Answers

Section B

16 (a) Analytical procedures

Analytical procedures can be used at all stages of an audit, however, ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA 520 *Analytical Procedures* identify three particular stages.

During the planning stage, analytical procedures must be used as risk assessment procedures in order to help the auditor to obtain an understanding of the entity and assess the risk of material misstatement.

During the final audit, analytical procedures can be used to obtain sufficient appropriate evidence. Substantive procedures can either be tests of detail or substantive analytical procedures.

At the final review stage, the auditor must design and perform analytical procedures which assist them when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

(b) Ratios

Ratios to assist the audit supervisor in planning the audit:

	20X8	20X7
Gross margin	7,410/19,850 = 37·3%	6,190/16,990 = 36·4%
Inventory holding period	1,850/12,440 * 365 = 54 days	1,330/10,800 * 365 = 45 days
OR		
Inventory turnover	12,440/1,850 = 6·7	10,800/1,330 = 8·1
Receivables collection period	2,750/19,850 * 365 = 51 days	1,780/16,990 * 365 = 38 days
Payables payment period	1,970/12,440 * 365 = 58 days	1,190/10,800 * 365 = 40 days
Current ratio	4,600/(1,970 + 810) = 1·65	3,670/1,190 = 3·08
Quick ratio	2,750/(1,970 + 810) = 0·99	(3,670 – 1,330)/1,190 = 1·97

(c) Audit risks and auditor's response

Audit risk	Auditor's response
During the year, Darjeeling Co has spent $0·9m on developing new product lines, some of which are in the early stages of their development cycle. This expenditure is classed as research and development under IAS® 38 *Intangible Assets*. The standard requires research costs to be expensed to profit or loss and only development costs to be capitalised as an intangible asset. The company has included all of this expenditure as an intangible asset. If research costs have been incorrectly classified as development expenditure, there is a risk that intangible assets could be overstated and expenses understated.	Obtain a breakdown of the expenditure and verify that it relates to the development of the new products. Review expenditure documentation to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.

Audit risk	Auditor's response
Darjeeling Co purchased and installed a new manufacturing line. The costs include purchase price ($2·2m), installation costs ($0·4m) and a five-year servicing and maintenance plan ($0·5m). As per IAS 16 *Property, Plant and Equipment*, the cost of an asset includes its purchase price and directly attributable costs only. IAS 16 does not allow servicing and maintenance costs to be capitalised as part of the cost of a non-current asset, as they are not directly related to the cost of bringing the asset to its working condition. The servicing costs relate to a five-year period and so should be charged to profit or loss over this time. The upfront payment represents a prepayment for five years; as the services are received, the relevant proportion of the cost should be charged to profit or loss. If the service for 20X8 has been carried out, then $0·1m ($0·5m/5) should be charged to profit or loss. Therefore property, plant and equipment (PPE) and profits are overstated and prepayments are understated.	Review the purchase documentation for the new manufacturing line to confirm the exact cost of the servicing and that it does relate to a five-year period. Discuss the accounting treatment with the finance director and the level of any necessary adjustment to ensure treatment is in accordance with IAS 16.
The company has borrowed $4m from the bank via an eight-year loan. This loan needs to be correctly split between current and non-current liabilities in order to ensure correct disclosure.	During the audit, the team would need to confirm that the $4 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and local legislation. Details of security should be agreed to the bank confirmation letter.
As the level of debt has increased, there should be additional finance costs as the loan has an interest rate of 5%. There is a risk that this has been omitted from the statement of profit or loss leading to understated finance costs and overstated profit.	The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of the 5% interest rate. Interest payments should be agreed to the cash book and bank statements to confirm the amount was paid and is not therefore a year-end payable.
Darjeeling Co intends to undertake a stock exchange listing in the next 12 months. In order to maximise the success of the potential listing, Darjeeling Co will need to present financial statements which show the best possible position and performance. The directors therefore have an incentive to manipulate the financial statements, by overstating revenue, profits and assets.	Earl & Co should ensure that there is a suitably experienced audit team. Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of revenue, profits and assets, including attendance at an audit team briefing. The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Significant estimates and judgements should be carefully reviewed in light of the misstatement risk.
The receivables collection period has increased from 38 to 51 days and management has extended the credit terms given to customers on the condition that sales order quantities were increased. The increase in receivable days could be solely due to these increased credit terms. However, it could also be due to an increased risk over recoverability of receivables as they may be overvalued and expenses understated.	Review and test the controls surrounding how Darjeeling Co identifies receivables balances which may not be recoverable and procedures around credit control to ensure that they are operating effectively. Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation. Also consider the adequacy of any allowance for receivables.

Audit risk	Auditor's response
This year the company made a 'price promise' to match the price of its competitors for similar products. Customers are able to claim the difference from the company for one month after the date of purchase of goods. The company should account for the price promise in accordance with IFRS® 15 *Revenue from Contracts with Customers*. As the company may be required to provide a refund, the anticipated refund amount should not be initially recognised as revenue but instead as a refund liability until the one-month price promise period has ended. This is a highly subjective area, with many judgements required with regards to the level of likely refund due. As this is a new liability, the directors may not have correctly accounted for this sum resulting in overstated revenue, under/overstated profits and liabilities.	Discuss with management the basis of the refund liability of $0·25m and obtain supporting documentation to confirm the reasonableness of the assumptions and calculations.
Darjeeling Co has stopped further sales of one of its paint products and a product recall has been initiated for any goods sold since June. This product recall will result in Darjeeling Co paying refunds to customers. The sales will need to be removed from the 20X8 financial statements and a refund liability recognised. Also inventory will need to be reinstated, albeit at a possibly written down value. Failing to account for this correctly could result in overstated revenue, understated liabilities and misstated inventory.	Review the list of sales of the paint product made between June and the date of the recall, agree that the sales have been removed from revenue and the inventory included. If the refunds have not been paid before the year end, review the draft financial statements to confirm that it is included within current liabilities.
The company is holding a number of damaged paint products in inventory and overall the inventory holding period has increased from 45 days to 54 days. Due to the issue with the paint consistency, the quality of these products is questionable and management is investigating whether these products can be rectified. There is a risk that this inventory may be overvalued as its net realisable value may be below cost.	Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications will be required to rectify the quality of the product. Testing should be undertaken to confirm cost and NRV of the affected paint products held in inventory and that on a line by line basis the goods are valued correctly.
Revenue has increased by 16·8% in the year; and the gross margin has increased slightly from 36·4% to 37·3%. This is a significant increase in revenue and, along with the increase in gross margin, may be related to the increased credit period and price promise promotion or could be due to an overstatement of revenue.	During the audit a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase. Also increased cut-off testing should be undertaken to verify that revenue is recorded in the right period and is not overstated.
The payables payment period has increased from 40 to 58 days. The current ratio has decreased from 3·08 to 1·65. The quick ratio has also decreased from 1·97 to 0·99. In addition, the bank balance has moved from $0·56m to an overdraft of $0·81m. These are all indicators that the company could be experiencing a reduction in its cash flow which could result in going concern difficulties or uncertainties. These uncertainties may not be adequately disclosed in the financial statements.	Detailed going concern testing to be performed during the audit, including the review of cash flow forecasts and the underlying assumptions. These should be discussed with management to ensure that the going concern basis is reasonable.

(d) Faulty inventory

- Obtain a breakdown of the damaged goods held in inventory and returned from customers and cast to confirm its accuracy.
- From the breakdown, agree the damaged goods quantities manufactured since June to production records; and agree to sales records the quantities sold.
- Agree on a sample basis the returns from customers as per the breakdown back to sales returns documentation to confirm the existence of the returns quantities.

– Discuss with management the current status of their plans for this product line and whether they are able to rectify the damage and then sell the goods on. If so, agree the costs of rectification to supporting documentation.

– If the damaged inventory has been rectified and sold post year end, agree to the sales invoice to assess NRV in line with the new cost of the product.

– Agree the cost of damaged goods to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.

– Discuss with management if the goods have been written down; if so, follow through the write down to the inventory valuation to confirm.

– Inspect monthly board meeting minutes from June 20X8 onwards to obtain further information regarding the faulty paint and its possible resale value.

(e) Revenue

– Compare the overall level of revenue against prior years and budget for the year and investigate any significant fluctuations.

– Perform a proof in total calculation for revenue, creating an expectation of the average price for the main paint products multiplied by the increased sales volumes for this year. This expectation should be compared to actual revenue and any significant fluctuations should be investigated.

– Obtain a schedule of sales for the year broken down into the main product categories and compare this to the prior year breakdown and for any unusual movements, discuss with management.

– Calculate the final gross profit margin for Darjeeling Co and compare this to the prior year and investigate any significant fluctuations.

– Select a sample of sales invoices for customers and agree the sales prices back to the price list or customer master data information to ensure the accuracy of invoices.

– For a sample of invoices, recalculate invoice totals including discounts and sales tax.

– Select a sample of credit notes raised, trace through to the original invoice and ensure the invoice has been correctly removed from sales.

– Select a sample of customer orders and agree these to the despatch notes and sales invoices through to inclusion in the sales ledger and revenue general ledger accounts to ensure completeness of revenue.

– Select a sample of despatch notes both pre and post year end and follow these through to sales invoices in the correct accounting period to ensure that cut-off has been correctly applied.

– For sales made under the price promise, compare the level of claims made to date with the refund liability recognised and assess whether it is reasonable.

– For a sample of sales invoices issued between June and the product recall, trace to subsequent credit notes to confirm that the sale has been removed from revenue.

17 (a) (i) Importance of communicating with those charged with governance

In accordance with ISA 260 *Communication with Those Charged with Governance*, it is important for the auditors to report to those charged with governance as it helps in the following ways:

– It assists the auditor and those charged with governance in understanding matters related to the audit, and in developing a constructive working relationship. This relationship is developed while maintaining the auditor's independence and objectivity.

– It helps the auditor in obtaining, from those charged with governance, information relevant to the audit. For example, those charged with governance may assist the auditor in understanding the entity and its environment, in identifying appropriate sources of audit evidence and in providing information about specific transactions or events.

– It helps those charged with governance in fulfilling their responsibility to oversee the financial reporting process, thereby reducing the risks of material misstatement of the financial statements.

– It promotes effective two-way communication between the auditor and those charged with governance.

(ii) Matters to be communicated to those charged with governance

– The auditor's responsibilities with regards to providing an opinion on the financial statements and that they have carried out their work in accordance with International Standards on Auditing.

– The auditor should explain the planned approach to the audit as well as the audit timetable.

– Any key audit risks identified during the planning stage should be communicated.

– In addition, any significant difficulties encountered during the audit should be communicated.

– Also significant matters arising during the audit, as well as significant accounting adjustments.

– During the audit, any significant deficiencies in the internal control system identified should be communicated in writing or verbally.
– How the external auditor and internal auditor may work together and any planned use of the work of the internal audit function.
– Those charged with governance should be notified of any written representations required by the auditor.
– Other matters arising from the audit which are significant to the oversight of the financial reporting process.
– If any suspected frauds are identified during the audit, these must be communicated.
– If the auditors are intending to make any modifications to the audit opinion, these should be communicated to those charged with governance.
– For listed entities, a confirmation that the auditors have complied with ethical standards and appropriate safeguards have been put in place for any ethical threats identified.

(b) Control deficiencies and recommendations

Control deficiency	Control recommendation
Each restaurant maintains a petty cash float of $400, and at any point in time the receipts and funds present should equal the float. It has been noted by the internal audit (IA) department that on occasions there are differences due to the fact that no log is maintained of petty cash requests. This could be as a result of sundry items being purchased without the relevant receipt or voucher being returned. There is also a possibility that the cash is being misappropriated by staff members, or being spent on non-business related items.	A petty cash log should be maintained so the purchase of sundry items is recorded in the log along with the sum borrowed, date and employee. On purchase of the items, the relevant employee should return the relevant receipt or voucher and any funds not spent. The log should be updated to confirm return of funds and receipts. On a weekly basis, the restaurant manager should reconcile the petty cash and if any receipts are missing, these should be followed up with the relevant employee. If it is cash which is missing, then this should be investigated further with the employees who made petty cash purchases during that period.
To speed up the cash payment by customers, for each venue the tills have the same log on code and these codes are changed fortnightly. In the event of cash discrepancies arising in the tills, it would be difficult to ascertain which employees may be responsible as there is no way of tracking who used which till. This could lead to cash being easily misappropriated.	Each employee should be provided with a unique log on code and this is required to be entered when using the tills. In order to facilitate the investigation of till differences, employees should be allocated to a specific till point for their shift. Any discrepancies which arise should initially be double checked to ensure they are not arithmetical errors. If still present, the relevant employees who had access to the till can be identified and further investigations can be undertaken.
The reconciliations of the tills to the daily sales readings are performed in total for all five tills at each venue rather than for each till. This means that when exceptions arise, it will be difficult to identify which till caused the difference and therefore which employees may require further till training or may have undertaken fraudulent transactions.	The reconciliations should be undertaken on an individual till by till basis rather than in aggregate and any discrepancies noted should be investigated immediately.
The cashing up of tills along with the recording of any cash discrepancies is undertaken by just one individual, the restaurant manager. There is a fraud risk as the manager could remove some of the cash and then simply record that there was an exception on the daily sales list. In addition, as there is no segregation of duties, the restaurant manager could, fraudulently or by error, record the total sales as per each till incorrectly leading to incorrect identification of discrepancies.	The cashing up process should be undertaken by two individuals together, ideally an assistant manager and the restaurant manager. One should count the cash and the other record it. Any exceptions to the till reading should be double checked to confirm that they are not simply arithmetical errors. If still present, the relevant employees who had access to the till can be identified and further investigations can be undertaken.

Control deficiency	Control recommendation
Daily sales sheets are scanned and emailed to head office on a weekly basis. There is a possibility that some sales sheets could be misplaced by the restaurant manager resulting in incomplete sales and cash receipts data being recorded into the accounting system.	Daily sales sheets for each venue should be sequentially numbered and remitted to head office on a daily basis. At head office, a sequence check should be undertaken on a regular basis to identify any missing sheets and any gaps should be investigated further. Once received, the cashier should post the sales and cash data for all six venues on a daily basis. Once processed, they should then be signed as posted by the cashier and filed away securely.
Cash is stored in a safe at each venue and the restaurant manager stores the safe key in a drawer of their desk when not in use. Although cash is banked on a daily basis, there could still be a significant sum of cash onsite each day. There is a risk of significant cash losses due to theft if access to the safe key is not carefully controlled.	The current key lock safe should be replaced with a safe with a digital code. Only authorised personnel should have the code which should be updated on a regular basis.
The cashier is responsible for several elements of the cash receipts system. She receives the daily sales sheets from restaurants, agrees that cash has cleared into the bank statements, updates the cash book and undertakes the bank reconciliations. There is a lack of segregation of duties and errors will not be identified on a timely basis.	These key roles should be split between different members of the finance team, with ideally the bank reconciliations being undertaken by another member of the team.
The cashier is not checking that payments made by credit card have resulted in cash being received by Camomile Co. The credit card statements are not reviewed or reconciled, they are just filed away. There is a risk that receipts of cash by credit card may have been omitted and this would not be identified on a timely basis as the bank is only reconciled every two months and may result in difficulties in resolving any discrepancies with the credit card company.	The cashier should reconcile the credit card vouchers per restaurant to the monthly statement received from the card company. The daily amounts per the statement should be agreed to the bank statement to ensure that all funds have been received. This reconciliation should be reviewed by a responsible official, such as the financial controller, who should evidence by signature that the review has been undertaken
The bank reconciliations are only carried out every two months. For a cash-based business, the bank reconciliation is a key control which reduces the risk of fraud. If it is not reconciled regularly enough, then this reduces its effectiveness as fraud and errors may not be identified on a timely basis.	The bank reconciliations should be performed on a monthly basis rather than every two months. The financial controller should continue to review each reconciliation and evidence her review by way of signature on the bank reconciliation.
The finance director only views the total amount of payments to be made rather than the amounts to be paid to each supplier. Without looking at the detail of the payments list, as well as supporting documentation, there is a risk that suppliers could be being paid an incorrect amount, or that sums are being paid to fictitious suppliers.	The finance director should review the whole payments list prior to authorising. As part of this, he should agree the amounts to be paid to supporting documentation, as well as reviewing the supplier names to identify any duplicates or any unfamiliar names. He should evidence his review by signing the bank transfer list.

18 (a) Substantive procedures for trade receivables

- Obtain the aged receivables listing and agree to the balance on the sales ledger control account and trial balance.
- Review the aged trade receivables ledger to identify any slow moving or old balances, discuss the status of these balances with the credit controller to assess whether they are likely to pay.
- Select a representative sample of trade receivables and review for any after-date cash receipts. Ensure that a sample of slow moving/old receivable balances is also selected.
- Review customer correspondence to identify any balances which are in dispute or unlikely to be paid and discuss with management.
- Review board minutes to identify whether there are any significant concerns in relation to payments by customers.

- Calculate the average receivables collection period and compare this to the prior year and investigate any significant differences.
- Inspect post year-end sales returns/credit notes and consider whether an additional allowance against receivables is required.
- Obtain a breakdown of the allowance for trade receivables, recalculate and compare to any potentially irrecoverable balances to assess if the allowance is adequate.
- Select a sample of goods despatched notes (GDN) immediately before and after the year end and follow through to the receivables ledger to ensure they are recorded in the correct accounting period.
- Select a sample of year-end receivables balances and agree back to valid supporting documentation of sales invoices, GDNs and sales orders to ensure existence.

(b) Substantive procedures for bank balances

- Obtain a bank confirmation letter from Jasmine Co's bankers for all of its accounts.
- Agree all accounts listed on the bank confirmation letter to the company's bank reconciliations or the trial balance/general ledger to ensure completeness of bank balances.
- For the current account, obtain Jasmine Co's bank reconciliation and cast to check the additions to ensure arithmetical accuracy.
- Agree the balance per the bank reconciliation to an original year-end bank statement and to the bank confirmation letter.
- Agree the reconciliation's balance per the cash book to the year-end cash book.
- Trace all the outstanding lodgements to the pre year-end cash book, post year-end bank statement and also to the paying-in book pre year end.
- Trace all unpresented cheques through to a pre year-end cash book and post year-end bank statement. For any unusual amounts or significant delays, obtain explanations from management.
- Examine any old unpresented cheques to assess whether they need to be written back.
- Review the cash book and bank statements for any unusual items or large transfers around the year end, as this could be evidence of window dressing.
- Examine the bank confirmation letter for details of any security provided by Jasmine Co, with regards to the bank overdraft or any legal right of set-off as this may require disclosure.
- For the savings bank accounts, review any reconciling items on the year-end bank reconciliations and agree to supporting documentation.
- Review the financial statements to ensure that the disclosure of bank balances is complete and accurate and classified appropriately between current assets and current liabilities.

(c) Going concern procedures

- Obtain the company's cash flow forecast and review the cash inflows and outflows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash.
- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/outflow.
- Evaluate management's plans for future actions, including their contingency plans in relation to ongoing financing and plans for generating revenue, and consider the feasibility of these plans.
- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase and if the revenue figures in the cash flow forecast are reasonable.
- Review any agreements with the bank to determine whether any covenants have been breached, especially in relation to the overdraft.
- Review any bank correspondence to assess the likelihood of the bank renewing the overdraft facility.
- Review post year-end correspondence with suppliers to identify if any have threatened legal action or any others have refused to supply goods.
- With the client's permission, enquire of the lawyers of Jasmine Co as to the existence of any litigation and if so, the likely outcome of any litigation.
- Perform audit tests in relation to subsequent events to identify any items which might indicate or mitigate the risk of going concern not being appropriate.
- Review the post year-end board minutes to identify any other issues which might indicate further 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.

– Consider whether the going concern basis is appropriate for the preparation of the financial statements.

– Obtain a written representation confirming the directors' view that Jasmine Co is a going concern.

(d) Auditor's report

As the outcome regarding the negotiations for the overdraft facility renewal will not be known at the time of signing the auditor's report, there is a material uncertainty which may cast significant doubt on the company's ability to continue as a going concern. The impact on the auditor's report depends on whether this uncertainty is deemed to be adequately disclosed in the financial statements.

Disclosure adequate
If the disclosures are adequate, then the auditor's report will need to include a material uncertainty related to going concern section. The section will state that the audit opinion is not modified, indicate that there is a material uncertainty and will cross reference to the disclosure note made by management. It would be included after the opinion and basis for opinion paragraph.

Disclosure inadequate
If the disclosures made by management are not adequate, the audit opinion will need to be modified as there is a material misstatement relating to inadequate disclosure. The failure to adequately disclose is likely to be material but not pervasive due to the ongoing nature of the negotiations and so a qualified opinion will be issued.

The opinion paragraph will state that 'except for' the failure to adequately disclose the uncertainty, the financial statements give a true and fair view. The report will contain a basis for opinion paragraph, subsequent to the opinion paragraph, explaining that a material uncertainty exists and that the financial statements do not adequately disclose this matter.

Section B			*Marks* *Marks available*	*Marks awarded*
16	**(a)**	**Analytical procedures**		
		Must be used at planning as risk assessment tool	1	
		Can be used to gather evidence during fieldwork	1	
		Must be used at completion to confirm overall conclusion	1	
			3	
	(b)	**Ratios**		
		Gross profit margin	1	
		Inventory holding period	1	
		Receivables collection period	1	
		Payables payment period	1	
		Current ratio	1	
		Quick ratio	1	
		Max 3 ratios, ½ for each calc	**3**	
	(c)	**Audit risks and responses** (only 8 risks required)		
		Treatment of research and development costs	2	
		Incorrect capitalisation of PPE costs	2	
		New significant loan finance	2	
		Finance costs	2	
		Risk of manipulation due to potential listing	2	
		Recoverability of receivables	2	
		Accounting for ‘price promise’	2	
		Product recall	2	
		Inventory valuation	2	
		Significant increase in revenue and gross margin	2	
		Cash flow difficulties	2	
		Max 8 issues, 2 marks each	**16**	
	(d)	**Substantive procedures – faulty inventory**		
		Obtain schedule of faulty inventory, cast and agree to inventory listing	1	
		Agree quantities affected to manufacturing and sales records	1	
		Agree a sample of returns to relevant documentation	1	
		Discuss issue with management and likelihood of subsequent sale	1	
		Agree any post year-end sales to invoice and assess NRV	1	
		Agree costs of faulty goods to supporting documentation	1	
		Discuss any write down with management	1	
		Inspect board minutes for evidence of resale or additional costs	1	
		Restricted to	**3**	
	(e)	**Substantive procedures – revenue**		
		Compare to prior year and investigate differences	1	
		Perform a proof in total and investigate differences	1	
		Obtain a schedule of revenue by product line and compare to prior year and investigate differences	1	
		Calculate final gross margin and investigate differences	1	
		Agree a sample of orders to GDN, invoice and GL	1	
		Select GDNs from before and after the year end and perform cut-off testing	1	
		For sales made under the price promise, compare level of claims to refund liability	1	
		For a sample of June invoices in relation to the faulty goods, trace to subsequent credit notes	1	
		Restricted to	**3**	
	Total marks		**30**	

				Marks available	Marks awarded
17	**(a)**	**(i)**	**Importance of communicating with TCWG**		
			Assists understanding of matters related to the audit	1	
			Obtains information relevant to the audit	1	
			Assists TCWG discharge their responsibilities	1	
			Promotes effective two-way communication	1	
			Restricted to	**2**	
		(ii)	**Matters to communicate to TCWG**		
			1 mark for any relevant and well described example	**2**	
	(b)		**Control deficiencies and recommendations** (only 8 issues required)		
			Petty cash differences	2	
			Access to tills	2	
			Tills reconciled in total	2	
			Lack of SOD – reconciling cash	2	
			Risk of incomplete daily sales sheets	2	
			Security of cash – access to safes	2	
			Lack of SOD – cashier	2	
			Credit card statements are not reconciled	2	
			Frequency of bank reconciliations	2	
			Payment list not adequately reviewed	2	
			Max 8 issues, 2 marks each	**16**	
	Total marks			**20**	

			Marks available	Marks awarded
18	**(a)**	**Substantive procedures – trade receivables**		
		Obtain aged receivables listing, cast and agree to TB	1	
		Review listing for old balances and discuss with management	1	
		Perform cash after-date testing	1	
		Inspect customer correspondence for evidence of disputed items and discuss with mgt	1	
		Calculate receivables collection period, compare to PY and investigate differences	1	
		Inspect post year-end returns and consider need for additional allowance	1	
		Obtain a breakdown of the allowance, recalculate and consider adequacy	1	
		Select sample of GDNs from before and after year end and confirm recorded in correct period	1	
		Select a sample of balances and agree to order, GDN and invoice	1	
		Restricted to	**5**	
	(b)	**Substantive procedures – bank balances**		
		Bank confirmation letter	1	
		Agree to bank reconciliation and TB	1	
		Cast bank reconciliations	1	
		Testing on bank reconciliations (1 mark per relevant procedure)	4	
		Review cash book and bank statements for window dressing	1	
		Examine bank letter for evidence of security granted	1	
		Review financial statement disclosure	1	
		Restricted to	**5**	
	(c)	**Going concern procedures**		
		Obtain cash flow forecast and assess assumptions	1	
		Perform sensitivity analysis on cash flow forecast	1	
		Evaluate management's plans for future actions	1	
		Review post year-end order book to assess levels of trade	1	
		Review agreements with the bank to determine whether any covenants breached	1	
		Review bank correspondence for evidence of renewal	1	
		Review correspondence with suppliers for dispute/legal action	1	
		Obtain confirmation from company lawyers about any legal action	1	
		Review post year-end board minutes for any indications of financial difficulties	1	
		Review management accounts to assess if in line with cash flow	1	
		Review financial statement disclosure	1	
		Consider if going concern basis is appropriate	1	
		Obtain a written representation	1	
		Restricted to	**5**	
	(d)	**Impact on auditor's report**		
		Discussion of issue	1	
		Disclosure adequate	2	
		Disclosure inadequate	2	
			5	
	Total marks		**20**	

AA Examiner's commentary on September/December 2018 sample questions

This commentary has been written to accompany the published sample questions and answers and is written based on the observations of markers. The aim is to provide constructive guidance for future candidates and their tutors, giving insight into what the marking team is looking for, and flagging pitfalls encountered by candidates who sat these questions.

Question 16

This 30-mark question was based on Darjeeling Co, which develops and manufactures specialist paint products. This question tested candidates' knowledge of analytical procedures, ratios, audit risks and responses and substantive procedures for inventory and revenue. Overall candidates' performance was satisfactory.

Part (a) for three marks required candidates to explain why analytical procedures are used during the three stages of an audit. One mark was awarded for each well explained point.

It was pleasing to see that many candidates were able to clearly explain WHY analytical review procedures were used at three distinct stages in the audit process. However, a number of candidates spent time detailing what analytical procedures were and gave examples, rather than why they were used. This is a knowledge area, which has been tested in previous diets. Candidates are again reminded to read the question requirement carefully and to ensure that they are only answering the question set.

Part (b) for three marks required candidates to calculate three ratios for the current and prior year. Candidates performed well, with many scoring full marks. However, a significant minority of candidates provided more than the three required ratios. Additionally, some candidates simply stated the ratio formula. However, marks were only awarded (½ mark) for each year's calculation. Therefore no credit was available for workings or stating of ratio formulae. Some candidates simply provided the formula or working but not the final calculation – perhaps because they did not have a calculator with them. Future candidates are reminded to bring a calculator into the exam as they are often required.

Part (c) for 16 marks required candidates to identify and describe eight audit risks and to explain the auditor's response to each in planning the audit of Darjeeling Co. Performance on this question was satisfactory.

Marks were awarded for identification of an audit risk (½ mark each), explanation of the audit risk (½ mark each) and an appropriate auditor's response to each risk (1 mark each). The scenario contained more than eight risks so it was pleasing that most candidates planned their time carefully and generally only attempted to list the required number of points.

As in previous diets, although candidates identified the risks, many candidates did not adequately explain the risk. To explain the risk, candidates need to state the area of the financial statements impacted with an assertion (for example cut off/valuation etc), or a reference to over/under/misstated, or a reference to inherent/control/detection risk. For example, candidates often correctly identified that the company had made a price promise to customers and therefore recognised a refund liability, this was awarded ½ mark for identification, however, no further credit was awarded for explanations relating to the business implications of false claims. To be awarded the ½ explanation mark candidates need to clearly state the audit implication, for example, that 'profit and the liability may be misstated'.

Candidates should ensure that when identifying audit risks they use the scenario fully and rather than listing generic risks they use the detail provided. For example, service and maintenance costs had been included within the cost of a new manufacturing line capitalised into property, plant and equipment. The audit risk therefore related to the incorrect capitalisation of the service and maintenance costs and answers should have focused on this specific issue. However, a significant number of candidates provided generic risks and responses relating to capital vs revenue expenditure.

Candidate performance in relation to auditor's responses continues to be mixed. While an auditor's response does not have to be a detailed audit procedure, rather an approach the audit team will take to address the identified risk, the responses given were often too weak such as 'discuss with management'. This is not a sufficient response to deal with any identified audit risk and candidates need to be able to use their knowledge of audit procedures to provide a valid response which would adequately address the risk identified.

Future candidates must take note that audit risk is and will continue to be an important element of the syllabus and must be understood. Candidates must also ensure that they include adequate question practice as part of their revision of this key topic.

Part (d) for three marks required candidates to describe substantive procedures the auditor should perform in relation to faulty products held within year-end inventory. One mark was awarded for each well described procedure. Performance on this requirement was disappointing.

Many candidates failed to provide three procedures, and those listed often focused on the wrong areas. Unfortunately, many answers focused on standard inventory count procedures rather than focusing on the key issue of valuation. It can only be assumed that candidates saw the words 'inventory' and 'at the year end' in the requirement and launched into year-end inventory count procedures without further thought. Again, candidates must take the time to read the question requirements carefully and spend time thinking about what is needed prior to writing their answers.

Where valuation was considered many answers were vague such as 'recalculate net realisable value' without any detail of how this should be performed. Some procedures such as 'discuss with management' were provided but without any detail as to what exactly should be discussed.

As addressed in previous examiner's reports, candidates must strive to **understand** substantive procedures. Learning a generic list of tests will not translate to exam success, as they must be applied to the question requirement.

Part (e) for five marks required candidates to describe substantive procedures the auditor should perform in relation to revenue. One mark was awarded for each well described procedure. Performance on this requirement was satisfactory.

The most common procedures provided by candidates were analytical review procedures, cut-off tests and tests of detail tracing to goods received notes, invoices and the sales ledger. Many provided a sufficient number of procedures to pass this requirement.

However, some substantive procedures were often vague, for example, 'review transactions to ensure cut-off is appropriate'. Other examples of procedures which were not adequately described such as 'compare revenue to the prior year' (awarded ½ mark), for the full 1 mark candidates needed to also state 'and investigate any significant differences'. Also cut-off procedures were sometimes recommended to be undertaken using sales invoices rather than goods received notes, which would only have scored ½ mark.

Question 17

This 20-mark question was based on Camomile Co, which operates a number of restaurant venues. This question tested the areas of communication to those charged with governance and control deficiencies and recommendations. Performance was disappointing.

Part (a) for four marks required candidates to explain why it is important to report to those charged with governance and to then provide two examples of matters which may be communicated. Candidates' performance was disappointing.

The majority of candidates were unable to explain why auditors communicate, and instead simply provided examples of matters to report for part (a)(i); these were then repeated for part (a)(ii). Candidates tended to gain the two available example marks for reporting suspected frauds and significant deficiencies or matters.

This is a knowledge area, which has been tested in previous diets. Candidates must practise past exam questions, ensure they study the breadth of the syllabus and ensure their responses are relevant to the requirement.

Part (b) for 16 marks required candidates to identify and explain from the scenario eight deficiencies in respect of the cash receipts and payments system and provide a recommendation to address each of these deficiencies. Performance was disappointing.

Internal control deficiency questions such as this typically require internal control deficiencies to be identified (½ mark each), explained (½ mark each) which must cover the implication of the deficiency to the company and a relevant recommendation to address the deficiency (1 mark).

The scenario in the exam contained more issues than were required to be discussed, however, unlike previous diets, it was noted that a significant minority of candidates did not identify the required eight points. This is possibly because they were less prepared for a scenario based on the cash receipts and payments system, having only focused on sales, purchases or payroll systems. Internal controls questions remain a highly examinable area and future candidates need to ensure that they have undertaken adequate question practice of all examinable control systems.

The deficiencies most candidates were able to identify were the frequency of the bank reconciliation process, access to the safe, the restaurant manager solely cashing up tills and all tills having the same log on code. However, a significant minority of candidates identified irrelevant or unrealistic deficiencies. Some candidates identified that the company's internal audit was too small or that a centralised purchasing department should be implemented. However, the requirement was to focus on the cash system and these points were unrelated to the control system being examined, hence were not awarded any credit. Incorrect answers such as 'employees are not supervised when they enter cash receipts from customers into the tills' were not credited as they were not deficiencies and demonstrated a lack of understanding of a cash system.

In addition, some candidates did not clearly understand/explain the implication of the deficiency. Candidates are required to explain the implication to the business to be awarded credit. For example, a candidate who correctly identified the deficiency 'cash tills are only cashed up by one individual' (identification ½ mark awarded), no credit was awarded for the explanation 'this could lead to an increased risk of fraud'. Candidates must clearly explain the implication to the business of any system errors not being identified, such as 'the restaurant manager may steal the cash and conceal the error or fraud as no one else is present during the cashing up process ' to be awarded the ½ explanation mark. In addition, some candidates correctly identified the deficiency 'bank reconciliations are only performed every two months' but failed to provide any implication at all, thereby restricting marks awarded.

Candidates were able to provide some good recommendations to address the deficiencies identified. However, some of the recommendations were not described in enough detail or were auditor responses rather than control recommendations for management.

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Question 18

This 20-mark question was based on Jasmine Co, a company which manufactures motor vehicle components. This question tested candidates' knowledge of substantive procedures for trade receivables and bank, going concern procedures and auditor's reports. Overall performance was mixed.

Part (a) for five marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Jasmine's trade receivables. Performance on this requirement was satisfactory.

One mark was awarded for each well described substantive procedure. Those candidates who had practised past questions scored well, noting procedures such as after-date cash receipts testing, analytical review procedures, review of aged receivables reports and discussions with management regarding recoverability and allowances. Although many candidates recommended cut-off testing, candidates once again suggested using invoices rather than goods dispatched notes.

Those candidates who did not score well provided procedures which lacked sufficient detail. For example, 'discuss receivables with management' without explaining what was to be discussed. Vague procedures such as this are not awarded any credit.

In addition, despite the scenario stating that a trade receivables circularisation was not going to be performed, it was disappointing to see that many candidates still recommended procedures relating to the circularisation. Candidates must carefully read the scenario and tailor their procedures accordingly.

Part (b) for five marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the company's bank balances. Performance on this requirement was disappointing.

As in part (a), one mark was awarded for each well described substantive procedure. Disappointingly, the substantive procedures often lacked detail and failed to focus specifically on auditing the bank balances. Candidates seemed to note that the bank balance was an overdraft and so focused on going concern procedures. Whether the bank balance is a current asset or liability, the principal focus of the procedures should have been to audit the bank reconciliation in detail, however, very few candidates did this.

The most common procedures listed included 'obtain a bank letter' which on its own would only have scored ½ mark. To obtain 1 mark the test needed to agree the account names to the trial balance or to agree the balance given to the bank reconciliation. Vague references to auditing the bank reconciliation were given, such as 'ensure the bank statement balance matches the cashbook balance'.

In order to score well in this very commonly tested area, candidates needed to focus on each line in the bank reconciliation and provide procedures to confirm that each line represented a valid reconciling item between the bank statement and cash book.

Part (c) for five marks required candidates to describe going concern procedures. Many candidates performed well on this requirement. Again one mark was available for each well described procedure.

This area has been tested extensively in previous diets and many candidates were able to provide a sufficient number of valid going concern procedures. A minority of procedures were too brief or vague, often not giving the source for the test, or stating 'ensure' without explaining how the test would achieve this. For example, 'obtain written representations' would not have gained any credit, to obtain the available mark the procedure should be 'obtain a written representation confirming the directors' view that Jasmine Co is a going concern'. In addition, a minority of candidates suggested 'the auditor should call the bank to ask if they will renew the company's bank overdraft'. This is impractical as the bank will not provide such a response to the auditor.

Part (d) for five marks required a discussion of an issue and the impact on the auditor's report of adequate and inadequate disclosure. The issue being brief going concern disclosures made in the financial statements.

Auditor's report questions have shown a gradual improvement in recent diets so it is very disappointing that performance for this requirement was poor.

Marks were awarded for a discussion of the issue (1 mark), the impact on the auditor's report of adequate disclosure (2 marks) and inadequate disclosure (2 marks).

It was disappointing that candidates often do not discuss the issue. In order to be awarded the mark for discussing the issue, candidates should not just re-write the issue from the question. In this case candidates needed to explain that as the outcome of the overdraft renewal would not be known until after the auditor's report was signed, this was a material uncertainty (½ mark) and that the effect on the auditor's report depends on the adequacy of the disclosure (½ mark).

The question then required candidates to consider the impact on the auditor's report of adequate and inadequate disclosure. Answers should have addressed each of these outcomes and this was clearly flagged in the requirement. To score well, candidates should have considered whether any additional information would be required in the auditor's report for 'adequate disclosure' and if the opinion would be impacted. Inadequate disclosure resulted in a modification of the opinion and as a result candidates tended to perform better.

Many answers were poorly structured as they did not split out the two possible outcomes and it was at times difficult to see which points related to which outcome, resulting in difficulties in allocating marks.

Incorrect answers for adequate disclosure focused on the use of emphasis of matter paragraphs. For inadequate disclosure some candidates suggested an adverse opinion, despite the scenario stating that the engagement partner was satisfied with the use of the going concern basis.

In addition, many answers failed to consider whether the audit opinion was modified or not. Future candidates should note that credit will only be awarded to a consideration of whether the opinion, rather than the report, requires modification.