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# Answers

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M, A Large Manufacturing Company

- 1 (a) The objectives of a Purchases and Trade Payables system are to ensure that:
- (i) Goods and services for an entity are only requisitioned when required.
  - (ii) Goods and services are supplied in accordance with the requirements of an entity in terms of quality and quantity and at the best available price.
  - (iii) Only goods and services required by an entity are accepted as a basis for subsequent payment.
  - (iv) Invoices paid by an entity relate to goods and services actually received.
  - (v) Payment is made to suppliers on a timely basis for goods and services received by an entity.
  - (vi) All *bona-fide* transactions relating to the purchases of goods and services are entered on a timely basis into the accounting records of an entity.
- (Full marks will be awarded for identifying FOUR of the above or other appropriate objectives).
- (b) The following procedures and control documentation should exist over the:
- (i) **Requisitioning and authorisation of purchases**
    - The task of requisitioning for the purchase of goods and services should be allocated only to specified responsible employees of the company.
    - Requisitions for the purchase of goods and services should be communicated on specified forms with uniform detail requirements including justification for the purchase.
    - The task of raising purchase orders should be allocated to responsible buying officials of M separate from the goods received and accounting functions.
    - Strict controls should be maintained over the security of purchase order stationery which should be pre-numbered.
    - Purchase order stationery should be multi-part, with copies being provided to the accounts department for matching to subsequent goods received documentation and invoice(s) as appropriate. A copy should also be forwarded to the goods received department for checking to subsequent deliveries.
  - (ii) **Acknowledgement of the receipt of goods and return of goods to suppliers.**
    - Goods received personnel should be separate from the ordering and accounting functions of M.
    - All goods received should be inspected and checked to copy purchase orders as to classification, quality and quantity.
    - Goods accepted should be recorded on pre-numbered multi-part stationery with one copy being forwarded to the accounts department for subsequent matching with purchase order(s) and invoice(s).
    - Goods returned to suppliers should be recorded on pre-numbered multi-part stationery with one copy being forwarded to the accounts department for matching to credit note(s). A copy should also be despatched with the specified goods returned for acknowledgement of delivery and returning to M.
  - (iii) **Checking and authorisation of purchase invoices prior to batching.**
    - Individuals involved in the processing of purchase invoices through the company's accounting system should be separate from the ordering, goods received and payment functions.
    - All purchase invoices received by M should be immediately forwarded to the company's accounts department.
    - Invoice details and arithmetical accuracy should be checked (and evidenced as such) and discrepancies resolved before further processing.
    - Invoices should be 'matched' with purchase order(s) and goods received note(s) and discrepancies resolved before further processing.
    - Matched invoices should be forwarded to the appropriate responsible official(s) in the company for authorisation and approval of accounts (general ledger) coding as appropriate.
    - There should be separate approval procedures, involving appropriate responsible officials of M, for the approval of invoices relating to utilities and other sundry services received not subject to the normal purchase ordering and goods received procedures.
    - Where invoices are forwarded to responsible officials of the company, a detailed register should be maintained to track their progress as appropriate.
    - Prior to batching, invoices should be pre-numbered in sequential order to facilitate completeness of processing.
- (c) Where received, statements from suppliers should be reconciled as soon as practicable with the relevant supplier accounts in the trade payables ledger of M. Reconciliations should be prepared by individuals separated from the processing of purchase invoices and payments to suppliers (to prevent the possibility of fraudulent activity), but where this is not practical they should be subject to close independent supervisory control.

The reconciliation of supplier statements supplements other controls over purchases and trade payables by helping to ensure completeness of, and to identify errors in processing of purchase ledger transactions. Any differences identified between supplier statements and trade payables ledger accounts may reveal the existence of unprocessed invoices for goods or services received, or even perhaps payments made on accounts but not received by suppliers. Any omissions or errors so revealed should be subject to immediate enquiry.

- (d) The term 'batch entry batch processing system' is used to describe a computer-based accounting system, through which data is entered and processed in discrete batches. Controls should ensure strong segregation of duties between the preparation of data for processing and the actual input and processing of the data through the computer system.

Preparation procedures should involve the use of control totals (pre-lists) established by monetary value, number of documents or a 'hash total' against which users can check data subsequently processed through the computer system and returned to them. If there is disparity between a pre-listed total and processed totals, then immediate reconciliation is required in order to ensure the integrity of processing.

## J J, A Limited Liability Company

- 2 (a) (i) A 'systems based' approach to an audit describes the approach adopted when reliance is placed on an entity's system of internal control, to determine the level of detailed testing of transactions and balances. In summary when adopting this approach an auditor needs to:

- Ascertain and record the internal control system in operation.
- Evaluate the extent to which it appears that reliance can be placed on the system to prevent error, omission or fraudulent activity.
- Perform tests of control (compliance tests) to confirm whether or not the preliminary evaluation of the control system is correct.
- Determine the level of detailed testing of transactions and balances to be carried out dependent on the outcome of the tests above. If in a particular area, internal control procedures are deemed to be strong then the level of detailed testing may be reduced. Conversely, where controls are weak then the level of detailed testing will have to be increased.

- (ii) A direct verification (or vouching) approach to an audit describes the approach when no reliance is placed on an entity's system of internal control, to determine the level of detailed testing of transactions and balances. The approach will be adopted when the number of transactions and balances subject to audit is very low. It will also be adopted when there is an absence of internal controls or where control is very weak. Consequently, dependent on the relative materiality of transactions and balances, where appropriate, it is not uncommon for testing levels to be set at between 50% and 100% of the population.

This approach is often more appropriate when auditing the financial statements of a small limited liability company because:

- Internal control procedures are often weak or easily overridden.
- Internal controls used by large entities are usually not practical in small business e.g. limited segregation of duties, supervisory control may be lacking or inadequate.
- Due to regular fluctuation from one year to the next in sales, profitability, overhead costs and asset purchases, the use of analytical review as a substantive test is less effective.
- The number of transactions and balances subject to audit will often be very low.
- Record keeping is unsophisticated and easy to audit. More efficient audit approach.

- (b) The main objectives are:

- (i) To confirm that all goods supplied during the period were duly invoiced.
- (ii) To confirm that all invoices raised during the period related to sales of the company.
- (iii) To confirm the reliability, accuracy and completeness of accounting for sales.

(Full marks will be awarded for stating any TWO of the above or other appropriate objectives).

- (c) I would:

- (i) Check for completeness of processing of invoices by:
  - Testing the numerical sequence of the sales invoice raised.
  - Comparing sales invoices to customer orders and goods despatched notes.
  - Vouching invoices to the sales day book.
- (ii) Check for accuracy of processing by:
  - Comparing prices charged on sales invoices to the authorised price list.
  - Checking calculations and additions of invoices (including any government taxes).
  - Vouching individual invoices to the sales day book.

**ZAIS, A Limited Liability Company**

- 3 (a)** A sampling approach to testing would not be appropriate in the following circumstances:
- (i) Where there is a statutory requirement to disclose specific items in the financial statements, for example directors' remuneration.
  - (ii) Where the population is very small and the results from sampling could not be relied on, for example when conducting certain compliance tests.
  - (iii) Where the population is small in number but comprises material individual balances or transactions, for example property additions.
  - (iv) Where the population is not homogenous and requires subdivision before sampling can be attempted, for example purchase invoices and credit notes.
  - (v) When the auditor is put 'on enquiry' for example when testing for fraud.
  - (vi) Where the costs of sampling outweigh the benefits as compared to 100% testing.
- (Full marks will be awarded for identifying FOUR of the above or other appropriate occasions).
- (b) (i)** The positive method of obtaining direct confirmation of trade receivables balances is the process whereby letters are sent to customers asking them to forward written confirmation (or to provide details of any differences) of the balance on their account as shown in the audit client's records.
- The negative method requests that customers should only respond if they do not agree the balance on their account as shown in the audit client's records. This type of confirmation should only be used when:
- The audit client has a strong internal control system over sales and trade receivables.
  - Other good corroborative evidence with regard to the existence of trade receivables has already been obtained from other tests carried out.
  - There are a large number of small balances.
  - A substantial number of errors is not expected.
  - The auditor has no reason to believe the debtors will disregard the request.
- (ii)** Whilst the main objective of obtaining written confirmation is to confirm the existence of debts outstanding, a secondary objective is to test the propriety of controls actually exercised over the sales and trade receivables function. Clearly if employees have been circumventing controls to conceal any (for example fraudulent) activity, they would have a vested interest in diverting the auditor's attention away from balances on accounts subject to such activity.
- (c) (i)** By confirming all customer account balances in excess of \$7,500, we will ensure coverage of some 57% of the total value of the population before taking account of further balances for inclusion. This is a significant proportion of the total value of the population and inclusion should therefore assist us in reaching a confident conclusion on the accuracy of the reported trade receivables figure. It will also assist us in interpreting the materiality of any errors brought to our attention from the balance of accounts tested.
- (ii)** Whilst we may not have any reason to doubt the existence of zero balances on customer accounts, there are a variety of reasons as to why these could be stated incorrectly. For example, as a consequence of cut-off errors (sales not recorded in the correct financial period), mis-posting of cash receipts (payments made in advance of a sales transaction) or fraudulent activity (diversion of cash received from a customer combined with suppression of sales activity). Confirmation of zero balance accounts will test for the occurrence of these events.
- (d)** Accounts requiring special attention would include:
- (i) Those which have exceeded the normal credit period.
  - (ii) Those which regularly exceed the authorised credit limit.
  - (iii) Those which have credit balances.
  - (iv) Those which show higher/lower balances at the balance sheet date as compared to other times during the year.
  - (v) Those accounts on which balances have been written off as bad debts or in respect of which provision has been made.
  - (vi) Those on which there are regular contras with supplier accounts in the company's trade payables ledger.
  - (vii) Those on which round sum payments are constantly received.
  - (viii) Those to which credit notes have been regularly posted.
  - (ix) Those to which journal credits or journal debits have been regularly posted.
  - (x) Those which appear to have received unusually favourable treatment with regard to credit limits, payment period and discounts allowed.
  - (xi) Those which apply to customers who are known to be 'connected' to Zais or its employees (related parties).
  - (xii) Accounts with nil balance.
  - (xiii) Accounts which have been paid by the date of the examination.
- (Full marks will be awarded for identifying SIX of the above or other appropriate types of account).

## PROFESSIONAL OBJECTIVITY

### 4 (a) ICPAS Code of Professional Conduct and Ethics includes the following fundamental principles:

- Members in accepting or continuing a professional assignment or occupation shall always have regard to any factor which might reflect adversely upon its integrity and objectivity in relation to that assignment or occupation.
- A member in public practice (such as the job of an auditor) shall both be and appear to be free of any interest which might be regarded, whatever its actual effect, as being incompatible with integrity and objectivity.
- Although a member not in public practice may be unable to both be and appear to be free of any interest which might conflict with a proper approach to his professional work, this does not diminish his duty to maintain integrity and objectivity in relation to that work.

Integrity and objectivity is the state of mind which has regard to all considerations relevant to the task in hand but no other.

Integrity and objectivity is a state of mind, but in certain roles the preservation of objectivity needs to be protected and demonstrated by the maintenance of a member's independence from influences which could affect his/her objectivity. The job of an auditor represents such a role.

The belief that a company's un-audited financial statements lack credibility, is fundamental to the supposition that they need to be audited. There is an assumption that the company's management may have lacked objectivity when preparing the financial statements, therefore in order to add credibility to them it is important that they are audited by impartial professionals, who are free from any influence and pressure which might impair their judgement when carrying out their audit work.

The nature of the audit function therefore demands that auditors are mentally independent and as such are totally objective in their audit approach. However, given that their independence is 'mental', no matter how they may argue that they are objective in their audit approach, the only people actually aware of their (mental) state of independence are auditors themselves.

Given the above, I consider the statement made to be invalid. In order to add credibility to their reporting function it is important that auditors remain visibly independent. If they do not and are therefore not *seen* to be independent, shareholders and users of financial statements may (albeit mistakenly), take the view that the auditors have not been objective in their approach, with the consequence that they will not place reliance on the auditors' opinion.

### (b) Poynt & Co

The ICPAS Code of Professional Conduct and Ethics requires a member to always have regard to any factor which might reflect adversely upon its integrity and objectivity in relation to that assignment and occupation.

An accounting firm involved in an audit or public accountant or staff member of the accounting firm who is directly involved in the audit shall not accept gifts or hospitality from an audit client except where the gifts are token in nature and the value is clearly insignificant (say \$200) having regard to the total audit fees of the client.

The value (\$3,000) of individual golf club membership would not be considered to be insignificant and the threat to the audit objectivity of Poynt and Co (if the memberships are accepted) is compounded by the fact that the total value of offer to the firm is \$15,000 (5 x \$3,000). On this basis, I would be concerned that objectivity could be, or be perceived to be threatened, and would strongly recommend that the partners politely decline the offer.

In addition to the above, I would also be concerned as to the motive of the managing director in making the offer. Given the total value of the offer, the timing of it (soon after the start of audit work) and the fact that it was made solely to the partners would alert me to the possibility that in return for the free membership, the company may have unreasonable expectations as to how the audit firm may respond when coming across contentious issues in the company's financial statements – for example, the adoption of unacceptable accounting policies.

### Pebury and Company

The ICPAS Code of Professional Conduct and Ethics requires a member to always have regard to any factor which might reflect adversely upon its integrity and objectivity in relation to that assignment and occupation.

Generally, a member's integrity and objectivity may be threatened or appear to be threatened as a result of a family or other close personal or business relationship.

The fact that an audit manager of Pebury and Company is married to the new financial director of one of the firm's audit clients, clearly poses a potential threat to audit objectivity. Given that the financial director is responsible for the preparation of the company's financial statements, there may well be a perception of impropriety with regard to the figures reported therein if her husband (as a senior member of the audit team) has a role in the audit function. To avoid such a threat I would strongly recommend that the firm ensures that the audit manager has no involvement whatsoever with that audit (or any other) assignment relating to Adlin. Given the size of the firm this should not unduly affect its operational efficiency.

My concern as to the possibility of perceived impropriety with regard to the figures reported in the financial statements, would be compounded by the fact that the financial director of the company will be entitled to an annual bonus based on the reported figures. Clearly she would have a vested interest in a high reported profit. Given this situation it is important that Pebury and Company should be *seen* to be totally objective in their audit approach. Such an approach involves careful selection of staff for specific assignments such that all members of the audit team are totally impartial.



## Bollies

The ICPAS Code of Professional Conduct and Ethics requires a member to always have regard to any factor which might reflect adversely upon its integrity and objectivity in relation to that assignment and occupation.

Objectivity may be or appear to be threatened by undue dependence on any audit client.

Currently fees receivable from the two connected companies owned by Thomas Arn, represent 8.7% (\$72,000/\$830,000) of Bollies' gross practice income. This would not appear to represent a threat to the perceived objectivity of the firm with regard to the existing audits. However, acceptance of the third audit appointment would mean that 16.7% (\$152,000/\$910,000) of the firm's gross practice income originates from the three companies owned by Thomas Arn. This could call into question the firm's objectivity with regard to all three audit assignments, and in the circumstances it may be prudent for Bollies to politely decline the further audit appointment.

Commercial considerations may encourage the partners of Bollies to accept the third audit appointment, notwithstanding any doubts as to their perceived objectivity. However Thomas Arn is an entrepreneur with a very dominant personality. Given this trait, the partners should be alert to the possibility that situations might arise on any of the audit assignments wherein he could use the threat of the loss of all three audit assignments (and associated fees) to put undue pressure on the firm. For example, he may request the firm to take an unusually optimistic view as to the recoverability of unpaid debts. The partners should pay particular attention to the possibility of this potential threat before deciding whether to accept the further appointment.

If the firm does proceed with the additional appointment I would strongly recommend that they should protect against the loss of independence on each of the audits by implementing additional safeguards to maintain objectivity. Such safeguards should be subject to an annual independent review by a partner unconnected with the audits and may include the employment of a different audit engagement partner and suitably qualified audit teams on each of the three audits.

(Full marks will be awarded for coverage of any FIFTEEN relevant points pertaining to each scenario with a maximum of NINE marks being available for each scenario).





The marking scheme generally indicates that 1 mark or 1½ marks are awarded for each point. However, consideration should be given to the depth and relevance of points provided by each candidate when answering the question; for example if only a brief explanation is given then it may only be worth ½ point whilst a detailed discussion could be worth up to a maximum of 2 points.

Marks are not allocated to specific points as the candidate may include a valid point within their answer which is not included in the model answer; the candidate should be given full credit for such points.

The majority of the questions require several points to be included within the answer, so if a candidate concentrates on a few points then they should not be given as much recognition, and their overall mark should be lower than a candidate who provides a range of points.

In conclusion, it is important that the overall standard of the candidate's answer is considered in terms of whether it is above or below a pass grade. After marking each question, the total mark awarded should be evaluated to assess whether it is fair. If it is decided that the total mark is not a proper reflection of the standard of the candidate's answer then the answer should be reviewed again, and the marks adjusted to ensure that the total awarded is fair. If the answer is of a pass standard then it should be awarded a minimum of 40%; if it is below a pass standard then it should be awarded less than 40%.

**M, A Large Manufacturing Company**

- 1 (a)** Stating objectives of the internal controls exercised over a Purchases and Trade Payables system.  
Generally 1 mark per objective up to a maximum of (4 marks)
- (b)** Identification of the internal controls that should exist over:
- (i)** Requisition and authorisation of purchases.
  - (ii)** Acknowledgement of the receipt of goods and the return of goods to suppliers.
  - (iii)** Checking and authorisation of purchase invoices prior to batching for processing through the computerised accounting system.
- Generally 1½ marks per point, with a maximum of 9 marks (6 x 1½) for each function (i), (ii) and (iii) up to a maximum of (15 marks)
- (c)** Explanation of how suppliers' statements should be used to supplement other controls.  
Generally 1 mark per point up to a maximum of (3 marks)
- (d)** Stating the meaning of the term 'batch entry batch processing system'. (1 mark)  
Explanation on the use of control totals in such a system. (2 marks)  
Generally ½ mark per point up to a maximum of (2 marks)
- Total (25 marks)**

**J J, A Limited Liability Company**

- 2 (a) (i)** Summarised explanation of what is meant by a 'systems based' approach to an audit.  
Generally up to 1½ marks per point up to a maximum of (10 marks)
- (ii)** Summarised explanation of what is meant by a 'direct verification (vouching)' approach to an audit and explanation of why the approach is often more appropriate for the audit of a small limited liability company.  
Generally up to 1½ marks per point up to a maximum of (8 marks)
- (b)** Statement of TWO main objectives of vouching despatch notes, sales invoices and the sales day book.  
Generally 1 mark per point up to a maximum of 2 marks for each objective (2 x 2) (4 marks)
- (c)** Statement of SIX sales invoice checking procedures.  
Generally ½ mark per point up to a maximum of (3 marks)
- Total (25 marks)**

**ZAIS, A Limited Liability Company**

- 3 (a)** Statement of FOUR circumstances when a sampling approach would not be appropriate:  
Generally 1½ marks per occasion up to a maximum of (6 marks)
- (b) (i)** Explanation of the difference between the positive and negative confirmation methods.  
Generally 1 mark per point up to a maximum of (2 marks)  
Description of circumstances when a negative method should be used.  
Generally 1 mark per point up to a maximum of (3 marks)
- (ii)** Explanation as to why employees should have no influence on the selection of the trade receivables balance to be confirmed.  
Generally 1 mark per point up to a maximum of (2 marks)
- (c)** Explanation of the significance of inclusion in the sample of:  
(i) Accounts with balances in excess of \$7,500  
(ii) Some accounts with zero balances.  
Generally 1 mark per point with a maximum of 3 marks for (i) and (ii) up to a maximum of (2 x 3) (6 marks)
- (d)** Description of SIX types of activity which would require special attention and representation in the sample:  
Generally 1 mark for each type of activity up to a maximum of (6 x 1) (6 marks)
- Total (25 marks)**

**PROFESSIONAL OBJECTIVITY**

- 4 (a)** Comment on statement including definition of (professional) objectivity.  
Generally 1 mark per point up to a maximum of (4 marks)  
Other commentary:  
Generally 1 mark per point up to a maximum of (6 marks)
- (b)** Commentary on objectivity/independence issues arising from the scenarios involving:  
– Poynt & Co  
– Pebury and Company  
– Bollies  
Generally 1 mark per point for commentary on the various issues, including specific concerns and recommendations with a maximum of 9 marks (9 x 1) for each scenario up to an overall maximum of (15 marks)
- Total (25 marks)**