
Answers

1 (a) Control Objectives – wages system

- Employees are only paid for work that they have done
- Gross pay has been calculated correctly
- Gross pay has been authorised
- Net pay has been calculated correctly
- Gross and net pay have been recorded accurately in the nominal ledger
- Only genuine employees are paid
- Correct amounts are paid to taxation authorities.

(b) The Directors

**Blake Ltd
110 High Street
Littlehampton
HH1 7YY**

3 December 2008

Dear Sirs

Management letter

We write to bring to your attention weaknesses in your company’s internal control systems and provide recommendations to alleviate those weaknesses.

(i) Weakness:

The logging in process for employees is not monitored.

Overtime is not authorised by a responsible official.

The code word authorising the accuracy of time worked to the wages system is the name of the cat of the department head.

The total amount of net wages transferred to employees is not agreed to the total of the list of wages produced by the payroll department.

Details of employees leaving the company are sent on an e-mail from the personnel department to payroll.

(ii) Possible effect:

Employees could bring cards for absent employees to the assembly plant and scan that card for the employee; absent employees would effectively be paid for work not done.

Employees may get paid for work not done e.g. they may clock-off late in order to receive ‘overtime’ payments.

The code word is not secure and could be easily guessed by an employee outside the department (names of pets are commonly used passwords).

‘Dummy’ employees – payments that do not relate to any real employee – could be added to the payroll payments list in the accounts department.

There is no check to ensure that all e-mails sent are actually received in the payroll department.

(iii) Recommendation:

The shift manager should reconcile the number of workers physically present on the production line with the computerised record of the number of employees logged in for work each shift.

All overtime should be authorised, either by the shift manager authorising an estimated amount of overtime prior to the shift commencing or by the manager confirming the recorded hours in the payroll department computer system after the shift has been completed.

The code word should be based on a random sequence of letters and numbers and changed on a regular basis.

Prior to net wages being sent to the bank for payment, the financial accountant should agree the total of the payments list to the total of wages from the payroll department.

There needs to be a control to ensure all e-mails are received in personnel – prenumbering of e-mails or tagging the e-mail to ensure a receipt is sent back to the personnel department will help meet this objective.

(i) Weakness:

In the accounts department, the accounts clerk authorises payment of net wages to employees.

(ii) Possible effect:

It is inappropriate that a junior member of staff should sign the payroll; the clerk may not be able to identify errors in the payroll or could even have included 'dummy employees' and is now authorising payments to those 'people',

(iii) Recommendation:

The payroll should be authorised by a senior manager or finance director.

If you require any further information on the above, please do not hesitate to contact us.

Yours faithfully

Global Audit Ltd

(c) Substantive analytical procedures

Substantive analytical procedure

Compare total salaries cost this year to total salaries cost last year.

Ascertain how many shift managers are employed by Blake and the total salary from the personnel department. Calculate total salary and compare to the salary disclosed in the financial statements.

Obtain a listing of total salary payments made each month.

Expectation

Assuming that the number of shift managers has remained unchanged, the total salary expenditure should have increased by inflation only.

Total salary should be approximately number of managers multiplied by average salary.

The total payments should be roughly the same apart from July onwards when salaries increased and November when the annual bonus was paid.

(d) Audit procedures to collect evidence

Audit procedure

Confirmation

Confirmation is the process of obtaining a representation of information or of an existing condition directly from a third party.

Observation

This procedure involves watching a procedure being performed by others – in this case watching shift-workers using the time recording system.

Inquiry

Inquiry involves obtaining information from client staff or external sources.

Benefit to auditor in testing accuracy of time recording system

Obtaining information from a third party will be difficult. The manufacturer of the time recording system could be approached to discuss known errors with the system; however, information provided may be limited by the need to protect the manufacturer's integrity.

It is therefore unlikely that the auditor will benefit from this procedure.

Testing will be limited to ensuring all shift-workers actually clock in and out when they arrive to and depart from work. The procedure has limited use as it only confirms it worked when shift-workers were observed. It also cannot confirm that hours have been recorded accurately.

Inquiry only confirms that shift-workers confirm they clock-in or out. It does not directly confirm the action actually happened or the accuracy of the recording of hours worked.

Audit procedure

Applicability in testing accuracy of time recording system

Recalculation

Recalculation means re-checking the arithmetical accuracy of the client's records; in this case the hours worked by the time-recording system.

Recalculation can confirm the hours worked are correctly calculated as the difference between the clocking in and out times in the time recording system. When used with reperformance evidence this will confirm the overall accuracy of the time recording system.

Reperformance

This is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

If the auditor notes the time of clocking in and out, then these times can be agreed to the time recording system confirming the accuracy of recording (or confirm that client staff actually perform this control). Repformance is therefore a good source of audit evidence.

Analytical procedures

Analytical procedures involve comparing financial or non-financial data for plausible relationships.

This procedure will be useful for the auditor as the total time recorded for each employee should be standard hours plus any estimate of the overtime worked.

2 (a) Competence and objectivity of experts

- The expert's professional qualification. The expert should ideally be a member of a relevant professional body or have the necessary licence to perform the work.
- The experience and reputation of the expert in the area in which the auditor is seeking audit evidence.
- The independence of the expert from the client company. The expert should not normally be employed by the client.

(b) Auditor rights

- Right of access to the company's books and records at any reasonable time to collect the evidence necessary to support the audit opinion.
- Right to require from the company's officers the information and explanations the auditor considers necessary to perform their duties as auditors.
- Right to receive notice of and attend meetings of the company in the same way as any member of the company.
- Right to speak at general meetings on any matter affecting the auditor or previous auditor.
- Where the company uses written resolutions, a right to receive a copy of those resolutions.

(c) Tangible fixed assets – assertions

- Completeness – ensure that all fixed assets are recorded in the fixed asset register by agreeing a sample of assets physically verified back to the register.
- Existence – ensure fixed assets exist by taking a sample of assets from the register and physically seeing the asset.
- Valuation and allocation – ensure assets are correctly valued by checking the reasonableness of depreciation calculations.
- Rights and obligations – ensure the company owns the asset by seeing appropriate document of ownership for example, a purchase invoice.
- Presentation and disclosure assertions – ensure all necessary financial statements disclosures have been made by reviewing the financial statements and ensure fixed assets are correctly categorised in those financial statements.

Note: only four assertions were required.

3 (a) Ethical threats

Ethical threat

Mr Son, the engagement partner has been involved with the client for the last nine years.

This means he may be too familiar with the client to be able to make objective decisions due to this long association (ES3 has a 10 year limit on engagement partners for limited companies).

There is no ethical rule which stops Mr Son recommending Zoe for the audit, or letting Zoe take part in the audit.

However, there may be the *impression* of lack of independence as Zoe is related to the engagement partner. Zoe could be tempted not to identify errors in case this prejudiced her father's relationship with the client.

As long as Mr Far paid a full fee to Stark Ltd for the investment advice, then there is no ethical threat. This would be a normal commercial transaction and Mr Far would not gain any benefit.

However, continued use of client services could imply a lack of independence especially as Mr Far is not paying a full fee and therefore receiving a benefit from the client.

The audit team have been offered a balloon flight at the end of the audit.

Acceptance of gifts from a client, unless of an insignificant amount, is not allowed. The fact that the flight costs less than the yacht expense is irrelevant, independence could still be impaired.

Agreeing to accept taxation work on the percentage of the tax saved is essentially accepting a contingent fee.

There will be pressure to gain the highest tax refund for the client and this could tempt the audit firm to suggest illegal tax avoidance schemes.

Representing Stark Ltd in court could be seen as an advocacy threat – that is the audit firm is promoting the position of the client.

Objectivity could be compromised because the audit firm is seen to take the position that the client is correct, affecting judgement on the tax issue.

Mitigation of threat

Mr Son should be rotated from being engagement partner. He can still contact the client but should not be in the position of signing the audit report.

To show complete independence, Zoe should not be part of the audit team. However, if Mr Son is no longer the engagement partner then this removes the ethical threat and Zoe could be included in the audit team.

To show independence from the client, Mr Far could be asked not to use the services of Stark Ltd again unless this is first agreed with the engagement partner.

The balloon flight should not be accepted. Investigation would also be needed to find out why hospitality was accepted in previous years.

The audit firm must confirm that assistance with taxation work is acceptable, although the fee must be based on time and experience for the job, not the contingent fee.

To remain independent, the audit firm should decline to represent the client in court.

(b) Benefits of internal audit

Regulation

Stark Ltd operates in a regulated sector and is under the supervision of a regulatory authority. It is very likely that there are regulatory controls and reports that Stark must produce or comply with. Establishing an internal audit department will enable Stark to produce those reports more efficiently and show compliance with the regulatory regime. Even if internal audit is not required now, codes of governance increasingly suggest that it is good practice to have an internal audit department.

Reports to the board

As a financial services provider, staff in Stark Ltd will be producing various financial reports for their board. The internal audit department will be able to monitor the accuracy of those reports, especially those not audited by the external auditors. This function will help enhance the accuracy and reliability of the reports.

Liaison with external auditors

The internal auditors can liaise with the external auditors, especially where it is possible for the external auditors to place reliance on the work of internal audit. This will decrease the time and cost of the external audit.

Internal audit can also monitor the external audit to ensure they are carrying out an efficient and effective service.

Monitor effectiveness of internal controls

It is likely that Stark has to maintain a strong internal control system as the company is regulated and will be handling significant amounts of client cash. Internal audit can review the effectiveness of those controls and make recommendations to management for improvement where necessary.

Value for Money Audit

Internal audit can carry out value for money audits within Stark Ltd. For example, a review could be undertaken on the cost-effectiveness of the various control systems or whether investment advice being provided is cost-effective given the nature of products being recommended and the income/commission generated from those products.

Risk assessment

Internal audit could also carry out risk assessments on the portfolios being recommended to clients to ensure the portfolio matched the client's risk profile and Stark Ltd's risk appetite. Any weaknesses in this area would result in a recommendation to amend investment policies as well as decreasing Stark's exposure to unnecessary risk.

Taxation services

Stark Ltd require assistance with the preparation of taxation computations and specialist assistance in court regarding a taxation dispute. Internal audit could assist in both areas as long as appropriate specialists were available in the department. Provision of these services would remove any conflict of interest that Stark's auditors have as well as ensuring expertise was available in house when necessary.

4 (a) Audit risk

Audit risk is the risk that an auditor gives an inappropriate opinion on the financial statements being audited.

Inherent risk is the susceptibility of an assertion to a misstatement that could be material individually or when aggregated with misstatements, assuming that there are no related controls. The risk of such misstatement is greater for some assertions and related classes of transactions, account balances, and disclosures than for others.

Control risk is the risk that a material error could occur in an assertion that could be material, individually or when aggregated with other misstatements, will not be prevented or detected on a timely basis by the company's internal control systems.

Detection risk is the risk that the auditors' procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

(b) Inherent risks in charity

Area of inherent risk

Income is from voluntary donations only. There is a risk that donations will fall, especially where donors' own income is limited by the 'credit crunch' etc.

Completeness of income – where there are no controls to ensure income is complete for example sales invoices are not raised to obtain donations and donations could be stolen by staff.

Funds can only be spent in accordance with the aims of the charity. There is a risk that funds are spent outside the aims of the charity.

Taxation rules relevant to charities. There is a risk that the rules will be broken due to lack of correct analysis of income/expenditure.

Requirement to report expenditure in accordance with the constitution – administration expenditure can be no more than 10% of total income. Risks here include income being overstated to allow expenditure to be overstated.

Donations to charity for specific activities for example provision of sports equipment. There is a risk that donations are not spent in accordance with donors' instructions.

Effect on audit approach

It is difficult to estimate that income in the future will be sufficient to meet the expenditure of the charity.

Audit of the going concern concept (as in ensuring that the charity can still operate) will therefore be quite difficult.

Audit tests are unlikely to be effective to meet the assertion of completeness. The audit report may need to be modified and qualified to explain the lack of evidence stating that completeness of income cannot be confirmed.

Careful review of expenditure will be necessary to ensure that expenditure is not '*ultra vires*' the objectives of the charity.

The auditor will need to review the constitution of the EuKaRe charity carefully in this respect.

The auditor will need to ensure that staff familiar with the taxation rules affecting the charity are on the audit team.

The trustees may attempt to hide 'excessive' expenditure on administration under other expense headings.

As the auditor has to report on the accuracy of income and expenditure then audit procedures must focus on the accuracy of recording of expenditure.

Documentation for any donation will need to be obtained and then expenditure agreed to the terms of the documentation. Any discrepancies will have to be reported to management.

(c) Weak control environment

Lack of segregation of duties/responsibilities

There is normally a limited number of staff working in the charity meaning that a full system of internal control including segregation of duties cannot be implemented. Staff are likely to be unclear as to their exact responsibilities as they are not formal 'employees' and are not part of the formal authority structure in the charity.

Volunteer staff

Many staff are volunteers and so will only work at the charity on an occasional basis. Controls will be performed by different staff on different days making the system unreliable.

Lack of qualified staff (human resource issues)

Selection of staff is limited – people tend to volunteer for work when they have time – and so they are unlikely to have professional qualifications or experience to implement or maintain good control systems.

No internal audit department (lack of organisational structure)

Any control system will not be monitored effectively, mainly due to the lack of any internal audit department. The charity will not have the funds or experience to establish internal audit.

Attitude of the trustees

It is not clear how the charity's trustees view risk. However, where trustees are not professionally trained or have little time to devote to the charity, then there may be an impression that controls are not important. The overall control environment may therefore be weak as other charity workers do not see the importance of maintaining good controls.

5 (a) Event 1

(i) The problem with the mattress stock provides additional evidence of conditions existing at the balance sheet date as the stock was in existence and the faulty springs were included in the stock at this time.

The value of the stock is overstated and should be reduced to the lower of cost and net realisable value in accordance with SSAP9 *Stocks and long-term contracts*.

An adjustment for this decrease in value must be made in the financial statements.

The mattresses should therefore be valued at £225,000, being the net realisable value.

(ii) The decrease in value of stock took place after the balance sheet date but before the financial statements and the audit report were signed.

The auditor is therefore still responsible for identifying material events that affect the financial statements.

Audit procedures are therefore required to determine the net book value of the stock and check that the £225,000 is actually the sales value of the mattresses.

Audit procedures will include:

- Obtain documentation from the insurers confirming their estimate of the value of the mattresses and that no further insurance claim can be made for the loss in value.
- Contact solicitors/administrators of the spring supplier to confirm no refund can be expected for the defective springs.
- Obtain the amended financial statements and ensure that the directors have included £225,000 as the value of the stock in the balance sheet and that the year-end value of stock has been decreased to £225,000 on the balance sheet, balance sheet note and the profit and loss account.
- Review stock lists to ensure that the defective springs were not used in any other mattresses and that further adjustments are not required to any other stock.
- Obtain an additional management representation point confirming the accuracy of the amounts written-off and confirming that no other items of stock are affected.
- Finally, assessing the effect on the audit opinion after the decision of the directors regarding the stock value is known. A qualified opinion may be required where appropriate adjustments are not made to the financial statements.

Event 2

(i) The release of dye occurred after the balance sheet date, so this is indicative of conditions existing after the balance sheet date – the event could not be foreseen at the balance sheet date.

In this case, no adjustment to the financial statements appears to be necessary.

However, the investigation by the Environmental Agency could result in a legal claim against the company for illegal pollution so as a material event it will need disclosure in the financial statements.

- (ii)** As with event 1, the event takes place before the signing of the audit report, therefore the auditors have a duty to identify material events affecting the financial statements.

Audit procedures will include:

- Obtain any documentation on the event, for example board minutes, copies of environmental legislation and possibly interim reports from the Environmental Agency to determine the extent of the damage.
- Inquire of the directors whether they will disclose the event in the financial statements.
- If the directors plan to make disclosure of the event, ensure that disclosure appears appropriate.
- If the directors do not plan to make any disclosure, consider whether disclosure is necessary and inform the directors accordingly.
- Where disclosure is not made and the auditor considers disclosure is necessary, modify the audit opinion on the grounds of disagreement and explain the reason for the qualification in the report. This will be for lack of disclosure (not provision) even though the amount cannot yet be determined.
- Alternatively, if the auditor considers that the release of dye and subsequent fine will affect ZeeDiem's ability to continue as a going concern, draw the members' attention to this in an emphasis of matter paragraph.

- (b)** The notification of a fine has taken place after the audit report has been signed.

Audit procedures will include:

- Discuss the matter with the directors to determine their course of action.
- Where the directors decide to amend the disclosure in the financial statements, audit the amendment and then re-draft and re-date the audit report as appropriate.
- Where the directors decide not to amend the disclosure in the financial statements, the auditor can consider other methods of contacting the members. For example, the auditor can speak in the upcoming general meeting to inform the members of the event.
- Other options such as resignation seem inappropriate due to the proximity of the annual general meeting (AGM). Resignation would allow the auditor to ask the directors to convene an extraordinary general meeting, but this could not take place before the AGM so the auditor should speak at the AGM instead.

	<i>Marks</i>
1 (a) 0.5 mark for each valid objective	
Maximum marks	<u>2</u>
(b) Management letter – 1 mark for each weakness, 1 for each possible effect and 1 for each recommendation = 3 marks * 4 sets of points = 12 marks	
Logging in process not monitored	
Overtime not authorised	
Poor password control (cat's name)	
Transfer total wages not checked	
Employees leaving details sent on e-mail	
Other valid points	
4 points * 3 marks each =	12
Letter format (that is not a report or memo at beginning)	1
Overall presentation	<u>1</u>
Maximum marks	<u>14</u>
(c) 1 mark for each valid procedure and 1 for expectation of result of procedure = 2 marks for each procedure	
Total salary cost	
Average salary	
List of payments each month	
Other valid points	
Maximum marks	<u>6</u>
(d) 0.5 mark for stating each procedure, 0.5 for explaining each procedure and 1 mark for discussing the use of that procedure (can include an example audit procedure as part of answer to obtain this mark) = 2 marks for each procedure	
Confirmation (note limited use)	
Observation	
Inquiry	
Recalculation	
Reperformance	
Analytical procedures	
Note inspection procedure not valid as stated in question.	
Maximum marks	<u>8</u>
Total marks	<u>30</u>

<p>2 (a) 1 mark for each factor</p> <p>Professional qualification Experience and reputation Independence Other valid points (including but not limited to Reputation Not employed by client Not related to client)</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>3</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>
<p>(b) 1 mark for each right of the auditor</p> <p>Access to company books Obtain information/explanation company officers Receive notice of/attend certain meetings Speak at certain meetings Receive copies certain resolutions Other valid points</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>3</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>
<p>(c) 0.5 for each assertion and 0.5 for each procedure</p> <p>Completeness Existence Valuation Rights and obligations Presentation and disclosure</p> <p>Maximum marks</p> <p>Total marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>4</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>10</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>

Note ISA (UK and Ireland) 500 mentions that any valid procedure may be used with balance sheet items – for example cut-off would be allowable where explaining recording of the asset in the correct accounting period. Allow therefore any valid assertion.

<p>3 (a) 1 for each ethical threat and 1 for explanation of how to mitigate that threat = 2 marks per linked points. Part (i) therefore is 6 marks total and part (ii) is 6 marks total</p> <p>Engagement partner – time providing service Engagement partner’s daughter takes part in audit Payment for investment advice Gift of balloon flight from client Contingent fee – taxation work Representing client in court Self-review threat from taxation service Fixed fee – normally calculate on time and experience? Other valid points</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>12</p>
<p>(b) Up to 2 marks per well-explained point</p> <p>Regulation Reports to the board Liaison with external auditors Monitor effectiveness of internal controls Value for money audit Risk assessment Taxation services Decrease external audit fee Monitor overall strategy of company Improve customer confidence in company Other valid points</p> <p>Maximum marks</p> <p>Total marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>8</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>20</p>
<p>4 (a) 1 mark for explanation of each term</p> <p>Audit risk Inherent risk Control risk Detection risk</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>4</p>
<p>(b) 1 mark for each area of inherent risk and 1 mark for explaining the effect on the audit approach = 2 marks per linked points</p> <p>Income voluntary only Completeness of income Funds spent in accordance with charity objectives Taxation rules Reporting of expenditure Donation for specific activities Administration not exceed 10% of income Misallocation of capital donations Other valid points</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>12</p>
<p>(c) 1 mark for each point on weak control environment</p> <p>Lack of segregation of duties Volunteer staff Lack of qualified staff No internal audit Attitude of trustees</p> <p>Maximum marks</p> <p>Total marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>4</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>20</p>

<p>5 (a) (i) Explanation of whether events adjusting or not. 2 marks for each event</p> <p>Defective stock Release of dye</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>4</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>
<p>(ii) 1 mark for each point regarding auditor responsibility and for each valid audit procedure. Maximum 6 marks for each event</p> <p>Auditors general responsibilities</p> <p>From balance sheet date to audit report From audit report date to AGM</p> <p>Defective stock</p> <p>Audit must identify material events post balance sheet Need to check value of £225,000 is receivable</p> <p>Documentation from insurers Payment from third party Disclosure in financial statements Total stock value end of year Other stock affected? Management representation point Discuss with directors May be a going concern issue Other valid points</p> <p>Release of dye</p> <p>Ensure that material event is disclosed appropriately in financial statements</p> <p>Documentation of event Extent of disclosure in financial statements Action if disagree with amount of disclosure Possibility of modified audit report Management representation letter Contact insurance company Going concern may be impaired Other valid points</p> <p>Maximum marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>12</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>
<p>(b) 1 mark for each audit procedure</p> <p>Discuss with directors Audit any amendment to financial statements Produce revised audit report Inform members in other methods – speak at meeting Resignation? Note not effective.</p> <p>Maximum marks</p> <p>Total marks</p>	<hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>4</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/> <p>20</p> <hr style="width: 20px; margin-left: auto; margin-right: 0;"/>