Time allowed: 3 hours 15 minutes

This question paper is divided into two sections:
Section A – ALL 15 questions are compulsory and MUST be attempted
Section B – ALL THREE questions are compulsory and MUST be attempted

Do NOT open this question paper until instructed by the supervisor.
Do NOT record any of your answers on the question paper.
This question paper must not be removed from the examination hall.
You are an audit supervisor of Earl & Co and are planning the audit of Darjeeling Co for the year ending 30 September 20X8. The company develops and manufactures specialist paint products and has been a client of your firm for several years. The audit manager has attended a planning meeting with the finance director and has provided you with the following notes of the meeting and financial statement extracts. You have been asked by the audit manager to undertake preliminary analytical procedures using the financial statement extracts.

**Planning meeting notes**

During the year Darjeeling Co has spent $0·9m, which is included within intangible assets, on the development of new product lines, some of which are in the early stages of their development cycle. Additionally, as the company is looking to expand production, during the year it purchased and installed a new manufacturing line. All costs, incurred in the purchase and installation of that asset, have been included within property, plant and equipment. These capitalised costs include the purchase price of $2·2m, installation costs of $0·4m and a five-year servicing and maintenance plan costing $0·5m. In order to finance the development projects and the new manufacturing line, the company borrowed $4m from the bank which is to be repaid in instalments over eight years and has an interest rate of 5%. Developing new products and expanding production is important as the company intends to undertake a stock exchange listing in the next 12 months.

The company started a number of initiatives during the year in order to boost revenue. It offered extended credit terms to its customers on the condition that their sales order quantities were increased. In addition, Darjeeling Co made an announcement in October 20X7 of its ‘price promise’: that it would match the prices of any competitor for similar products purchased. Customers who are able to prove that they could purchase the products cheaper elsewhere are asked to claim the difference from Darjeeling Co, within one month of the date of purchase of goods, via its website. The company intends to include a refund liability of $0·25m, which is based on the monthly level of claims to date, in the draft financial statements.

The finance director informed the audit manager that a problem arose in June 20X8 in relation to the mixing of materials within the production process for one particular product line. A number of these faulty paint products had already been sold and the issue was identified following a number of complaints from customers about the paint consistency being incorrect. As a precaution, further sales have been stopped and a product recall has been initiated for any of these specific paint products sold since June. Management is investigating whether the paint consistency of the faulty products can be rectified and subsequently sold.

**Financial statement extracts for year ending 30 September**

<table>
<thead>
<tr>
<th></th>
<th>Forecast 20X8</th>
<th>Actual 20X7</th>
</tr>
</thead>
<tbody>
<tr>
<td>Revenue</td>
<td>$19,850</td>
<td>$16,990</td>
</tr>
<tr>
<td>Cost of sales</td>
<td>($12,440)</td>
<td>($10,800)</td>
</tr>
<tr>
<td>Gross profit</td>
<td>7,410</td>
<td>6,190</td>
</tr>
<tr>
<td>Inventory</td>
<td>1,850</td>
<td>1,330</td>
</tr>
<tr>
<td>Trade receivables</td>
<td>2,750</td>
<td>1,780</td>
</tr>
<tr>
<td>Bank</td>
<td>(810)</td>
<td>560</td>
</tr>
<tr>
<td>Trade payables</td>
<td>1,970</td>
<td>1,190</td>
</tr>
</tbody>
</table>
Required:

(a) Explain why analytical procedures are used during THREE stages of an audit. (3 marks)

(b) Calculate THREE ratios, for BOTH years, which would assist you in planning the audit of Darjeeling Co. (3 marks)

(c) Using the information provided and the ratios calculated, describe EIGHT audit risks and explain the auditor's response to each risk in planning the audit of Darjeeling Co.

   Note: Prepare your answer using two columns headed Audit risk and Auditor’s response respectively. (16 marks)

(d) Describe substantive procedures the auditor should perform in relation to the faulty paint products held in inventory at the year end. (3 marks)

(e) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Darjeeling Co's revenue. (5 marks)

(30 marks)
ISA 260 *Communication with Those Charged with Governance* provides guidance to auditors in relation to communicating with those charged with governance on matters arising from the audit of an entity’s financial statements.

**Required:**

(i) **Explain why it is important for auditors to communicate throughout the audit with those charged with governance; and**

(ii) **Identify TWO examples of matters which the auditor may communicate to those charged with governance.**

Note: The total marks will be split equally between each part. (4 marks)

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**b** Camomile Co operates six restaurant and bar venues which are open seven days a week. The company’s year end is 31 December 20X8. You are the audit supervisor reviewing the internal controls documentation in relation to the cash receipts and payments system in preparation for the interim audit, which will involve visiting a number of the venues as well as the head office. The company has a small internal audit (IA) department based at head office.

The purchasing department based at the company’s head office is responsible for ordering food and beverages for all six venues. In addition, each venue has a petty cash float of $400, held in the safe, which is used for the purchase of sundry items. When making purchases of sundries, employees are required to obtain the funds from the restaurant manager, purchase the sundries and return any excess money and the receipt to the manager. At any time the petty cash sum held and receipts should equal the float of $400 but it has been noted by the company’s IA department that on some occasions this has not been the case.

Each venue has five cash tills (cash registers) to take payments from customers. Three are located in the bar area and two in the restaurant area. Customers can pay using either cash or a credit card and for any transaction either the credit card vouchers or cash are placed in the till by the employee operating the till. To speed up the payment process, each venue has a specific log on code which can be used to access all five tills and is changed every two weeks.

At each venue at the end of the day, the tills are closed down by the restaurant manager who counts the total cash in all five tills and the sum of the credit card vouchers and these totals are reconciled with the aggregated daily readings of sales taken from each till. Any discrepancies are noted on the daily sales sheet. The daily sales sheet records the sales per the tills, the cash counted and the total credit card vouchers as well as any discrepancies. These sheets are scanned and emailed to the cashier at head office at the end of each week.

Approximately 30% of Camomile Co’s customers pay in cash for their restaurant or bar bills. Cash is stored in the safe at each venue on a daily basis after the sales reconciliation has been undertaken. Each safe is accessed via a key which the restaurant manager has responsibility for. Each key is stored in a drawer of the manager’s desk when not being used. Cash is transferred to the bank via daily collection by a security company. The security company provides a receipt for the sums collected, and these receipts are immediately forwarded to head office. The credit card company remits the amounts due directly into Camomile Co’s bank account within two days of the transaction.

At head office, on receipt of the daily sales sheets and security company receipts, the cashier agrees the cash transferred by the security company has been banked for all venues. She agrees the cash per the daily sales sheets to bank deposit slips and to the bank statements. The cashier updates the cash book with the cash banked and details of the credit card vouchers from the daily sales sheets. On a monthly basis, the credit card company sends a statement of all credit card receipts from the six venues which is filed by the cashier.

Every two months, the cashier reconciles the bank statements to the cash book. The reconciliations are reviewed by the financial controller who evidences her review by signature and these are filed in the accounts department. All purchases of food and beverages for the venues are paid by bank transfer. At the relevant payment dates, the finance director is given the total amount of the payments list which he authorises.
Required:

Identify and explain EIGHT DEFICIENCIES in Camomile Co’s cash receipts and payments system and provide a recommendation to address each of these deficiencies.

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

(20 marks)
Jasmine Co manufactures motor vehicle components and its year end was 30 June 20X8. You are an audit supervisor of Peppermint & Co and the final audit is due to commence shortly. Total assets are $43·2m and profit before tax is $7·2m. The following matters have been brought to your attention:

**Trade receivables**
Jasmine Co's trade receivables ledger is comprised of a large number of customers. In previous years, the audit team has undertaken a positive trade receivables circularisation to confirm year-end balances. However, the customer response rate has historically been low and so alternative audit procedures have been undertaken. A decision has been made that for the current year audit a circularisation will not be performed. The year-end trade receivables balance is $3·9m (20X7: $2·8m) and the allowance for trade receivables is $410,000 (20X7: $300,000).

**Bank balances**
The bank and cash figure included in Jasmine Co's draft financial statements is comprised of a number of bank account balances: an overdraft of $5·1m which is the company’s main current account and $0·2m relating to several savings accounts. The finance director has informed the audit manager that all accounts have been reconciled as at the year end.

The overdraft of $5·1m has increased significantly since the prior year (20X7: $1·2m). The directors have informed you that the overdraft facility, which the company requires in order to operate on a daily basis, is due for renewal in October 20X8 and that they are confident it will be renewed.

Required:

(a) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Jasmine Co's trade receivables. (5 marks)

(b) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Jasmine Co's bank balances. (5 marks)

(c) Describe the audit procedures the auditor should perform in assessing whether or not Jasmine Co is a going concern. (5 marks)

During the final audit, the finance director has informed the audit team that Jasmine Co's bankers will not make a decision on the renewal of the overdraft facility until after the auditor's report is signed. The audit engagement partner is satisfied that the use of the going concern basis is appropriate.

The directors have agreed to include some brief going concern disclosures in the draft financial statements and the audit team still have to assess the adequacy of these disclosures.

Required:

(d) Discuss the issue and describe the impact on the auditor's report of Jasmine Co of adequate AND inadequate going concern disclosure. (5 marks)

(20 marks)

End of Question Paper