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# Answers

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Section A

**1 D**

In line with ACCA's *Code of Ethics and Conduct*, a self-interest threat would arise due to the personal relationship between the audit engagement partner and finance director.

A self-interest threat, not intimidation threat, would arise as a result of the overdue fee and due to the nature of the non-audit work, it is unlikely that a self-review threat would arise.

**2 C**

In order to maintain independence, Cassie Dixon would be the most appropriate replacement as audit engagement partner as she has no ongoing relationship with Bush Co. Appointing any of the other potential replacements would give rise to self-review or familiarity threats to independence.

**3 B**

If Alan Marshlow accepts the position as a non-executive director for Plant Co, self-interest and self-review threats are created which are so significant that no safeguards can be implemented. Further as per ACCA's *Code of Ethics and Conduct*, no partner of the firm should serve as a director of an audit client and as such, Horti & Co would need to resign as auditor.

**4 C**

Assuming a management responsibility is when the auditor is involved in leading or directing the company or making decisions which are the remit of management.

Designing and maintaining internal controls, determining which recommendations to implement and setting the scope of work are all decisions which should be taken by management.

**5 A**

Weed Co is a listed company and the fees received by Horti & Co from the company have exceeded 15% of the firm's total fees for two years. As per ACCA's *Code of Ethics and Conduct*, this should be disclosed to those charged with governance and an appropriate safeguard should be implemented. In this case, it would be appropriate to have a pre-issuance review carried out prior to issuing the audit opinion for the current year.

**6 B**

A supplier with a low balance at the year end but with a high volume of transactions during the year may indicate that not all liabilities have been recorded at the year-end date.

**7 C**

A purchase of a large volume of goods close to the year end would increase the payables payment period.

The prompt payment and trade discounts would both decrease the payables payment period, and the extended credit terms in this instance would have no impact as there is no closing balance with the new supplier.

**8 D**

The difference of \$144,640 with Oxford Co relates to goods which were received by Chester Co prior to the year end but were not recorded in the accounting records until after the year-end date. As Chester Co had a liability to pay for the goods at the date of receipt, an accrual should be created for the goods received not yet invoiced.

**9 A**

The difference in respect of Poole Co may have arisen if the invoice had been paid twice in error as an additional \$156,403 will have been debited to the supplier account.

**10 B**

Reviewing the accruals listing would not help the auditor confirm the purchase ledger balance with Bath Co as accruals are recorded separately from the purchase ledger balance.

**11 D**

As part of the overall review of the financial statements, the auditor should assess whether the information and explanations gathered during the audit and accounting policies are adequately reflected and disclosed.

Pre-conditions should be considered as part of the auditor’s acceptance procedures and a detailed review of the audit working papers is conducted as part of the firm’s quality control procedures.

**12 B**

An increase in the proportion of cash sales since the interim audit would increase sales but not trade receivables resulting in a decreased trade receivables collection period.

**13 B**

The effective date of the revaluation, the amount of the revaluation increase and the carrying amount of the head office under the cost model are disclosures required by IAS<sup>®</sup> 16 *Property, Plant and Equipment*.

**14 A**

Misstatements (2) and (3) are individually material and would require adjustment for an unmodified opinion to be issued.

Misstatement (1) is immaterial and if Viola Co did not make this adjustment, an unmodified opinion could still be issued.

**15 A**

Misstatement (4) is immaterial at 2.2% of profit before tax (\$2.9m/\$131.4m) and would not require further disclosure. Therefore as all other adjustments have been made, no material misstatement exists and an unmodified opinion can be issued.

**Section B**

**16 (a) Documenting systems**

	<b>Description</b>	<b>Advantage</b>
<b>Narrative notes</b>	Narrative notes consist of a written description of the system. They detail what occurs in the system at each stage and include any controls which operate at each stage.	They are simple to record; after discussion with staff members, these discussions are easily written up as notes.  They can facilitate understanding by all members of the audit team, especially more junior members who might find alternative methods too complex.
<b>Questionnaires</b>	Internal control questionnaires (ICQs) or internal control evaluation questionnaires (ICEQs) contain a list of questions for each major transaction cycle; ICQs are used to assess whether controls exist whereas ICEQs assess the effectiveness of the controls in place.	Questionnaires are quick to prepare, which means they are a timely method for recording the system.  They ensure that all controls present within the system are considered and recorded, hence missing controls or deficiencies are clearly highlighted to the audit team.

**(b) Deficiencies, controls and test of controls**

<b>Control deficiency</b>	<b>Control recommendation</b>	<b>Test of control</b>
<p>Customer credit limits are set by sales ledger clerks. Sales ledger clerks are not sufficiently senior and so may set limits too high, leading to irrecoverable debts, or too low, leading to a loss of sales.</p>	<p>Credit limits should be set by a senior member of the sales department and not by sales ledger clerks. These limits should be regularly reviewed by a responsible official.</p>	<p>For a sample of new customers accepted in the year, review the authorisation of the credit limit, and ensure that this was performed by a responsible official.</p> <p>Enquire of sales ledger clerks as to who can set credit limits.</p>
<p>Customer orders are given a number based on the sales person's own identification number. These numbers are not sequential. Without sequential numbers, it is difficult for Freesia Co to identify missing orders and to monitor if all orders are being dispatched in a timely manner. If they are not, this could lead to a loss of customer goodwill.</p>	<p>Sales orders should be sequentially numbered. On a regular basis, a sequence check of orders should be undertaken to identify any missing orders.</p>	<p>Re-perform the control by undertaking a sequence check of sales orders. Discuss any gaps in the sequence with sales ordering staff.</p>
<p>Lily Shah, a finance clerk, is responsible for several elements of the cash receipts system as she posts the bank transfer receipts from the bank statements to the cash book, updates the sales ledger and performs the bank reconciliations.</p> <p>There is a lack of segregation of duties and errors will not be identified on a timely basis. There is also an increased risk of fraud.</p>	<p>The key roles of posting bank receipts, updating the sales ledger and performing bank reconciliations should be split between different individuals. If this is not practical, then as a minimum, the bank reconciliations should be undertaken by another member of the finance team.</p>	<p>Review the file of completed bank reconciliations to identify who prepared them.</p> <p>Review the log of IDs of individuals who have posted bank receipts and updated the sales ledger to assess whether these are different individuals.</p> <p>Discuss with the financial controller which members of staff undertake the roles of processing of bank receipts and updating of the cash book and sales ledger.</p>
<p>GRNs are only sent to the finance department. Failing to send a copy to the purchase ordering department means that it is not possible to monitor the level of unfulfilled orders. This could result in a significant level of unfulfilled orders leading to stock-outs and a consequent loss of sales.</p> <p>In addition, if the GRN is lost, then it will not be possible for the finance department to match the invoice to proof of goods being received. This could result in a delay to the invoice being paid and a loss of supplier goodwill.</p>	<p>The GRN should be created in three parts with one copy of the GRN being sent to the ordering department. The second copy should be held at the warehouse and the third sent to the finance department.</p> <p>A purchase ordering clerk should agree their copy of the GRN to the purchase order and change the order status to complete. On a regular basis, a review should be undertaken for all unfulfilled orders and these should be followed up with the relevant supplier.</p>	<p>Review the file of copy GRNs held by the purchase ordering department and review for evidence that these are matched to orders and flagged as complete.</p> <p>Review the file of unfulfilled purchase orders for any overdue items and discuss their status with an ordering clerk.</p>
<p>Camilla Brown, the purchase ledger clerk, only utilises document count controls when inputting invoices into the purchase ledger.</p> <p>Document count controls can confirm the completeness of input. However, they do not verify the accuracy or validity of input.</p> <p>If the invoices are not input correctly, suppliers may not be paid on time, or paid incorrect amounts leading to an overpayment or loss of supplier goodwill who may withdraw credit facilities.</p>	<p>The purchase ledger clerk should instead input the invoices in batches and apply application controls, such as control totals, rather than just completeness checks to ensure both completeness and accuracy over the input of purchase invoices. In addition, sequence checks should be built into the system to ensure completeness of input.</p>	<p>The audit team should utilise test data procedures to assess whether data can be entered without the use of batch control totals and also whether sequence checks are built into the system.</p> <p>Observe the inputting of purchase invoices and identify what application controls are utilised by the clerk.</p>

Control deficiency	Control recommendation	Test of control
<p>The company values its inventory using standard costs, which are not being kept up-to-date.</p> <p>If the standard costs were reviewed 18 months ago, there is the risk that the costs are misstated as changes in raw materials and wages inflation may not have been adjusted for. This could result in inventory being under or overvalued and profits being misstated.</p> <p>In addition for year-end reporting, IAS 2 <i>Inventories</i> only allows standard costs to be used for valuation purposes if they are a close approximation to actual costs, which is unlikely if the standard costs remain unchanged for a long period of time. Therefore the valuation may not be in line with IAS 2.</p>	<p>A review of all standard costs currently in use should be undertaken by a senior manager in the production department. Actual costs for materials, labour and overheads should be ascertained and compared to the proposed standard costs to ensure they are a close approximation.</p> <p>The revised standard costs should be reviewed by the production director who should evidence this review. At least annually, a review of the standard costs should be undertaken to ensure they are up-to-date.</p>	<p>Obtain a copy of the standard costs used for inventory valuation, assess when the review was last undertaken and inspect for evidence of review by the production director.</p>
<p>Overtime worked is not authorised prior to being paid. The information per employee is collated and submitted to payroll by a production clerk, but not authorised. The production director is only informed about overtime levels via quarterly reports.</p> <p>These reports are reviewed sometime after the payments have been made which could result in unauthorised overtime or amounts being paid incorrectly and Freesia Co's payroll cost increasing.</p>	<p>All overtime should be authorised by a responsible official prior to the payment being processed by the payroll department. This authorisation should be evidenced in writing.</p>	<p>Review the overtime report for evidence of authorisation and note the date this occurred to ensure that this was undertaken prior to the payment of the overtime.</p>
<p>The finance director compares the total of the list of bank transfers with the total to be paid per the payroll records.</p> <p>There could be employees omitted or fictitious employees added to the payment listing so that, although the total payments list agrees to payroll totals, there could be fraudulent or erroneous payments being made.</p>	<p>The finance director, when authorising the payments, should on a sample basis perform checks from the human resource department's staff records to payment list and vice versa to confirm that payments are complete and only made to <i>bona fide</i> employees.</p> <p>The finance director should sign the payments list as evidence that these checks have been undertaken.</p>	<p>Obtain a sample of payments lists and review for signature by the finance director as evidence that the control is operating correctly.</p>

**(c) Accrual for employment tax payable**

Substantive procedures the auditor should adopt in respect of auditing this accrual include:

- Compare the accrual for employment tax payable to the prior year, investigate any significant differences.
- Agree the year-end employment tax payable accrual to the payroll records to confirm accuracy.
- Re-perform the calculation of the accrual for a sample of employees to confirm the accuracy.
- Undertake a proof in total test for the employment tax accrual by multiplying the payroll cost for June 20X9 with the appropriate tax rate. Compare this expectation to the actual accrual and investigate any significant differences.
- Agree the subsequent payment to the post year-end cash book and bank statements to confirm completeness.
- Review any correspondence with tax authorities to assess whether there are any additional outstanding payments due. If so, confirm they are included in the year-end accrual.
- Review any disclosures made of the employment tax accrual and assess whether these are in compliance with accounting standards and legislation.

(d) Corporate governance weaknesses and recommendations

Weakness	Recommendation
<p>The finance director is a member of the audit committee.</p> <p>The audit committee should be made up entirely of independent NEDs. The role of the committee is to maintain objectivity with regards to financial reporting; this is difficult if the finance director is a member of the committee as the finance director will be responsible for the preparation of the financial statements.</p> <p>The remuneration for directors is set by the finance director. However, no director should be involved in setting their own remuneration as this may result in excessive levels of pay being set.</p> <p>Executive remuneration includes a significant annual profit related bonus. Remuneration should motivate the directors to focus on the long-term growth of the business, however, annual targets can encourage short-term strategies rather than maximising shareholder wealth.</p> <p>The chairman has sole responsibility for liaising with the shareholders and answering any of their questions. However, this is a role which the board as a whole should undertake.</p>	<p>The audit committee must be comprised of independent NEDs only; therefore the finance director should resign from the committee.</p> <p>There should be a fair and transparent policy in place for setting remuneration levels. The NEDs should form a remuneration committee to decide on the remuneration of the executives. The board as a whole should decide on the pay of the NEDs.</p> <p>The remuneration of executives should be restructured to include a significant proportion based on long-term company performance. For example, executives could be granted share options, as this would encourage focus on the longer term position.</p> <p>All members of the board should be involved in ensuring that satisfactory dialogue takes place with shareholders, for example, all should attend meetings with shareholders such as the annual general meeting.</p> <p>The board should state in the annual report the steps they have taken to ensure that the members of the board, and in particular the non-executive directors, develop an understanding of the views of major shareholders about the company.</p>

17 (a) Materiality and performance materiality

Materiality and performance materiality are dealt with under ISA 320 *Materiality in Planning and Performing an Audit*. Auditors need to establish the materiality level for the financial statements as a whole, as well as assess performance materiality levels, which are lower than the overall materiality for the financial statements as a whole.

**Materiality**

Materiality is defined in ISA 320 as follows: 'Misstatements, including omissions, are considered to be material if they, individually or in the aggregate, could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements.'

If the financial statements include a material misstatement, then they will not present fairly (give a true and fair view) the position, performance and cash flows of the entity.

A misstatement may be considered material due to its size (quantitative) and/or due to its nature (qualitative) or a combination of both. The quantitative nature of a misstatement refers to its relative size. A misstatement which is material due to its nature refers to an amount which might be low in value but due to its prominence and relevance could influence the user's decision, for example, directors' transactions.

As per ISA 320, materiality is often calculated using benchmarks such as 5% of profit before tax or 1% of total revenue or total assets. These values are useful as a starting point for assessing materiality, however, the assessment of what is material is ultimately a matter of the auditor's professional judgement. It is affected by the auditor's perception of the financial information, the needs of the users of the financial statements and the perceived level of risk; the higher the risk, the lower the level of overall materiality.

In assessing materiality, the auditor must consider that a number of errors each with a low value may, when aggregated, amount to a material misstatement.

**Performance materiality**

Performance materiality is defined in ISA 320 as follows: 'The amount set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.'

Hence performance materiality is set at a level lower than overall materiality for the financial statements as a whole. It is used for testing individual transactions, account balances and disclosures. The aim of performance materiality is to reduce the risk that the total of all of the errors in balances, transactions and disclosures exceeds overall materiality.

**(b) Audit risks and auditor's response**

<b>Audit risk</b>	<b>Auditor's response</b>
<p>The external audit team may place reliance on the controls testing work undertaken by the IA department.</p> <p>If reliance is placed on irrelevant or poorly performed testing, then the external audit team may form an incorrect conclusion on the strength of the internal controls at Peony Co. This could result in them performing insufficient levels of substantive testing, thereby increasing detection risk.</p>	<p>The external audit team should meet with IA staff, read their reports and review their files relating to store visits to ascertain the nature of the work undertaken.</p> <p>Before using the work of IA, the audit team will need to evaluate and perform audit procedures on the entirety of the work which they plan to use, in order to determine its adequacy for the purposes of the audit. In addition, the team will need to re-perform some of the testing carried out by IA to assess its adequacy.</p>
<p>Forecast ratios from the finance director show that the gross margin is expected to increase from 56% to 60% and the operating margin is expected to decrease from 21% to 18%.</p>	<p>The classification of costs between cost of sales and operating expenses should be reviewed in comparison to the prior year and any inconsistencies investigated.</p>
<p>This movement in gross margin is significant and inconsistent with the fall in operating margin. There is a risk that costs may have been omitted or included in operating expenses rather than cost of sales. Misclassification of expenses would result in understatement of cost of sales and overstatement of operating expenses.</p>	
<p>Peony Co's inventory valuation policy is selling price less average profit margin, as this is industry practice. Inventory should be valued at the lower of cost and net realisable value (NRV).</p>	<p>Testing should be undertaken to confirm cost and NRV of inventory and that on a line-by-line basis the goods are valued correctly.</p>
<p>IAS 2 <i>Inventories</i> allows this as a cost calculation method as long as it is a close approximation to cost. If this is not the case, then inventory could be under or overvalued.</p>	<p>In addition, valuation testing should focus on comparing the cost of inventory to the selling price less margin for a sample of items to confirm whether this method is actually a close approximation to cost.</p>
<p>The company utilises a perpetual inventory system at its warehouse rather than a full year-end count. Under such a system, all inventory must be counted at least once a year with adjustments made to the inventory records on a timely basis. Inventory could be under or overstated if the perpetual inventory counts are not all completed, such that some inventory lines are not counted in the year.</p>	<p>The timetable of the perpetual inventory counts should be reviewed and the controls over the counts and adjustments to records should be tested.</p>
<p>During the interim audit, it was noted that there were significant exceptions with the inventory records being higher than the inventory in the warehouse. As the year-end quantities will be based on the records, this is likely to result in overstated inventory.</p>	<p>In addition, the level of adjustments made to inventory should be considered to assess their significance. This should be discussed with management as soon as possible as it may not be possible to place reliance on the inventory records at the year end, which could result in the requirement for a full year-end inventory count.</p>
<p>A number of assets which had not been fully depreciated were identified as being obsolete.</p>	
<p>This is an indication that the company's depreciation policy of non-current assets may not be appropriate, as depreciation in the past appears to have been understated. If an asset is obsolete, it should be written off to the statement of profit or loss. Therefore depreciation may be understated and profit and assets overstated.</p>	<p>Discuss the depreciation policy for non-current assets with the finance director and assess its reasonableness. Enquire of the finance director if the obsolete assets have been written off. If so, review the adjustment for completeness.</p>

Audit risk	Auditor's response
<p>Peony Co is planning to include a current asset of \$0.7m, which relates to advertising costs incurred and adverts shown on TV before the year end.</p> <p>The costs were incurred and adverts shown in the year ending 20X9 and there is no basis for including them as a current asset at the year end. The costs should be recognised in operating expenses in the current year financial statements.</p> <p>If these costs are not expensed, current assets and profits will be overstated.</p>	<p>Discuss with management the rationale for including the advertising as a current asset. Request evidence to support the assessment of probable future cash flows, and review for reasonableness.</p> <p>Review supporting documentation for the advertisements to confirm that all were shown before the 20X9 year end.</p> <p>Request that management remove the current asset and record the amount as an expense in the statement of profit or loss.</p>
<p>During the year, Peony Co outsourced its payroll function to an external service organisation. A detection risk arises as to whether sufficient and appropriate evidence is available at Peony Co to confirm the completeness and accuracy of controls over the payroll cycle and liabilities at the year end.</p>	<p>Discuss with management the extent of records maintained at Peony Co for the period since January 20X9 and any monitoring of controls which has been undertaken by management over payroll.</p> <p>Consideration should be given to contacting the service organisation's auditor to confirm the level of controls in place, a type 1 or type 2 report could be requested.</p>
<p>The payroll function was transferred to the service organisation from 1 January 20X9, which is five months prior to the year end. If any errors occurred during the transfer process, these could result in wages and salaries being under/overstated.</p>	<p>Discuss with management the transfer process undertaken and any controls which were put in place to ensure the completeness and accuracy of the data.</p> <p>Where possible, undertake tests of controls to confirm the effectiveness of the transfer controls. In addition, perform substantive testing on the transfer of information from the old to the new system.</p>
<p>A \$3m loan was obtained in March 20X9. This finance needs to be accounted for correctly, with adequate disclosure made. The loan needs to be allocated between non-current and current liabilities. Failure to classify the loan correctly could result in misclassified liabilities.</p>	<p>Re-perform the company's calculations to confirm that the split of the loan note is correct between non-current and current liabilities and that total financing proceeds of \$3m were received.</p> <p>In addition, the disclosures for this loan note should be reviewed in detail to ensure compliance with relevant accounting standards.</p>
<p>Peony Co is planning to make approximately 60 employees redundant after the year end.</p> <p>The timing of this announcement has not been confirmed; if it is announced to the staff before the year end, then under IAS 37 <i>Provisions, Contingent Liabilities and Contingent Assets</i>, a redundancy provision will be required at the year end as a constructive obligation will have been created. Failure to provide or to provide an appropriate amount will result in an understatement of provisions and expenses.</p>	<p>Discuss with management the status of the redundancy announcement; if before the year end, review supporting documentation to confirm the timing. In addition, review the basis of and recalculate the redundancy provision.</p>

## 18 (a) Inventory valuation

- Obtain the breakdown of WIP and agree a sample of WIP assessed during the inventory count to the WIP schedule, agreeing the percentage completion to that recorded at the inventory count.
- For a sample of inventory items (finished goods and WIP), obtain the relevant cost sheets and agree raw material costs to recent purchase invoices, labour costs to time sheets or payroll records and confirm overheads allocated are of a production related nature.
- Examine post year-end credit notes to determine whether there have been returns which could signify that a write down is required.
- Select a sample of year-end finished goods and compare cost with post year-end sales invoices to ascertain if net realisable value (NRV) is above cost or if an adjustment is required.
- Discuss the basis of WIP valuation with management and assess its reasonableness.
- Select a sample of items included in WIP at the year end and ascertain the final unit cost price by verifying costs to be incurred to completion to relevant supporting documentation. Compare to the unit sales price included in sales invoices post year-end to assess NRV.



- Review aged inventory reports and identify any slow moving goods, discuss with management why these items have not been written down or if an allowance is required.
- For the defective batch of product Crocus, review board minutes and discuss with management their plans for selling these goods, and why they believe these goods have a NRV of \$90,000.
- If any Crocus products have been sold post year end, review the sales invoice to assess NRV.
- Agree the cost of \$450,000 for product Crocus to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.
- Confirm if the final adjustment for the damaged product is \$360,000 (\$450,000 – \$90,000) and discuss with management if this adjustment has been made. If so, follow through the write down to confirm.

**(b) Research and development**

- Obtain and cast a schedule of intangible assets, agree the closing balances to the general ledger, trial balance and draft financial statements.
- Discuss with the finance director the rationale for the four-year useful life and consider its reasonableness.
- Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm that it is in line with the amortisation policy of straight line over four years and that amortisation only commenced from the point of production.
- For the three new computing software projects, discuss with management the details of each project along with the stage of development and whether it has been capitalised or expensed.
- For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss.
- For those capitalised as development, agree costs incurred to invoices.
- Confirm technically feasible and intention to complete the project by discussion with development managers or review of feasibility reports.
- Review market research reports to confirm Hyacinth Co has the ability to sell the product once complete and probable future economic benefits will arise.
- Review the costs, projected revenue and cash flow budgets for the each of the three projects to confirm Hyacinth Co has adequate resources to complete the development stage and that probable future economic benefits exist. Agree the budgets to supporting documentation.
- Review the disclosures for intangible assets in the draft financial statements to verify that they are in accordance with IAS 38 *Intangible Assets*.

**(c) Sales tax liability**

- Agree the year-end sales tax liability in the trial balance to the tax return/reconciliation submitted to the tax authority and cast the return/reconciliation.
- Agree the quarterly sales tax charged equates to 15% of the last quarter's sales as per the sales day book.
- Recalculate the sales tax incurred as per the reconciliation is equal to 15% of the final quarter's purchases and expenses as per the purchase day book.
- Recalculate the amount payable to the tax authority as being sales tax charged less sales tax incurred.
- Compare the year-end sales tax liability to the prior year balance or budget and investigate any significant differences.
- Agree the subsequent payment to the post year-end cash book and bank statements to confirm completeness and that it has been paid in line with the terms of the tax authority.
- Review any current and post year-end correspondence with the tax authority to assess whether there are any additional outstanding payments due. If so, confirm they are included in the year-end liability.
- Review any disclosures made of the sales tax liability to ensure that it is shown as a current liability and assess whether disclosures are in compliance with accounting standards and legislation.

**(d) Subsequent event**

A flood has occurred at the off-site warehouse and property, plant and equipment and inventory valued at \$0.7 million have been damaged and now have no scrap value. The directors do not believe they are likely to be able to claim on the company's insurance for the damaged assets. This event occurred after the reporting period and is not an event which provides evidence of a condition at the year end and so this is a non-adjusting event.

The damaged assets of \$0.7 million are material as they represent 10.9% (\$0.7m/\$6.4m) of profit before tax and 3.0% (\$0.7m/\$23.2m) of total assets. As a material non-adjusting event, the assets do not need to be written down to zero in this

financial year. However, the directors should consider including a disclosure note detailing the flood and the value of assets impacted.

The following audit procedures should be applied to form a conclusion on any amendment:

- Obtain a schedule showing the damaged property, plant and equipment and agree the net book value to the non-current assets register to confirm the total value of affected assets.
- Obtain a schedule of the water damaged inventory, visit the off-site warehouse and physically inspect the impacted inventory. Confirm the quantity of goods present in the warehouse to the schedule; agree the original cost to pre year-end production costs.
- Review the condition of other PPE and inventory to confirm all damaged assets identified.
- Review the damaged property, plant and equipment and inventory and discuss with management the basis for the zero scrap value assessment.
- Discuss with management why they do not believe that they are able to claim on their insurance; if a claim were to be made, then only uninsured losses would require disclosure, and this may be an immaterial amount.
- Discuss with management whether they will disclose the effect of the flood, as a non-adjusting event, in the year-end financial statements.

		<i>Marks</i>
<b>Section A</b>		
Questions 1–15 – each worth 2 marks		<b><u>30</u></b>
<b>Section B</b>		
	<i>Marks available</i>	<i>Marks awarded</i>
<b>16 (a) Methods of documenting internal control systems</b>		
Narrative notes	2	
Questionnaires	<u>2</u>	
	<b>4</b>	
<b>(b) Control deficiencies, recommendations and tests of control (only 6 required)</b>		
Credit limits	3	
No sequential numbering of orders	3	
Segregation of duties – cash receipts	3	
Insufficient copies of GRN	3	
Controls over inputting of invoices	3	
Out-of-date standard costs	3	
Overtime not authorised	3	
Authorisation of bank transfer	<u>3</u>	
<b>Max 6 issues, 3 marks each</b>	<b><u>18</u></b>	
<b>(c) Substantive procedures – accrual for employment tax</b>		
Compare to prior year and investigate differences	1	
Agree accrual to year-end payroll records	1	
Recalculate accrual and consider reasonableness	1	
Perform proof in total and investigate variances	1	
Confirm post year-end payment	1	
Review correspondence with tax authorities for any additional liabilities	1	
Review disclosure and confirm in line with accounting standards	<u>1</u>	
<b>Restricted to</b>	<b>4</b>	
<b>(d) Corporate governance weakness and recommendations (2 issues required)</b>		
Composition of audit committee	2	
Finance director sets remuneration	2	
Executive directors' remuneration	2	
Only chairman liaises with shareholders	<u>2</u>	
<b>Max 2 issues, 2 marks each</b>	<b>4</b>	
<b>Total marks</b>		<b><u>30</u></b>

	<i>Marks available</i>	<i>Marks awarded</i>
<b>17 (a) Materiality and performance materiality</b>		
Materiality definition	1	
Material due to size or nature	1	
Materiality benchmarks	1	
Depends on judgement and risk	1	
Performance materiality definition	1	
Used for testing individual balances	1	
Set at lower level than materiality	1	
<b>Restricted to</b>	<u>4</u>	
<b>(b) Audit risks and responses (only 8 required)</b>		
Reliance on internal audit – increased detection risk	2	
Unusual movement in margins	2	
Inventory valuation policy	2	
Perpetual inventory system	2	
Obsolete PPE	2	
Advertising expenditure	2	
Use of payroll service organisation	2	
Transfer of data to service organisation	2	
Bank loan	2	
Redundancy plan	2	
<b>Max 8 issues, 2 marks each</b>	<u>16</u>	
<b>Total marks</b>		<u>20</u>

<b>18 (a) Substantive procedures – valuation of inventory</b>	
Agree percentage completion recorded at inventory count to final inventory records	1
Confirm costs to invoice/timesheets	1
Inspect post year-end sales invoices for finished goods to assess NRV	1
Discuss basis of WIP valuation with management	1
Inspect WIP valuation with sales prices less costs to complete	1
Review aged inventory reports and discuss allowance	1
Discuss with management basis of valuation for Crocus products	1
Inspect post year-end sales value of Crocus products	1
Confirm adjustment regarding Crocus products	1
<b>Restricted to</b>	<u>6</u>
 <b>(b) Substantive procedures – R&amp;D expenditure</b>	
Obtain schedule, cast and agree to trial balance	1
Review reasonableness of useful lives	1
Recalculate amortisation and confirm in line with policy	1
Discuss with management treatment of costs for new products	1
Agree research costs expensed	1
For capitalised costs, confirm IAS 38 criteria met	1
Inspect budgets to confirm adequate resources to complete	1
Review disclosure and confirm in line with accounting standards	1
<b>Restricted to</b>	<u>4</u>
 <b>(c) Substantive procedures – accrual for sales tax liability</b>	
Obtain schedule/return, cast and agree to trial balance	1
Recalculate sales tax in relation to sales and agree to return	1
Recalculate sales tax in relation to purchases and agree to return	1
Recalculate overall amount due to tax authority	1
Compare liability to prior year end, investigate differences	1
Confirm payment to post year-end cashbook and bank statements	1
Review correspondence with the tax authority for evidence of additional liability	1
Review disclosure and confirm in line with IAS 37	1
<b>Restricted to</b>	<u>4</u>
 <b>(d) Subsequent event</b>	
Discussion of amendment	3
Audit procedures	3
	<u>6</u>
<b>Total marks</b>	<u><u>20</u></u>



# AA Examiner's commentary on March/June 2019 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 Freesia Co, a listed furniture manufacturer. This question tested candidates' knowledge of methods of documenting internal control systems, control deficiencies, recommendations and tests of controls, substantive procedures and corporate governance. Performance was mixed.

Part (a) for four marks required candidates to describe documenting internal control systems using narrative notes and questionnaires and explain an advantage of using each method. Performance in this knowledge-based question was satisfactory.

There were some good responses, however, a number of candidates were unable to describe each method in enough detail to sufficiently differentiate the two methods of documentation. A number of candidates also discussed the disadvantages of each method, which was not a requirement of the question. In addition, a number of responses described types of questionnaires in too much detail given the marks available.

Candidates are reminded to read the question requirement carefully to ensure that they are only answering the question set and to consider the marks available when writing their answers.

Part (b) for 18 marks required candidates to identify and explain from the scenario six deficiencies, recommend a control to address each of these deficiencies, and describe a test of control the external auditors should perform. Performance was satisfactory.

Internal control deficiency questions such as this typically require internal control deficiencies to be identified ( $\frac{1}{2}$  mark each), explained ( $\frac{1}{2}$  mark each) which must cover the implication of the deficiency to the company, a relevant recommendation to address the deficiency (1 mark), and a test of control the external auditors should perform to assess of the control is operating effectively (1 mark).

The scenario in the exam contained more issues than were required to be discussed. It was pleasing that the majority of candidates were able to identify six deficiencies. Very few candidates, however, identified the lack of controls over the accuracy of purchase invoice entry, or the lack of sufficient copies of goods received notes. A minority of candidates identified irrelevant or unrealistic deficiencies. For example, a significant number of candidates were concerned about the range of work performed by the warehouse staff although this was not flagged as an issue in the scenario.

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 'credit limits are set by the sales ledger clerks' (identification  $\frac{1}{2}$  mark awarded), no credit was awarded for the explanation 'the sales ledger clerk is not senior enough'. Candidates must clearly explain the implication to the business that 'this could result in irrecoverable debts if limits set are too high or loss of sales if limits are too low' to be awarded the  $\frac{1}{2}$  explanation mark.

Candidates were able to provide recommendations to address the deficiencies identified, however, often the recommendations were not described in enough detail. For example, the recommendation that 'sales orders should be sequentially numbered' was awarded only  $\frac{1}{2}$  mark, candidates needed to also recommend that 'there should be regular sequence checks' to be awarded the full one mark.

Candidates were also able to describe tests of controls the external auditor should perform, however, often they were not described in enough detail. For example, the test of control of 'reviewing the authorised overtime report' was awarded only  $\frac{1}{2}$  mark, candidates needed to recommend the auditor also 'notes the date of review to ensure the report is authorised prior to payment' to be awarded the full one mark.

It was pleasing that many candidates followed the instructions to set their answer out in three columns, being control deficiency, control recommendation and test of control.

Internal control questions remain a highly examinable area and future candidates need to ensure that they have undertaken adequate question practice of all examinable control systems.

Part (c) for four marks required candidates to describe substantive procedures the auditor should perform in relation to a year-end accrual for employment tax payable. One mark was available for each well-described procedure. Performance on this requirement was disappointing. Many candidates failed to provide four procedures, and those listed often focused on payroll expenses and deductions rather than the relevant year-end accrual. Candidates must take the time to read the question requirements carefully and spend time thinking about what is needed prior to writing their answers.

Part (d) for four marks required candidates to describe two corporate governance weaknesses faced by Freesia Co and provide a recommendation to address each weakness to ensure compliance with corporate governance principles. One mark was available per well-explained weakness and one mark per recommendation. Performance was mixed.

Candidates generally identified two weaknesses, however, often did not adequately explain why each was a weakness. For example, a significant number of candidates correctly identified the weakness 'the finance director decides on the directors' remuneration' ( $\frac{1}{2}$  mark), however, only stronger candidates explained 'this could result in setting excessive pay' ( $\frac{1}{2}$  mark). Weaker candidates simply explained this weakness as being 'against corporate governance rules' and were not awarded the second  $\frac{1}{2}$  mark.

Recommendations were mixed. A significant number of candidates did not state a clear action as a recommendation. No mark was awarded for giving a statement rather than an action. For example, 'the finance director should not set the remuneration' was not awarded credit. Candidates needed to recommend 'a remuneration committee of non-executive directors should be established to set executives' pay' for one mark.

### **Question 17**

This 20-mark question was based on Peony Co, a food retailer. This question tested candidates' knowledge of materiality and audit risks and responses. Candidates' overall performance was satisfactory.

Part (a) for four marks required candidates to define and explain materiality and performance materiality. One mark was available for each well-explained point. This is a knowledge area which has been tested in previous exam sessions. Performance was mixed.

A significant number of candidates correctly described performance materiality as 'being lower than materiality' (1 mark) and 'comprised of small aggregated errors' (1 mark). However, it was disappointing that a number of candidates were not familiar with the commonly used benchmarks for quantitative materiality.

Part (b) 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 Peony Co. Performance was satisfactory.

Marks were awarded for identification of audit risk ( $\frac{1}{2}$  mark each), explanation of audit risks ( $\frac{1}{2}$  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.

Candidates identified the risks well. However, a significant minority of candidates noted 'the client had been an audit client for a number of years and hence the auditor would be too familiar with the client'. This was not awarded any credit, as this is a risk to the auditor's independence which should be considered prior to continuing with the engagement.

As in previous exam sessions, many candidates did not adequately explain the risk. To explain the risk, candidates need to state the specific 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.

Misstated was only awarded credit if it was clear the balance could be either over or understated. A significant minority of candidates stated 'inventory could be misstated due to the inventory records being higher than physical counts'. This was not awarded credit as the balance could clearly only be 'overstated'.

A significant minority of candidates did not clearly state the specific area of the financial statement impacted. For the above example stating 'current assets could be overstated' without any reference to inventory was not awarded credit. Candidates must clearly demonstrate that they understand the specific area of the financial statements impacted, to be awarded the  $\frac{1}{2}$  implication mark.

Candidates' performance in relation to auditor's responses continues to be mixed. While an auditor's response does not have to be a detailed procedure, rather an approach the audit team will take to address the identified risk, the responses given were often too weak. For example, in response to the possible errors in the transfer of data to the service organisation, the response 'check the transfers' was not sufficient, candidates needed to explain how, for example, by 'performing substantive testing on the transfer of information from the old to the new system or performing tests of controls to confirm the effectiveness of the transfer controls'.

A significant number of candidates gave management rather than auditor's response. For example, when discussing the redundancy plan a number of candidates noted 'there may be a lack of staff for future expansion'. This was not awarded credit.

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



## Question 18

This 20-mark question was based on Hyacinth Co, a manufacturer of computer components. This question tested candidates' knowledge of substantive procedures for inventory, research and development, and the year-end sales tax liability. The question also tested candidates' knowledge of the treatment of subsequent events in the financial statements. Overall performance was mixed.

Part (a) for six marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the valuation of Hyacinth Co's inventory. Performance on this requirement was disappointing. One mark was awarded for each well-described audit procedure.

The most common procedures provided by candidates were confirming raw material costs to purchase invoices, and comparing post year-end sales invoices to cost to assess net realisable value.

While it was pleasing that a significant number of candidates noted analytical review procedures, these were often not adequately explained for a full one mark. For example, many candidates only noted 'compare year-end inventory days with the prior year' (this was awarded  $\frac{1}{2}$  mark), for an additional  $\frac{1}{2}$  mark the candidate needed to also state 'and investigate any significant differences'.

It was disappointing that despite the requirement stating procedures for the 'valuation' of inventory, a significant number of candidates listed procedures for the existence and completeness of inventory such as 'attending the inventory count'. This was not awarded any credit. Candidates must carefully read the requirement of the question and tailor their answers accordingly.

In addition, many candidates did not specifically refer to audit procedures for the Crocus product which had not met customer quality and technical standards. Candidates are advised again to carefully read the scenario and tailor their procedures to address the issues described.

Part (b) for four marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Hyacinth Co's research and development expenditure. Performance on this requirement was mixed. One mark was awarded for each well-described audit procedure.

The most common procedures provided by candidates were to cast the schedule of intangible assets, agree it to the trial balance, and discuss with management if the new projects were capitalised or expensed.

In order to score well in this very commonly tested area, candidates needed to explain how a procedure should be performed. For example, 'ensure the four year amortisation policy is reasonable' would not have gained full credit. The candidate needed to explain how the auditor could achieve this. For one mark the candidate needed to state 'discuss with the finance director the rationale for the four-year useful life and consider its reasonableness'.

While it was pleasing that a significant number of candidates noted the auditor should 'review the disclosures of intangibles in the financial statements' ( $\frac{1}{2}$  mark), it was disappointing that candidates did not also state 'and verify that they are in line with accounting standards' to be credited a further  $\frac{1}{2}$  mark. Candidates are reminded that substantive procedures must be well explained to be awarded a full one mark.

It was pleasing that candidates noted (for 1 mark) that 'if capitalised, agree compliance with the criteria in IAS 38 for capitalisation'. However it was disappointing that few candidates suggested detailed testing to ensure this compliance. For example, very few candidates noted 'review market research reports to confirm the ability to sell the product'.

It was disappointing that many candidates listed generic audit procedures, which were not relevant to the scenario. For example, a significant number of candidates noted analytical review procedures with the prior year, which was not appropriate.

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 requirements.

Part (c) for four marks required candidates to describe substantive procedures to obtain sufficient and appropriate audit evidence in relation to Hyacinth Co's year-end sales tax liability. Performance was disappointing. One mark was awarded for each well-described audit procedure.

The most common procedures provided by candidates were analytical review procedures and after-date cash payment.

A significant minority of candidates disappointingly listed procedures for revenue rather than sales tax, and/or listed procedures to audit the sales tax system throughout the year rather than testing the year-end liability. Candidates again are advised to read the question carefully.

Part (d) for six marks required candidates to (i) explain whether the financial statements required amendment in relation to a flood and (ii) describe audit procedures, which should be performed in order to form a conclusion on any required amendment. One mark was available per valid point and the marks were split equally between each part.

Performance for part (i) was reasonable. A significant number of candidates scored well by calculating materiality, concluding the 'matter was material', and stating that 'the financial statements required amendment'. However, it was disappointing that few candidates stated either that 'a disclosure note was necessary' or specifically stated that 'it was a non-adjusting event'.

Performance for part (ii) was disappointing. Despite the scenario stating that 'the company is unlikely to be able to claim on its insurance', a significant number of candidates inappropriately suggested 'writing to the insurance company'. A significant number of candidates also discussed the potential impact on the auditor's report, but this was not a requirement of the question. Candidates are again reminded to read the question requirement carefully.