Answers

1 (a) – Prior year internal control questionnaires

- Obtain the audit file from last year's audit. Ensure that the documentation on the sales system is complete. Review the audit file for indications of weaknesses in the sales system and note these for investigation this year.
- Obtain system documentation from the client. Review this to identify any changes made in the last 12 months.
- Interview client staff to ascertain whether systems have changed this year and to ensure that the internal control questionnaires produced last year are correct.
- Perform walk-through checks. Trace a few transactions through the sales system to ensure that the internal control questionnaires on the audit file are accurate and can be relied upon to produce the audit programmes for this year.
- During walk-through checks, ensure that the controls documented in the system notes are actually working, for example, verifying that documents are signed as indicated in the notes.

(b) – Tests of control

Test of control	Reason for test
Review a sample of goods despatch notes (GDN) for signatures of the goods despatch staff and customer.	Ensures that the goods despatched are correctly recorded on the GDNs.
Review a sample of GDNs for signature of the accounts staff.	Ensures that the GDN details have been entered onto the computer system.
Observe despatch system ensuring Seeley staff have seen the customers' identification card prior to goods being loaded into customers' vans.	Ensures that goods are only despatched to authorised customers.
Review the error report on numeric sequence of GDNs produced in the accounts department and enquire action taken regarding omissions.	Ensures that the sequence of GDNs is complete.
Observe despatch process to ensure that the customers' credit limit is reviewed prior to goods being despatched.	Ensures that goods are not despatched to poor/bad credit risks. Note: reviewing credit limits is not specifically stated in the scenario; however, most despatch/sales systems will have this control and most candidates mentioned this in their answers. Hence marks were awarded for this point.
Review a selection of invoices ensuring they have been signed by accounts staff.	Ensures the accurate transfer of goods despatched information from the GDN to the invoice.

(c) Assertions – receivables

Assertion	Application to direct confirmation of receivables
Existence	The receivable actually exists which is confirmed by the receivable replying to the receivables confirmation.
Rights and obligations	The receivable belongs to Seeley Co. The receivable confirms that the amount is owed to Seeley again by replying to the confirmation.
Valuation and allocation	Receivables are included in the financial statements at the correct amount – the receivable will dispute any amounts that do not relate to that account.
Cut-off	Transactions and events have been recorded in the correct accounting period. The circularisation will identify reconciling items such as sales invoices/cash in transit.

(d) (i) Receivables circularisation – procedures

- Obtain a list of receivables balances, cast this and agree it to the receivables control account total at the end of the year. Ageing of receivables may also be verified at this time.
- Determine an appropriate sampling method (cumulative monetary amount, value-weighted selection, random, etc.) using materiality for the receivable balance to determine the sampling interval or number of receivables to include in the sample.

- Select the balances to be tested, with specific reference to the categories of receivable noted below.
- Extract details of each receivable selected from the ledger and prepare circularisation letters.
- Ask the chief accountant at Seeley Co (or other responsible official) to sign the letters.
- The auditor posts or faxes the letters to the individual receivables.

(ii) Specific receivables for selection:

1. Large or material items. These will be selected partly to ensure that no material error has occurred and partly to increase the overall value of items tested.
2. Negative balances. There are 15 negative balances on Seeley's list of receivables. Some of these will be tested to ensure the credit balance is correct and to ensure that payments have not been posted to the wrong ledger account.
3. Receivables in the range $0 to $20,000. This group is unusual because it has a relatively higher proportion of older debts. Additional testing may be necessary to ensure that the receivables exist and to confirm that Seeley is not overstating sales income by including many smaller receivables balances in the ledger.
4. Receivables with balances more than two months old. Receivables with old balances may indicate a provision is required for non-payment. The lack of analysis in Seeley Co's receivable information indicates a high risk of non-payment as the age of many debts is unknown.
5. Random sample of remaining balances to provide an overall view of the accuracy of the receivables balance.

2 (a) Sufficiency of evidence

- Assessment of risk at the financial statement level and/or the individual transaction level. As risk increases then more evidence is required.
- The materiality of the item. More evidence will normally be collected on material items whereas immaterial items may simply be reviewed to ensure they appear correct.
- The nature of the accounting and internal control systems. The auditor will place more reliance on good accounting and internal control systems limiting the amount of audit evidence required.
- The auditor's knowledge and experience of the business. Where the auditor has good past knowledge of the business and trusts the integrity of staff then less evidence will be required.
- The findings of audit procedures. Where findings from related audit procedures are satisfactory (e.g. tests of controls over receivables) then substantive evidence will be collected.
- The source and reliability of the information. Where evidence is obtained from reliable sources (e.g. written evidence) then less evidence is required than if the source was unreliable (e.g. verbal evidence).

(b) Management representation letter contents

- No irregularities involving management or employees that could have a material effect on the financial statements
- All books of account and supporting documentation have been made available to the auditors
- Information and disclosures with reference to related parties is complete
- Financial statements are free from material misstatements including omissions
- No non-compliance with any statute or regulatory authority
- No plans that will materially alter the carrying value or classification of assets or liabilities in the financial statements
- No plans to abandon any product lines that will result in any excess or obsolete inventory
- No events, unless already disclosed, after the balance sheet date that need disclosure in the financial statements.

(c) Additional audit procedures

- The auditor could expand the amount of test of controls in that audit area. This may indicate that the control weakness was not as bad as initially thought.
- The problem could be raised with the directors, either verbally or in a management letter, to ensure that they are aware of the problem.
- The auditor could perform additional substantive procedures on the audit area. This action will help to quantify the extent of the error and makes the implicit assumption that the control system is not operating correctly.
- If the matter is not resolved, then the auditor will also need to consider a qualification in the audit report; the exact wording depending on the materiality of the errors found.

3 (a) (i) Explanation of analytical procedures

Analytical procedures are used in obtaining an understanding of an entity and its environment and in the overall review at the end of the audit.

'Analytical procedures' actually means the evaluation of financial and other information, and the review of plausible relationships in that information. The review also includes identifying fluctuations and relationships that do not appear consistent with other relevant information or results.

(ii) Types of analytical procedures

Analytical procedures can be used as:

– Comparison of comparable information to prior periods to identify unusual changes or fluctuations in amounts.

– Comparison of actual or anticipated results of the entity with budgets and/or forecasts, or the expectations of the auditor in order to determine the potential accuracy of those results.

– Comparison to industry information either for the industry as a whole or by comparison to entities of similar size to the client to determine whether receivable days, for example, are reasonable.

(iii) Use of analytical procedures

Risk assessment procedures

Analytical procedures are used at the beginning of the audit to help the auditor obtain an understanding of the entity and assess the risk of material misstatement. Audit procedures can then be directed to these 'risky' areas.

Analytical procedures as substantive procedures

Analytical procedures can be used as substantive procedures in determining the risk of material misstatement at the assertion level during work on the income statement and balance sheet.

Analytical procedures in the overall review at the end of the audit

Analytical procedures help the auditor at the end of the audit in forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity.

(b) Net profit

Overall, Zak's result has changed from a net loss to a net profit. Given that sales have only increased by 17% and that expenses, at least administration expenses, appear low, then there is the possibility that expenditure may be understated.

Sales – increase 17%

According to the directors, Zak has had a 'difficult year'. Reasons for the increase in sales income must be ascertained as the change does not conform to the directors' comments. It is possible that the industry as a whole, has been growing allowing Zak to produce this good result.

Cost of sales – fall 17%

A fall in cost of sales is unusual given that sales have increased significantly. This may have been caused by an incorrect inventory valuation and the use of different (cheaper) suppliers which may cause problems with faulty goods in the next year.

Gross profit (GP) – increase 88%

This is a significant increase with the GP% changing from 33% last year to 53% in 2008. Identifying reasons for this change will need to focus initially on the change in sales and cost of sales.

Administration – fall 6%

A fall is unusual given that sales are increasing and so an increase in administration to support those sales would be expected. Expenditure may be understated, or there has been a decrease in the number of administration staff.

Selling and distribution – increase 42%

This increase does not appear to be in line with the increase in sales – selling and distribution would be expected to increase in line with sales. There may be a mis-allocation of expenses from administration or the age of Zak's delivery vans is increasing resulting in additional service costs.

Interest payable – small fall

Given that Zak has a considerable cash surplus this year, continuing to pay interest is surprising. The amount may be overstated – reasons for lack of fall in interest payment e.g. loans that cannot be repaid early, must be determined.

Investment income – new this year

This is expected given cash surplus on the year, although the amount is still very high indicating possible errors in the amount or other income generating assets not disclosed on the balance sheet extract.

(c) Obtaining a bank letter

- Review the need to obtain a bank letter from the information obtained from the preliminary risk assessment of Zak.
- Prepare a standard bank letter in the format agreed with banks in your jurisdiction.
- Obtain authorisation on that letter from a director of Zak for the bank to disclose information to the auditor.
- Where Zak has provided their bank with a standing authority to disclose information to the auditors, refer to this authority in the bank letter.
- The auditor sends the letter directly to Zak's bank with a request to send the reply directly back to the auditors.

4 (a) Outsourcing internal audit

Advantages of outsourcing internal audit

Staff recruitment

There will be no need to recruit staff for the internal audit department; the outsourcing company will provide all staff and ensure staff are of the appropriate quality.

Skills

The outsourcing company will have a large pool of staff available to provide the internal audit service. This will provide access to specialist skills that the company may not be able to afford if the internal audit department was run internally.

Set up time

The department can be set-up in a few weeks rather than taking months to advertise and recruit appropriate staff.

Costs

Costs for the service will be agreed in advance. This makes budgeting easier for the recipient company as the cost and standard of service expected are fixed.

Flexibility (staffing arrangements)

Staff can be hired to suit the workloads and requirements of the recipient company rather than full-time staff being idle for some parts of the year.

Disadvantages of outsourcing internal audit

Staff turnover

The internal audit staff allocated to one company may change frequently; this means that company systems may not always be fully understood, decreasing the quality of the service provided.

External auditors

Where external auditors provide the internal audit service there may be a conflict of interest (self-review threat), where internal audit work is then relied upon by external auditors.

Cost

The cost of the outsourced service may be too high for the company, which means that an internal audit department is not established at all. There may be an assumption that internal provision would be even more expensive.

Confidentiality

Knowledge of company systems and confidential data will be available to a third party. Although the service agreement should provide confidentiality clauses, this may not stop breaches of confidentiality e.g. individuals selling data fraudulently.

Control

Where internal audit is provided in-house, the company will have more control over the activities of the department; there is less need to discuss work patterns or suggest areas of work to the internal audit department.

(b) Need for internal audit

For establishing an internal audit department

Value for money (VFM) audits

MonteHodge has some relatively complex systems such as the stock market monitoring systems. Internal audit may be able to offer VFM services or review potential upgrades to these systems checking again whether value for money is provided.

Accounting system

While not complex, accounting systems must provide accurate information. Internal audit can audit these systems in detail ensuring that fee calculations, for example, are correct.

Computer systems

Maintenance of computer systems is critical to MonteHodge's business. Without computers, the company cannot operate. Internal audit could review the effectiveness of backup and disaster recovery arrangements.

Internal control systems

Internal control systems appear to be limited. Internal audit could check whether basic control systems are needed, recommending implementation of controls where appropriate.

Effect on audit fee

Provision of internal audit may decrease the audit fee where external auditors can place reliance on the work of internal audit. This is unlikely to happen during the first year of internal audit due to lack of experience.

Image to clients

Provision of internal audit will enable MonteHodge Co to provide a better 'image' to its clients. Good controls imply client monies are safe with MonteHodge.

Corporate governance

Although MonteHodge does not need to comply with corporate governance regulations, internal audit could still recommend policies for good corporate governance. For example, suggesting that the chairman and chief executive officer roles are split.

Compliance with regulations

MonteHodge is in the financial services industry. In most jurisdictions, this industry has a significant amount of regulation. An internal audit department could help ensure compliance with those regulations, especially as additional regulations are expected in the future.

Assistance to financial accountant

The financial accountant in MonteHodge is not qualified. Internal audit could therefore provide assistance in compliance with financial reporting standards, etc as well as recommending control systems.

Against establishing of internal audit department

No statutory requirement

As there is no statutory requirement, the directors may see internal audit as a waste of time and money and therefore not consider establishing the department.

Accounting systems

Many accounting systems are not necessarily complex so the directors may not see the need for another department to review their operations, check integrity, etc.

Family business

MonteHodge is owned by a few shareholders in the same family. There is therefore not the need to provide assurance to other shareholders on the effectiveness of controls, accuracy of financial accounting systems, etc.

Potential cost

There would be a cost of establishing and maintaining the internal audit department. Given that the directors consider focus on profit and trusting employees to be important, then it is unlikely that they would consider the additional cost of establishing internal audit.

Review threat

Some directors may feel challenged by an internal audit department reviewing their work (especially the financial accountant). They are likely therefore not to want to establish an internal audit department.

5 (a) Going concern

Going concern means that the enterprise will continue in operational existence for the foreseeable future without the intention or necessity of liquidation or otherwise ceasing trade. It is one of the fundamental accounting concepts used by auditors and stated in FRS 1 *Presentation of Financial Statements*.

The auditor's responsibility in respect of going concern is explained in SSA 570 *Going Concern*. The SSA states 'when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements'.

The auditor's responsibility therefore falls into three areas:

(i) To carry out appropriate audit procedures that will identify whether or not an organisation can continue as a going concern.

(ii) To ensure that the organisation's management have been realistic in their use of the going concern assumption when preparing the financial statements.

(iii) To report to the members where they consider that the going concern assumption has been used inappropriately, for example, when the financial statements indicate that the organisation is a going concern, but audit procedures indicate this may not be the case.

(b) Audit procedures regarding going concern

– Obtain a copy of the cash flow forecast and discuss the results of this with the directors.

– Discuss with the directors their view on whether Smithson can continue as a going concern. Ask for their reasons and try and determine whether these are accurate.

– Enquire of the directors whether they have considered any other forms of finance for Smithson to make up the cash shortfall identified in the cash flow forecast.

– Obtain a copy of any interim financial statements of Smithson to determine the level of sales/income after the year-end and whether this matches the cash flow forecast.

– Enquire about the possible lack of capital investment within Smithson identified by the employee leaving. Review current levels of non-current assets with similar companies and review purchase policy with the directors.

– Consider the extent to which Smithson relied on the senior employee who recently left the company. Ask the human resources department whether the employee will be replaced and if so how soon.

– Obtain a solicitor's letter and review to identify any legal claims against Smithson related to below standard services being provided to clients. Where possible, consider the financial impact on Smithson and whether insurance is available to mitigate any claims.

– Review Smithson's order book and client lists to try and determine the value of future orders compared to previous years.

– Review the bank letter to determine the extent of any bank loans and whether repayments due in the next 12 months can be made without further borrowing.

– Review other events after the end of the financial year and determine whether these have an impact on Smithson.

– Obtain a letter of representation point confirming the directors' opinion that Smithson is a going concern.

(c) Audit procedures if Smithson is not considered to be a going concern

– Discuss the situation again with the directors. Consider whether additional disclosures are required in the financial statements or whether the financial statements should be prepared on a 'break up' basis.

– Explain to the directors that if additional disclosure or restatement of the financial statements is not made then the auditor will have to modify the audit report.

– Consider how the audit report should be modified. Where the directors provide adequate disclosure of the going concern situation of Smithson, then an emphasis of matter paragraph is likely to be appropriate to draw attention to the going concern disclosures.

– Where the directors do not make adequate disclosure of the going concern situation then qualify the audit report making reference to the going concern problem. The qualification will be an 'except for' opinion or an adverse opinion depending on the auditor's opinion of the situation.

(d) Negative assurance

Negative assurance means that nothing has come to the attention of an auditor which indicates that the cash flow forecast contains any material errors. The assurance is therefore given on the absence of any indication to the contrary.

In contrast, the audit report on statutory financial statements provides positive or reasonable assurance; that is the financial statements do show a true and fair view.

Using negative assurance, the auditor is warning users that the cash flow forecast may be inaccurate. Less reliance can therefore be placed on the forecast than the financial statements, where the positive assurance was given.

With negative assurance, the auditor is also warning that there were limited audit procedures that could be used; the cash flow relates to the future and therefore the auditor cannot obtain all the evidence to guarantee its accuracy. Financial statements relate to the past, and so the auditor should be able to obtain the information to confirm they are correct; hence the use of positive assurance.

1 (a) Accuracy of internal control questionnaires

1 mark for each well-explained step

- Prior year audit file
- System weaknesses identified not actioned by client
- Review system documentation
- Interview client staff
- Walk-through check
- Identify controls in above
- Other relevant procedures

Maximum marks 4

(b) Tests of control despatch and sales system

1 mark for stating procedure and 1 mark for the reason for that procedure. Limit marks to 0·5 where the reason is not fully explained. Maximum 2 marks per point.

Procedure
- GDN signature – despatch staff
- GDN signature – accounts staff
- Observe despatch system
- Error report GDN numeric sequence
- Credit limit control
- Invoices – signed
- Credit checking – either account setup or prior to despatch of goods
- GDN signed by customer – shows receipt of goods
- Observe the despatch system
- Other relevant procedures

Maximum marks 12

(c) Assertions – direct confirmation of receivables

1 mark for each good explanation. (Note any asssertion is allowed if showed linked to receivables circularisation)

Assertions
- Existence
- Rights and obligations
- Valuation and allocation (normally needs links to liquidator)
- Completeness (where linked to invoices not recorded by client co)
- Other relevant points

Maximum marks 4

(d) Receivables circularisation procedures

1 mark per procedure

(i) Procedure

- List of receivables
- Sampling method
- Select balances for testing
- Extract details from ledger
- Prepare letters – client sign
- Post letters
- Choose date if not year end
- Confirm with management can circularise receivables
- Other relevant points

5

(ii) Specific receivables for selection – 1 mark each explained point (must include reason for selection for full mark)

- Negative balances
- Material balances
- $0 to $20,000 balances
- Old balances
- Random sample remaining balances
- Other relevant points

	5
Maximum marks	10
Total marks	**30**

2 (a) Sufficiency of evidence

1 mark for each point

- Financial statement risk
- Materiality
- Accounting/internal control systems
- Auditor's knowledge
- Audit procedures
- Source and reliability
- Sampling method used
- Other relevant points

Maximum marks	4

(b) Management representation letter contents

0·5 mark per valid point

Maximum marks	3

(c) 1 mark for each point with explanation

- Increase tests of controls
- Discuss with management
- Substantive procedures
- Qualification of audit report
- Include in management letter
- Discuss with audit committee

Maximum marks	3
Total marks	**10**

3 (a) Analytical review

1 mark for each valid, well-explained, point

(i)
- Obtain information on client situation
- Evaluation financial information

(ii)
- Comparison prior periods
- Comparison actual/anticipated results
- Comparison industry information
- Specific procedures for individual account balances (e.g. receivables)
- Ratio analysis e.g. GP% year on year
- Proof in total e.g. total wages = employees * average wage

(iii)
- Risk assessment procedures
- Substantive procedures
- End of audit analytical procedures

Maximum marks 8

(b) Risks – income statement

0·5 mark, for identifying unusual changes in income statement. Award up to 1 more mark. Total 1·5 marks per point.

- Net profit
- Revenue
- Cost of sales
- Gross profit
- Administration
- Selling and distribution
- Interest payable
- Interest receivable (must be linked to the change in bank balance – not enough cash for interest received)
- Other relevant points

Maximum marks 9

(c) Bank letter

1 mark for each audit procedure

- Evaluate need for letter
- Prepare bank letter – standard form
- Client permission
- Refer to standing authority at bank
- Letter direct to bank

Maximum marks 3

Total marks **20**

4 **(a)** 1 mark for each well-explained point

For outsourcing internal audit
- Staff recruitment
- Skills
- Set up time
- Costs
- Flexibility of staffing arrangements
- Independence of external firm
- Other valid points

Against outsourcing internal audit
- Staff turnover
- External auditors
- Cost
- Confidentiality
- Control
- Independence (where services provided by same firm)
- Other valid points

Maximum marks	8

Note to markers – there is no split of marks between advantages and disadvantages.

(b) Up to 2 marks for each well-explained point

For internal audit
- VFM audits
- Accounting system
- Computer systems
- Internal control systems
- Effect on audit fee
- Image to clients
- Corporate governance
- Lack of control
- Law change
- Assistance to financial accountant
- Nature of industry (financial services)
- Other relevant points

Against internal audit
- No statutory requirement
- Family business
- Potential cost
- Review threat
- Other relevant points

Maximum marks	12
Total marks	**20**

5 (a) Going concern meaning

1 mark each for:

– Definition
– SSA 570 explanation (don't need the SSA number)
– Audit procedures
– Realistic use of assumption
– Report to members
– Report to audit committee and/or directors
– Discussion with management on going concern
– Other relevant points

Maximum marks	4

(b) Audit procedures on going concern

1 mark per procedure (0·5 if brief or unclear e.g. 'check the cash flow')

– Cash flow
– Directors' view going concern
– Other finance
– Interim financial statements
– Lack of non-current assets
– Reliance on senior employee
– Solicitor's letter
– Review order book
– Review bank letter
– Review other post balance sheet events
– Management representation
– Other relevant points

Maximum marks	8

(c) Audit procedures company may not be a going concern

1 mark per action (0·5 if brief or unclear e.g. 'discuss with directors')

– Discuss with directors
– Need to modify audit report
– Possible emphasis of matter
– Possible qualification
– Letter of representation
– Other relevant points

Maximum marks	4

(d) Negative assurance

1 mark per action (0·5 if brief or unclear e.g. 'check the cash flow')

– Definition
– Audit report = positive assurance
– Level of reliance
– Limited audit procedures
– Other relevant points

Maximum marks	4
Total marks	**20**