This paper is divided into two sections:

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

Section B – ALL SIX 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

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Paper

ACCA

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

Please use the space provided on the inside cover of the Candidate Answer Booklet to indicate your chosen answer to each multiple choice question.

1 Which of the following sampling methods correctly describes systematic sampling?

- A** A sampling method which is a type of value-weighted selection in which sample size, selection and evaluation results in a conclusion in monetary amounts
- B** A sampling method which involves having a constant sampling interval, the starting point for testing is determined randomly
- C** A sampling method in which the auditor selects a block(s) of contiguous items from within the population

(1 mark)

2 An audit junior has been assigned to the audit of bank and cash balances of Howard Co. He has obtained the following audit evidence:

- 1 Bank reconciliation carried out by the cashier
- 2 Bank confirmation report from Howard's bankers
- 3 Verbal confirmation from the directors that the overdraft limit is to be increased
- 4 Cash count carried out by the audit junior

What is the order of reliability of the audit evidence starting with the most reliable first?

- A** 4, 2, 1 and 3
- B** 2, 1, 4 and 3
- C** 4, 3, 2 and 1
- D** 2, 4, 1 and 3

(2 marks)

3 Fellaini Co operate a large department store and have a large internal audit department in place. The management of Fellaini Co are keen to increase the range of assignments that internal audit undertake.

Which of the following assignments could the internal audit department of Fellaini Co be asked to perform by management?

- A** Internal audit department members could undertake 'mystery shopper' reviews, where they enter the store as a customer, purchase goods and rate the overall shopping experience
- B** Internal audit could be asked to assist the external auditors by requesting bank confirmation letters
- C** Internal audit could be asked to implement a new payroll package for the payroll department
- D** Internal audit could be asked to assist the finance department with the preparation of the year end financial statements.

(2 marks)

- 4 Application controls are manual or automated procedures that operate over accounting applications to ensure that all transactions are complete and accurate

Which TWO of the following are application controls?

- 1 Password protection of programs
- 2 Batch controls
- 3 One for one checking
- 4 Regular back up of programs

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

(2 marks)

- 5 **Which TWO of the following are fundamental principles as stated in the ACCA's Code of Ethics and Conduct?**

- 1 Objectivity
- 2 Independence
- 3 Confidentiality
- 4 Professional skepticism

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

(2 marks)

- 6 Auditors usually carry out their audit work at different stages known as the interim audit and the final audit.

Which of the following statements, if any, is/are correct?

- 1 Carrying out tests of control on the company's sales day books would normally be undertaken during an interim audit.
- 2 Review of aged receivables ledger to identify balances requiring write down or allowance would normally be undertaken during a final audit.

- A** Neither 1 nor 2
- B** Both 1 and 2
- C** 1 only
- D** 2 only

(2 marks)

7 Which of the following statements relate to review engagements?

- 1 Subject matter is plausible
- 2 Reasonable assurance
- 3 Nothing has come to our attention which would indicate that the subject matter contains material misstatements
- 4 Positive assurance

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

(2 marks)

8 When placing reliance on the work of an expert is the following statement true or false?

In order to place reliance, the auditor is required to evaluate the work performed by the expert.

- A** True
- B** False

(1 mark)

9 An emphasis of matter paragraph is used in an audit report to draw attention to a matter affecting the financial statements.

Which TWO of the following are correct in relation to an Emphasis of Matter Paragraph in the Auditor's Report?

- 1 It is used when there is a significant uncertainty
- 2 It constitutes a qualified audit opinion
- 3 The audit report is referred to as an unmodified report
- 4 The matter is deemed to be fundamental to the users understanding of the financial statements

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

(2 marks)

10 During the planning stages of the final audit, the auditor believes that the probability of giving an inappropriate audit opinion is too high.

How should the auditor amend the audit plan to resolve this issue?

- A** Increase the materiality level
- B** Decrease the inherent risk
- C** Decrease the detection risk

(1 mark)

- 11** The audit of Giggs Co's financial statements for the year ended 31 October 2014 has been completed; the audit report and the financial statements have been signed but not yet issued.

The finance director of Giggs Co has just informed the audit team that he has received notification that a material receivable balance has become irrecoverable and Giggs Co will not receive any of the amounts owing.

What actions, if any, should the auditor now take to satisfy their responsibilities under ISA 560 *Subsequent Events*?

- A** No actions required as the audit report and financial statements have already been signed
- B** Request management to adjust the financial statements, verify the adjustment and provide a new audit report
- C** Request management to make disclosure of this event in the financial statements
- D** Request that management adjust for this event in the following year's financial statements as it occurred in year ending 31 October 2015.

(2 marks)

- 12** ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* sets out the five components of internal control.

Which of the following is NOT set out as a component of internal control within ISA 315?

- A** Control environment
- B** The information system relevant to financial reporting
- C** Human resource policies and practices

(1 mark)

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

- 1 The audit engagement partner for Hazard Co (Hazard), a listed company, has been in place for approximately six years and her son has just accepted a job offer from Hazard as a sales manager. This role would entitle him to shares in Hazard as part of his remuneration package.

Hazard's directors are considering establishing an internal audit department, and the finance director has asked the audit firm, Remy & Co about the differences between internal audit and external audit.

If the internal audit department is established, and Remy & Co is appointed as internal as well as external auditors, then Hazard has suggested that the external audit fee should be renegotiated with at least 20% of the fee being based on the profit after tax of the company as they feel this will align the interests of Remy & Co and Hazard.

Required:

(a) Using the information above:

- (i) Explain the ethical threats which may affect the independence of Remy & Co in respect of the audit of Hazard Co; and (3 marks)
- (ii) For each threat explain how it might be reduced to an acceptable level. (3 marks)

(b) Distinguish between internal and external audit. (4 marks)

(10 marks)

- 2 (a) Auditors are required to obtain sufficient appropriate audit evidence. Tests of control and substantive procedures can be used to obtain such evidence.

Required:

Define a 'test of control' and a 'substantive procedure'. (2 marks)

- (b) Balotelli Beach Hotel Co (Balotelli) operates a hotel providing accommodation, leisure facilities and restaurants. Its year end was 31 October 2014. You are the audit senior of Mario & Co and are currently preparing the audit programmes for the year end audit of Balotelli. You are reviewing the notes of last week's meeting between the audit manager and finance director where two material issues were discussed.

Depreciation

Balotelli incurred significant capital expenditure during the year on updating the leisure facilities for the hotel. The finance director has proposed that the new leisure equipment should be depreciated over 10 years using the straight-line method.

Food poisoning

Balotelli's directors received correspondence in September from a group of customers who attended a wedding at the hotel. They have alleged that they suffered severe food poisoning from food eaten at the hotel and are claiming substantial damages. Balotelli's lawyers have received the claim and believe that the lawsuit against the company is unlikely to be successful.

Required:

Describe substantive procedures to obtain sufficient and appropriate audit evidence in relation to the above two issues.

Note: The total marks will be split equally between each issue. (8 marks)

(10 marks)

- 3 (a) You are the audit manager of Savage & Co and you are briefing your team on the approach to adopt in undertaking the review and finalisation stage of the audit. In particular, the audit senior is unsure about the steps to take in relation to uncorrected misstatements.

Required:

Describe the auditor's responsibility in respect of misstatements. (2 marks)

- (b) You are the audit manager of Villa & Co and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues:

Czech Co

Czech Co is a pharmaceutical company and has incurred research expenditure of \$2.1m and development expenditure of \$3.2m during the year, this has all been capitalised as an intangible asset. Profit before tax is \$26.3m.

Dawson Co

Dawson Co's computerised wages program is backed up daily, however for a period of two months the wages records and the back-ups have been corrupted, and therefore cannot be accessed. Wages and salaries for these two months are \$1.1m. Profit before tax is \$10m.

Required:

For each of the clients above:

- (i) **Discuss the issue, including an assessment of whether it is material; and** (4 marks)
(ii) **Describe the impact on the audit report if the issue remains unresolved.** (4 marks)

(10 marks)

- 4 (a) **Explain FOUR financial statement assertions relevant to account balances at the period end.** (4 marks)

- (b) Torres Leisure Club Co (Torres) operates a chain of health and fitness clubs. Its year end was 31 October 2014. You are the audit manager and the year-end audit is due to commence shortly. The following matter has been brought to your attention. Torres's trade receivables have historically been low as most members pay monthly in advance. However during the year a number of companies have taken up group memberships at Torres and hence the receivables balance is now material. The audit senior has undertaken a receivables circularisation for the balances at the year end; however, there are a number who have not responded and a number of responses with differences.

Required:

Describe substantive procedures you would perform to obtain sufficient and appropriate audit evidence in relation to Torres's trade receivables. (6 marks)

(10 marks)

- 5 You are the audit senior of Holtby & Co and are planning the audit of Walters Co (Walters) for the year ended 31 December 2014. The company produces printers and has been a client of your firm for two years; your audit manager has already had a planning meeting with the finance director. He has provided you with the following notes of his meeting and financial statement extracts.

Walters's management were disappointed with the 2013 results and so in 2014 undertook a number of strategies to improve the trading results. This included the introduction of a generous sales-related bonus scheme for their salesmen and a high profile advertising campaign. In addition, as market conditions are difficult for their customers, they have extended the credit period given to them.

The finance director of Walters has reviewed the inventory valuation policy and has included additional overheads incurred this year as he considers them to be production related.

The finance director has calculated a few key ratios for Walters; the gross profit margin has increased from 44.4% to 52.2% and receivables days have increased from 61 days to 71 days. He is happy with the 2014 results and feels that they are a good reflection of the improved trading levels.

Financial statement extracts for year ended 31 December

	DRAFT 2014 \$m	ACTUAL 2013 \$m
Revenue	23.0	18.0
Cost of sales	(11.0)	(10.0)
Gross profit	12.0	8.0
Operating expenses	(7.5)	(4.0)
Profit before interest and taxation	4.5	4.0
Inventory	2.1	1.6
Receivables	4.5	3.0
Cash	–	2.3
Trade payables	1.6	1.2
Overdraft	0.9	–

Required:

(a) Using the information above:

- (i) Calculate an additional **THREE** ratios, for **BOTH** years, which would assist the audit senior in planning the audit; and (3 marks)
- (ii) From a review of the above information and the ratios calculated, describe **SIX** audit risks and explain the auditor's response to each risk in planning the audit of Walters Co. (12 marks)

- (b) Describe the procedures that the auditor of Walters Co should perform in assessing whether or not the company is a going concern.** (5 marks)

(20 marks)

6 Garcia International Co (Garcia) is a manufacturer of electrical equipment. It has factories across the country and its customer base includes retailers as well as individuals, to whom direct sales are made through their website. The company's year end is 30 September 2014. You are an audit supervisor of Suarez & Co and are currently reviewing documentation of Garcia's internal control in preparation for the interim audit.

Garcia's website allows individuals to order goods directly, and full payment is taken in advance. Currently the website is not integrated into the inventory system and inventory levels are not checked at the time when orders are placed. Inventory is valued at the lower of cost and net realisable value.

Goods are despatched via local couriers; however, they do not always record customer signatures as proof that the customer has received the goods. Over the past 12 months there have been customer complaints about the delay between sales orders and receipt of goods. Garcia has investigated these and found that, in each case, the sales order had been entered into the sales system correctly but was not forwarded to the despatch department for fulfilling.

Garcia's retail customers undergo credit checks prior to being accepted and credit limits are set accordingly by sales ledger clerks. These customers place their orders through one of the sales team, who decides on sales discount levels.

Raw materials used in the manufacturing process are purchased from a wide range of suppliers. As a result of staff changes in the purchase ledger department, supplier statement reconciliations are no longer performed. Additionally, changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks as well as supervisors.

In the past six months Garcia has changed part of its manufacturing process and as a result some new equipment has been purchased, however, there are considerable levels of plant and equipment which are now surplus to requirement. Purchase requisitions for all new equipment have been authorised by production supervisors and little has been done to reduce the surplus of old equipment.

Required:

(a) In respect of the internal control of Garcia International Co:

- (i) Identify and explain SIX deficiencies;**
- (ii) Recommend a control to address each of these deficiencies; and**
- (iii) Describe a test of control Suarez & Co would perform to assess if each of these controls is operating effectively.**

Note: The total marks will be split equally between each part (18 marks)

(b) Describe substantive procedures Suarez & Co should perform at the year end to confirm plant and equipment additions. (2 marks)

(20 marks)

End of Question Paper

Answers

Section A

Question	Answer	See Note
1	B	1
2	D	2
3	A	3
4	D	4
5	D	5
6	B	6
7	A	7
8	A	8
9	B	9
10	C	10
11	B	11
12	C	12

Notes:

- 1 The descriptions are correct but relate to alternative sampling methods. A is monetary unit sampling and C is block selection method of sampling.
- 2 Audit evidence is often described in terms of the degree of reliability. Third party as most reliable followed by auditor generated, company documentation and least reliable verbal evidence.
- 3 B is incorrect as external auditors alone would request bank confirmation letters, this is not something they would expect internal audit to perform. C is incorrect since internal audit would not retain their independence if they implemented accounting packages; their role is to review how the package operates once implemented. D is incorrect as internal audit should not help prepare financial statements.
- 4 The controls given at 1 and 4 are incorrect as they are general IT controls that relate to many applications and support the overall IT system.
- 5 Professional skepticism refers to the state of mind the auditor should maintain whilst conducting the audit. With regards to independence there is an overriding requirement to be independent rather than it being a specific principle.
- 6 Tests of control are typically undertaken at the interim audit stage. Reviewing the aged receivables would be undertaken on the year end balances and hence at the final audit.
- 7 Statements 2 and 4 are incorrect as they relate to the level of assurance provided by an external audit rather than a review engagement.
- 8 The auditor can only rely on the work undertaken by an expert if this has been evaluated.
- 9 Statement 2 is incorrect since an emphasis of matter does not result in a qualified opinion. Statement 3 is incorrect as an emphasis of matter results in the report being modified but the opinion is unqualified.
- 10 It is inappropriate to adjust materiality levels to determine audit risk. Inherent risk is not under the auditor's control. Audit risk depends on inherent risk, control risk and detection risk. Only detection risk can be changed by the auditor to reduce audit risk.
- 11 A is incorrect as even though the financial statements have been signed the auditor has an on-going responsibility. C is incorrect as this is an adjusting event and so must be adjusted for as opposed to just disclosed. D is incorrect as the event requires adjustment in the current year financial statements even though it occurred in year ending 31 October 2015.
- 12 Human resource policies and practices is an element of a control environment which is itself a component of internal control.

Section B

1 (a) Ethical threats and managing these risks

Ethical threat

A familiarity threat arises where an engagement partner is associated with a client for a long period of time.

Remy's partner has been involved in the audit of Hazard Co for six years and hence may not maintain her professional skepticism and objectivity.

The engagement partner's son has accepted a job as a sales manager at Hazard Co.

This could represent a self-interest/familiarity threat if the son was involved in the financial statement process.

A self-interest threat can arise when an audit firm has a financial interest in the company.

In this case the partner's son will receive shares as part of his remuneration. As the son is an immediate family member of the partner then if he holds the shares it will be as if the partner holds these shares, and this is prohibited.

A self-review threat can arise when an audit firm provides an internal audit service to an audit client.

Fees based on the outcome or results of work performed are known as contingent fees and are prohibited by ACCA's *Code of Ethics and Conduct*.

Hence Hazard's request that 20% of the external audit fee is based on profit after tax would represent a contingent fee.

Managing risk

Remy & Co should monitor the relationship between engagement and client staff, and should consider rotating engagement partners when a long association has occurred.

In addition, ACCA's *Code of Ethics and Conduct* recommends that engagement partners rotate off an audit after five years for listed and public interest entities. Therefore consideration should be given to appointing an alternative audit partner.

It is unlikely that as a sales manager the son would be in a position to influence the financial statements and hence additional safeguards would not be necessary.

If it was believed that additional safeguards were required then consideration should be given to appointing an alternative audit partner.

In this case as holding shares is prohibited by ACCA's *Code of Ethics and Conduct* then either the son should refuse the shares or more likely the engagement partner will need to be removed from the audit.

Remy & Co should have appropriate safeguards by ensuring the audit team is not involved in the internal audit service and also ensuring client staff remain responsible for the internal audit activities and approve all the work done.

Remy & Co will not be able to accept contingent fees and should communicate to Hazard that the external audit fee needs to be based on the time spent and level of work performed

(b) Differences between internal and external audit

External Audit

Objective

The main objective of the external auditor is to express an opinion on the truth and fairness of the financial statements.

Reporting

External auditors report to the shareholders or members of the company. External audit reports are contained within the financial statements and hence are publicly available.

Scope of work

The external auditor's work is limited to verifying the truth and fairness of the financial statements of the company.

Relationship with company

External auditors are appointed by the company's shareholders. They are independent of the company.

Internal Audit

The main objective of internal audit is to improve a company's operations, by reviewing the efficiency and effectiveness of the company's internal controls.

Internal auditors normally report to management or those charged with governance. Internal audit reports are not publicly available and are only intended to be seen by the addressee of the report. The reports are normally provided to the board of directors and those charged with governance such as the audit committee.

The internal auditor can have a wide scope of work and it is determined by the requirements of management or those charged with governance. Commonly internal audit focus on the company's internal control environment, but any other area of a company's operations can be reviewed.

Internal auditors are appointed by management. As internal auditors are normally employees of the company they lack independence. However, the internal audit department can be outsourced and this can increase their independence.

2 (a) Tests of control and substantive procedures

Tests of control test the operating effectiveness of controls in preventing, detecting or correcting material misstatements.

Substantive procedures are aimed at detecting material misstatements at the assertion level. They include tests of detail of transactions, balances, disclosures and substantive analytical procedures

(b) Substantive procedures

Depreciation

- Review the reasonableness of the depreciation rates applied to the new leisure facilities and compare to industry averages.
- Review the capital expenditure budgets for the next few years to assess whether there are any plans to replace any of the new leisure equipment, as this would indicate that the useful life is less than 10 years.
- Review profits and losses on disposal of assets disposed of in the year, to assess the reasonableness of the depreciation policies.
- Select a sample of leisure equipment and recalculate the depreciation charge to ensure that the non-current asset register is correct.
- Perform a proof in total calculation for the depreciation charged on the equipment, discuss with management if significant fluctuations arise.
- Review the disclosure of the depreciation charges and policies in the draft financial statements.

Food poisoning

- Review the correspondence from the customers claiming food poisoning to assess whether Balotelli has a present obligation as a result of a past event.
- With the client's permission, send an enquiry letter to the lawyers of Balotelli to obtain their view as to the probability of the claim being successful.
- Review board minutes to understand whether the directors believe that the claim will be successful or not.
- Review the post year-end period to assess whether any payments have been made to any of the claimants.
- Discuss with management as to whether they propose to include a contingent liability disclosure or not, consider the reasonableness of this.
- Obtain a written management representation confirming management's view that the lawsuit is unlikely to be successful and hence no provision is required.
- Review the adequacy of any disclosures made in the financial statements

3 (a) Misstatements

As per ISA 450 *Evaluation of Misstatements Identified during the Audit* the auditor has a responsibility to accumulate misstatements which arise over the course of the audit unless they are very small amounts.

Identified misstatements should be considered during the course of the audit to assess whether the audit strategy and plan should be revised.

The auditor should determine whether uncorrected misstatements are material in aggregate or individually.

All misstatements should be communicated to those charged with governance on a timely basis and the auditor should request that they make necessary amendments. If this request is refused then the auditor should consider the potential impact on their audit report.

A written representation should be requested from management to confirm that unadjusted misstatements are immaterial.

(b) Audit reports

Czech Co

Czech Co has incurred research expenditure of \$2.1m and development expenditure of \$3.2m and this has all been capitalised within intangible assets. This is contrary to IAS 38 *Intangible Assets*, as research expenditure should be expensed to profit or loss account rather than capitalised.

The error is material as it represents 8% of profit before tax (2.1m/26.3m) and hence management should adjust the financial statements by removing the research expenditure from intangibles and charging it to profit or loss account instead.

If management refuse to amend this error then the audit report will need to be modified. As management has not complied with IAS 38 and the error is material but not pervasive then a qualified opinion would be necessary.

The basis of opinion paragraph would need to include a paragraph explaining the material misstatement in relation to the provision of depreciation on land and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

Dawson Co

Dawson Co's wages program has been corrupted leading to a loss of payroll data for a period of two months. The auditors should attempt to verify payroll in an alternative manner. If they are unable to do this then payroll for the whole year would not have been verified.

Wages and salaries for the two month period represents 11% of profit before tax (1.1m/10m) and therefore is a material balance for which audit evidence has not been available.

The auditors will need to modify the audit report as they are unable to obtain sufficient appropriate evidence in relation to a material, but not pervasive, element of wages and salaries and therefore a qualified opinion will be required.

The basis of opinion section will be amended to explain the limitation in relation to the lack of evidence over two months of payroll records. The opinion paragraph will be qualified 'except for'.

4 (a) Financial statement assertions for balances at the period end.

- (i) Existence – Assets, liabilities and equity interests exist.
- (ii) Rights and obligations – The entity holds or controls the rights to assets, and liabilities are the obligations of the entity.
- (iii) Completeness – All assets, liabilities and equity interests that should have been recorded have been recorded.
- (iv) Valuation and allocation – Assets, liabilities and equity interests are included in the financial statements at appropriate amounts and any resulting valuation or allocation adjustments are appropriately recorded.

(b) Substantive procedures receivables

- For non-responses, with the client's permission, the team should arrange to send a follow up circularisation.
- If the customer does not respond to the follow up, then with the client's permission, the senior should telephone and ask whether they are able to respond in writing to the circularisation request.
- If there are still non-responses, then the senior should undertake alternative procedures to confirm receivables.
- For responses with differences, the senior should identify any disputed amounts, and identify whether these relate to timing differences or whether there are possible errors in the records of Torres.
- Any differences due to timing, such as cash in transit, should be agreed to post year-end cash receipts in the cash book.
- The receivables ledger should be reviewed to identify any possible mis-postings as this could be a reason for a response with a difference.
- If any balances have been flagged as disputed by the receivable, then these should be discussed with management to identify whether a write down is necessary.

5 (a) (i) Ratios to assist the audit supervisor in planning the audit:

	2014	2013
Operating margin	$4.5/23 = 19.6\%$	$4/18 = 22.2\%$
Inventory days	$2.1/11 * 365 = 70$ days	$1.6/10 * 365 = 58$ days
Payable days	$1.6/11 * 365 = 53$ days	$1.2/10 * 365 = 44$ days
Current ratio	$6.6/2.5 = 2.6$	$6.9/1.2 = 5.8$
Quick ratio	$(6.6 - 2.1)/2.5 = 1.8$	$(6.9 - 1.6)/1.2 = 4.4$

(ii) Audit risks and responses:

Audit risk	Audit response
Management were disappointed with 2013 results and hence undertook strategies to improve the 2014 trading results. There is a risk that management might feel under pressure to manipulate the results through the judgements taken or through the use of provisions.	Throughout the audit the team will need to be alert to this risk. They will need to carefully review judgemental decisions and compare treatment against prior years.
A generous sales-related bonus scheme has been introduced in the year, this may lead to sales cut-off errors with employees aiming to maximise their current year bonus.	Increased sales cut-off testing will be performed along with a review of post year-end sales returns as they may indicate cut-off errors.
Revenue has grown by 28% in the year however, cost of sales has only increased by 10%. This increase in sales may be due to the bonus scheme and the advertising however, this does not explain the increase in gross margin. There is a risk that sales may be overstated.	During the audit a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase.
Gross margin has increased from 44.4% to 52.2%. Operating margin has decreased from 22.2% to 19.6%. This movement in gross margin is significant and there is a risk that costs may have been omitted or included in operating expenses rather than cost of sales.	The classification of costs between cost of sales and operating expenses will be compared with the prior year to ensure consistency.
There has been a significant increase in operating expenses which may be due to the bonus and the advertising campaign but could be related to the misclassification of costs.	

Audit risk	Audit response
The finance director has made a change to the inventory valuation in the year with additional overheads being included. In addition inventory days have increased from 58 to 70 days. There is a risk that inventory is overvalued.	The change in the inventory policy will be discussed with management and a review performed of the additional overheads included to ensure that these are of a production nature. Detailed cost and net realisable value testing to be performed and the aged inventory report to be reviewed to assess whether inventory requires writing down.
Receivables days have increased from 61 to 71 days and management have extended the credit period given to customers. This leads to an increased risk of recoverability of receivables.	Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation.
The current and quick ratios have decreased from 5.8 to 2.6 and 4.4 to 1.8 respectively. In addition, the cash balances have decreased significantly over the year.	Detailed going concern testing to be performed during the audit and discussed with management to ensure that the going concern basis is reasonable.
Although all ratios are above the minimum levels, this is still a significant decrease and along with the increase of sales could be evidence of overtrading which could result in going concern difficulties.	

(b) Going concern procedures

- Obtain Walters’ cash flow forecast and review the cash in and out flows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Review any current agreements with the bank to determine whether any key ratios have been breached with regards to the bank overdraft.
- Review the company’s post year-end sales and order book to assess the levels of trade and if the revenue figures in the cash flow forecast are reasonable.
- Review post year end correspondence with suppliers to identify whether any restriction in credit have arisen, and if so ensure that the cash flow forecast reflects an immediate payment for trade payables.
- Inquire of the lawyers of Walters as to the existence of litigation and claims; if any exist then consider their materiality and impact on the going concern basis.
- Perform audit tests in relation to subsequent events to identify any items that might indicate or mitigate the risk of going concern not being appropriate.
- Review the post year end board minutes to identify any other issues that might indicate financial difficulties for the company.
- Review post year end management accounts to assess if in line with cash flow forecast.
- Consider whether any additional disclosures as required by IAS 1 *Presentation of Financial Statements* in relation to material uncertainties over going concern should be made in the financial statements.
- Obtain a written representation confirming the director’s view that Walters is a going concern.

6 (a) Garcia International's (Garcia) internal control

Deficiency	Control	Test of control
Currently the website is not integrated into inventory system. This can result in Garcia accepting customer orders when they do not have the goods in inventory. This can cause them to lose sales and customer goodwill.	The website should be updated to include an interface into the inventory system; this should check inventory levels and only process orders if adequate inventory is held. If inventory is out of stock, this should appear on the website with an approximate waiting time.	Test data could be used to attempt to process orders via the website for items which are not currently held in inventory. The orders should be flagged as being out of stock and indicate an approximate waiting time.
For goods despatched by local couriers, customer signatures are not always obtained. This can lead to customers falsely claiming that they have not received their goods. Garcia would not be able to prove that they had in fact despatched the goods and may result in goods being despatched twice.	Garcia should remind all local couriers that customer signatures must be obtained as proof of delivery and payment will not be made for any despatches with missing signatures.	Select a sample of despatches by couriers and ask Garcia for proof of delivery by viewing customer signatures.

Deficiency	Control	Test of control
There have been a number of situations where the sales orders have not been fulfilled in a timely manner. This can lead to a loss of customer goodwill and if it persists will damage the reputation of Garcia as a reliable supplier.	Once goods are despatched they should be matched to sales orders and flagged as fulfilled. The system should automatically flag any outstanding sales orders past a predetermined period, such as five days. This report should be reviewed by a responsible official.	Review the report of outstanding sales orders. If significant, discuss with a responsible official to understand why there is still a significant time period between sales order and despatch date. Select a sample of sales orders and compare the date of order to the goods despatch date to ascertain whether this is within the acceptable predetermined period.
Customer credit limits are set by sales ledger clerks. Sales ledger clerks are not sufficiently senior and so may set limits too high, leading to irrecoverable debts, or too low, leading to a loss of sales.	Credit limits should be set by a senior member of the sales ledger department and not by sales ledger clerks. These limits should be regularly reviewed by a responsible official.	For a sample of new customers accepted in the year, review the authorisation of the credit limit, and ensure that this was performed by a responsible official. Enquire of sales ledger clerks as to who can set credit limits.
Sales discounts are set by Garcia's sales team. In order to boost their sales, members of the sales team may set the discounts too high, leading to a loss of revenue.	All members of the sales team should be given authority to grant sales discounts up to a set limit. Any sales discounts above these limits should be authorised by sales area managers or the sales director. Regular review of sales discount levels should be undertaken by the sales director, and this review should be evidenced.	Discuss with members of the sales team the process for setting sales discounts. Review the sales discount report for evidence of review by the sales director.
Supplier statement reconciliations are no longer performed. This may result in errors in the recording of purchases and payables not being identified in a timely manner.	Supplier statement reconciliations should be performed on a monthly basis for all suppliers and these should be reviewed by a responsible official.	Review the file of reconciliations to ensure that they are being performed on a regular basis and that they have been reviewed by a responsible official
Changes to supplier details in the purchase ledger master file can be undertaken by purchase ledger clerks. This could lead to key supplier data being accidentally amended or fictitious suppliers being set up, which can increase the risk of fraud.	Only purchase ledger supervisors should have the authority to make changes to master file data. This should be controlled via passwords. Regular review of any changes to master file data by a responsible official and this review should be evidenced.	Request a purchase ledger clerk to attempt to access the master file and to make an amendment, the system should not allow this. Review a report of master data changes and review the authority of those making amendments.
Garcia has considerable levels of surplus plant and equipment. Surplus unused plant is at risk of theft. In addition, if the surplus plant is not disposed of then the company could lose sundry income.	Regular review of the plant and equipment on the factory floor by senior factory personnel to identify any old or surplus equipment. As part of the capital expenditure process there should be a requirement to confirm the treatment of the equipment being replaced.	Observe the review process by senior factory personnel, identifying the treatment of any old equipment. Review processed capital expenditure forms to ascertain if the treatment of replaced equipment is stated.
Purchase requisitions are authorised by production supervisors. Production supervisors are not sufficiently independent or senior to authorise capital expenditure.	Capital expenditure authorisation levels to be established. Production supervisors should only be able to authorise low value items, any high value items should be authorised by the board.	Review a sample of authorised capital expenditure forms and identify if the correct signatory has authorised them.

(b) Substantive procedures additions

- Obtain a breakdown of additions, cast the list and agree to the non-current asset register to confirm completeness of plant and equipment (P&E).
- Select a sample of additions and agree cost to supplier invoice to confirm valuation.
- Verify rights and obligations by agreeing the addition of plant and equipment to a supplier invoice in the name of Garcia.
- Review the list of additions and confirm that they relate to capital expenditure items rather than repairs and maintenance.
- Review board minutes to ensure that significant capital expenditure purchases have been authorised by the board.
- For a sample of additions recorded in P&E, physically verify them on the factory floor to confirm existence.

	<i>Marks</i>
Section A	
Questions 1–12 multiple choice	20
Total marks	<u>20</u>
Section B	
1 (a) Up to 1 mark per well explained threat and up to 1 mark for method of managing risk, overall maximum of 6 marks.	
Familiarity threat – long association of partner	
Self-interest threat – son gained employment at client company	
Self-interest threat – financial interest (shares) in client company	
Self-review threat – audit firm providing internal audit service	
Contingent fees	6
(b) Up to 1 mark per well explained point	
Objective	
Whom they report to	
Reports – publicly available or not	
Scope of work	
Appointed by	
Independence of company	4
	<u>10</u>
2 (a) 1 mark for each definition	
Definition of test of control	
Definition of substantive test	2
(b) Up to 1 mark per relevant substantive procedure, maximum of 4 marks for each issue.	
Depreciation	
Review the reasonableness of the depreciation rates and compare to industry averages	
Review the capital expenditure budgets	
Review profits and losses on disposal for assets disposed of in year	
Recalculate the depreciation charge for a sample of assets	
Perform a proof in total calculation for the depreciation charged on the equipment	
Review the disclosure of depreciation in the draft financial statements	
Food poisoning	
Review the correspondence from the customers	
Send an enquiry to the lawyers as to the probability of the claim being successful	
Review board minutes	
Review the post year-end period to assess whether any payments have been made	
Discuss with management as to whether they propose to include a contingent liability disclosure	
Obtain a written management representation	
Review any disclosures made in the financial statements	8
	<u>10</u>

Marks

3 (a)	Up to 1 mark per well described point Auditor should accumulate misstatements Consider if audit strategy/plan should be revised Assess if uncorrected misstatements material Communicate to those charged with governance, request changes If refused then assess impact on audit report Request written representation	2
(b)	Up to 1 mark per valid point, overall maximum of 4 marks per client issue. Discussion of issue Calculation of materiality Type of audit report modification required Impact on audit report	<u>8</u> 10 <u><u> </u></u>
4 (a)	Up to 1 mark per assertion, ½ mark for stating assertion and ½ mark for explanation. Existence – explanation Rights and obligations – explanation Completeness – explanation Valuation and allocation – explanation	4
(b)	Up to 1 mark per relevant substantive procedure For non-responses arrange to send a follow up circularisation With the client's permission, telephone the customer and ask for a response For remaining non-responses, undertake alternative procedures to confirm receivables For responses with differences, identify any disputed amounts, identify whether these relate to timing differences or whether there are possible errors in the records Cash in transit should be vouched to post year-end cash receipts in the cash book Review receivables ledger to identify any possible mis-postings Disputed balances, discuss with management whether a write down is necessary	<u>6</u> 10 <u><u> </u></u>

		<i>Marks</i>
5	<p>(a) (i) ½ mark per ratio calculation per year</p> <p>Operating margin Inventory days Payable days Current ratio Quick ratio</p>	3
	<p>(ii) Up to 1 mark per well explained audit risk, maximum of 6 marks for risks and up to 1 mark per audit response, maximum of 6 marks for responses</p> <p>Management manipulation of results Sales cut-off Revenue growth Misclassification of costs between cost of sales and operating Inventory valuation Receivables valuation Going concern risk</p>	12
	<p>(b) 1 mark per well explained point – If the procedure does not clearly explain how this will help the auditor to consider going concern then a ½ mark only should be awarded:</p> <p>Review cash flow forecasts Review bank agreements, breach of key ratios Review post year-end sales and order book Review suppliers correspondence Inquire of lawyers for any litigation Subsequent events Board minutes Management accounts Consider additional disclosures under IAS 1 Written representation</p>	5 <hr style="width: 100%;"/> 20 <hr style="width: 100%;"/>
6	<p>(a) Up to 1 mark per deficiency, up to 1 mark per well explained control and up to 1 mark for each well described test of control, maximum of 6 marks for deficiencies, maximum of 6 marks for controls and maximum of 6 marks for tests of control.</p> <p>Website not integrated into inventory system Customer signatures Unfulfilled sales orders Customer credit limits Sales discounts Supplier statement reconciliations Purchase ledger master file Surplus plant and equipment Authorisation of capital expenditure</p>	18
	<p>(b) Up to 1 mark per substantive procedure</p> <p>Additions Cast list of additions and agree to non-current asset register Vouch cost to recent supplier invoice Agree addition to a supplier invoice in the name of Garcia to confirm rights and obligations Review additions and confirm capital expenditure items rather than repairs and maintenance Review board minutes to ensure authorised by the board Physically verify them on the factory floor to confirm existence</p>	2 <hr style="width: 100%;"/> 20 <hr style="width: 100%;"/>