
Answers

- 1 (a) The FIVE components of internal control of an entity are:
- (i) The control environment.
 - (ii) The entity's risk assessment process.
 - (iii) The information system, including the related business processes relevant to financial reporting and communication.
 - (iv) Control activities.
 - (v) Monitoring of controls.
- (b) The objectives of the internal control which should be exercised over a sales and trade receivables system are to ensure that:
- bad debts are minimised.
 - only *bona fide* orders received from customers are executed.
 - *bona fide* orders received from customers are executed promptly
 - all goods despatched or services provided are properly invoiced
 - all goods despatched or services provided are promptly invoiced
 - all debts due are collected in accordance with credit terms
 - credits are made to customer accounts only when properly due
 - sales invoice and sales credit documentation are promptly and correctly recorded in the books of account
 - the books of account accurately reflect sales and trade receivables information.
- (c) (i) **Weakness**
The sales director and the sales clerks have full (amend) access to all trade receivables ledger files.
- Implication**
As sales department staff are responsible for the authorisation and administration of sales transactions and for recording transaction details in the company's accounting records, there is a high risk of fraud and error arising on the sales and trade receivables area.
- Recommendations**
The responsibilities for the authorisation, administering and recording of sales transactions in the company's accounting records should be allocated to separate individuals. Recording of sales transactions in the company's accounting records should be carried out only by appropriately experienced accounts department staff. Sales staff should have 'read' access only to trade receivables ledger files.
- (ii) **Weakness**
The sales director is responsible for granting credit facilities to new customers.
- Implication**
The sales director has a vested interest in granting new credit facilities in order to achieve sales targets. He is also in a position to enter into fraudulent arrangements with customers. As a consequence Haydn Co is exposed to the increased possibility of losses arising from bad debts and fraudulent transactions.
- Recommendations**
The responsibility to grant new credit facilities to customers should be vested in a responsible official of the company, segregated from the sales department and recording of transactions in the accounting records.
- (iii) **Weakness**
Credit limits are not applied to customer accounts.
- Implication**
There is a strong possibility that Haydn Co will incur bad debts if appropriate credit limits are not applied to customer accounts and strictly adhered to.
- Recommendations**
A maximum credit limit should be applied to each customer account, based on a customer's financial strength and ability to pay. Customer accounts should be closely monitored by an independent credit controller to ensure that credit limits are not exceeded.

(iv) Weakness

The sales director is responsible for pursuing late paying customers.

Implication

Haydn Co's exposure to cash flow difficulties and bad debts could be increased. This is because the director may have a pre-disposition not to place undue pressure on late paying customers for fear of their withdrawing custom with regard to future stationery purchases. Additionally the director may be exposed to beneficial offers from customers, made to him in his personal capacity, to allow advantageous payment terms on specific customer accounts.

Recommendations

The responsibility for credit control should be vested in a responsible official of the company, who is totally segregated from the authorisation, processing and recording of sales transactions.

(v) Weakness

Telephone orders are accepted for the despatch of the company's products.

Implication

Haydn Co's exposure to losses is increased as a consequence of goods being despatched in response to unauthorised or bogus telephone orders.

Recommendations

Haydn Co should only accept written orders from *bona fide* customers. Procedures for ordering from Haydn Co should be made clear to all customers, through the issue of terms and conditions of trading, and these should be strictly adhered to by Haydn Co. Any doubts as to the authenticity of written orders received from customers should be removed before execution of those orders.

(vi) Weakness

Sales clerks have full (amend) access to product price data contained in the standing data file of the sales invoicing programme.

Implication

The sales clerks are responsible for generating sales invoices to customers and therefore have the opportunity to influence, either fraudulently or erroneously, prices charged for the company's products.

Recommendations

Access to the standing data file containing product price data should be restricted to the sales director and other appropriate senior responsible officials of the company. Strict controls should be exercised over the updating of this information and it should be regularly monitored to ensure that prices on file equate to those on Haydn Co's authorised price list.

(vii) Weakness

Sales invoices are raised and forwarded to customers prior to the receipt of confirmation that goods have been despatched to customers.

Implication

Sales invoices could be forwarded to customers in the absence of goods being despatched to them. In such instances Haydn Co would be erroneously recognising the revenue from the sales transaction in its accounting records whilst also incorrectly recognising a trade receivable.

Dependent on customers' own internal controls, it is likely that relationships may become strained if customers constantly receive invoices in advance of the receipt of goods ordered.

Recommendations

Current procedures with regard to the production of sales invoices and goods despatch notes should be modified. The stores department should generate pre-numbered goods despatch notes to accompany all goods despatched and copies should be retained for control purposes.

Sales invoices should be prepared and forwarded to customers only after the stores department have confirmed to the sales department that goods have been despatched, by for example forwarding a copy of the pre-numbered despatch note.

Copy invoices should then be forwarded to the accounts department for posting to the accounting records by appropriately experienced employees, who should have no involvement in the receipt of monies from customers.

(viii) Weakness

The assistant accountant is responsible for dealing with customer invoices queries and the issue of sales credit notes.

Implication

As sales department staff deal with the preparation and processing of sales invoices, it is likely that the assistant accountant will not have the knowledge to deal effectively with customer queries. In addition, the company's exposure to fraud and error is increased as a consequence of the assistant accountant having the discretion to raise credit notes whilst also having authority to post into the company's accounting records.

Recommendations

The assistant accountant should have no involvement in the decision to raise sales credit notes. Customer queries should be directed to individuals involved in the preparation of sales invoices.

(Full marks will be awarded for answers identifying only FOUR weaknesses in the system, for relevant comments as to the implications arising from the weakness and for making appropriate recommendations).

- 2 (a) Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. An auditor adopting a risk-based auditing approach obtains an understanding of an entity and its environment, and having assessed the risks of material misstatements in the financial statements at the assertion level, directs audit resources to the risky areas as appropriate.

The risk of material misstatement at the assertion level consists of two components, these being inherent risk and control risk:

Inherent Risk

This is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there were no related controls.

Control Risk

This is the risk that a misstatement that could occur in an assertion and that could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control.

Inherent risk and control risk are the entity's risks and they exist independently of the audit of the financial statements. However the auditor is required to assess both of these components of audit risk as a basis for determining the level of substantive procedures to carry out.

Detection risk relates to the nature, timing and extent of the auditor's procedures. It is risk that the auditor will not detect a misstatement that exists in an assertion that could be material individually or when aggregated with other misstatements. It is the function of the effectiveness of an audit procedure and of its application by the auditor.

The audit risk model used by auditors, dictates that for a given level of audit risk, the acceptable level of detection risk bears an inverse relationship to the assessment of the risk of material misstatement at the assertion level. For example, on an audit assignment where the risk of material misstatement at the assertion level has been assessed as high, in order to achieve a low level of audit risk, detection risk must be set as low. In such circumstances the auditor would need to direct an appropriate level of resources to the testing of the assertion in question. This will comprise adequate planning, proper assignment of personnel, the application of professional scepticism and supervision and review of the audit work performed.

(Full marks will be given to answers containing points as above or other relevant points).

- (b) The purpose of audit working papers is to record information relating to a specific audit, on the planning of the audit work, the nature, timing and extent of audit procedures performed, the results thereof, and the conclusions drawn from the audit evidence obtained. Audit working papers record an auditor's reasoning in arriving at conclusions on specific areas of an entity's financial statements. This, together with other information included in the working papers, could be useful in the event of there being litigation against the audit firm in connection with the audit or for the planning of future audits.

The extent of working papers to be prepared is a matter for the professional judgement of the auditor, and will depend on the auditor's assessment of risk attaching to the audit assignment and the extent of substantive procedures carried out. It is generally accepted that the working papers prepared and retained should be sufficient such that they would provide another auditor, who has no previous connection with the audit, with an understanding of the work performed and the basis of the principal decisions taken.

(Full marks will be awarded for answers including similar points to those stated as above or other appropriate points).

- (c) The following information should be included on the header of every working paper prepared in connection with the audit of the financial statements of Brahms Limited for the year ending 31 December 2005.
- (i) The client's name – Brahms Co.
 - (ii) The balance sheet date – 31 December 2005.
 - (iii) The file reference of the working paper – normally standard within the audit firm.
 - (iv) The date the working paper was prepared.
 - (v) The name or initials of the person preparing the working paper.
 - (vi) The subject of the working paper.
 - (vii) The date the working paper was reviewed.
 - (viii) The name or initials of the person reviewing the working paper.

- 3 (a)** The five generalisations about the reliability of audit evidence are:
- Audit evidence is more reliable when it is obtained from independent sources outside the entity.
 - Audit evidence that is generated internally is more reliable when the related controls imposed by the entity are effective.
 - Audit evidence obtained directly by the auditor (for example, observation of the application of a control) is more reliable than audit evidence obtained indirectly or by inference (for example, inquiry about the application of a control).
 - Audit evidence is more reliable when it exists in documentary form, whether paper, electronic or other medium (for example, a contemporaneously written record of a meeting is more reliable than a subsequent oral representation of the matters discussed).
 - Audit evidence provided by original documents is more reliable than audit evidence provided by photocopies or facsimiles.
- (b)** The implied or explicit management assertions made about classes of transactions and events for the period under audit are:
- (i) Occurrence – transactions and events that have been recorded have occurred and pertain to the entity.
 - (ii) Completeness – all transactions and events that should have been recorded have been recorded.
 - (iii) Accuracy – amounts and other data relating to recorded transactions and events have been recorded appropriately.
 - (iv) Cut-off – transactions and events have been recorded in the correct accounting period.
 - (v) Classification – transactions and events have been recorded in the proper accounts.
- (c)** The auditor may wish to carry out the following substantive procedures to test for completeness.

Area of financial statements	Procedure to verify completeness
Sales	Follow despatch notes through to sales invoicing and check for posting to sales account.
Trade payables	Review unmatched goods received notes on hand at the balance sheet date and verify posting to payables account.
Accrued expenses	Review charges to overhead expenses in period following balance sheet date and ensure none incorrectly omitted from accruals.
Provisions	Examine correspondence from company's legal advisers to ensure that management have considered all payments relevant to current litigation.
Inventory	Attend year end inventory count to ensure that all inventories are listed for subsequent valuation.
Non-current assets	Identify assets owned by the company and check to ensure inclusion in non-current assets register.

(Full marks will be awarded for stating the above or other relevant substantive procedures).

- 4 (a) A qualified external auditor should possess the following personal qualities.

Integrity

There is an expectation from users of audited information that an auditor will at all times be honest, fair and truthful. If an auditor does not display these attributes then it is unlikely that others will rely on his judgement or opinion.

Objectivity

As with integrity (above) an auditor's objectivity must be beyond question if he/she is to report as auditor. Consequently a qualified auditor must have the ability to retain independence of mind whilst carrying out his/her professional duties, irrespective of any pressure that is brought to bear.

Professional Scepticism

During the course of an audit assignment, the auditor must find sufficient appropriate evidence to support the audit opinion. In determining the quantity and quality of this evidence, the auditor must know when it is prudent to exercise professional scepticism. For example, in deciding the extent of reliance to be placed on a specific verbal management representation.

Good Communication Skills

In order to carry out a satisfactory audit, the auditor must be able to communicate effectively with individuals, possessing varying levels of seniority, and experience and with different cultural backgrounds. If the auditor is unable to communicate effectively both orally and in writing, it is likely that ineffective audit procedures will be carried out.

Good Information Technology Skills

Most entities make use of information technology for financial reporting and operational purposes. Similarly, most audit firms use computer-assisted audit techniques to assist them in their audit work. Consequently if an auditor does not possess good information technology skills then he/she may not be able to contribute effectively to the audit process.

Thorough Knowledge of Accounting and Auditing Issues

Given that it is the auditor's responsibility to prepare a report on the financial statements of an entity, it is important that the auditor retains contemporary knowledge of relevant accounting and auditing issues. This knowledge should include developments in both accounting and auditing standards.

(Full marks will be awarded for stating the above or other appropriate qualities).

- (b) Materiality is concerned with errors in, or omissions from, a set of financial statements. It can be defined in the following terms:

'Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement. Thus, materiality provides a threshold or cut-off point rather than being a primary qualitative characteristic which information must have if it is to be useful.'

(Full marks will be awarded for definitions similar to the above).

- (c) An auditor may need to obtain audit evidence from an expert to provide an independent:
- valuation of assets, for example land and buildings.
 - determination of quantities of assets, for example stockpiles of minerals.
 - determination of the condition of plant and machinery, for example a large engineering machine.
 - determination of a valuation using specialised techniques, for example in an actuarial valuation.
 - measurement of completed works, for example on a long term building contract.
 - legal opinion, for example on the interpretation of the terms of a legal agreement.
- (d) (i) Management typically provide accounting estimates in connection with:
- general provisions for the write down of inventory valuation
 - depreciation provisions
 - accrued revenue
 - provisions for losses on lawsuits
 - profits or losses on construction contracts in progress
 - provisions to meet warranty claims

(Full marks will be awarded for identifying four of the above or other relevant matters).

- (ii) The auditor should adopt one or a combination of the following approaches in the audit of an estimate:
- review and test the process used by management to develop the estimate
 - use an independent estimate for comparison with that prepared by management
 - review subsequent events which confirm the estimate made.

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 given 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%.

Haydn Co

- 1 (a)** Stating the components of internal control.
Generally 1 mark per component up to a maximum of (5 marks)
- (b)** Stating objectives of the internal control which should be exercised over the sales and trade receivables system of Haydn Co.
Generally 1 mark per objective up to a maximum of (4 marks)
- (c)** Sales and trade receivables system.
Generally 1 mark per point for identifying a weakness in the system, up to a maximum of (4 marks)
Generally 1½ mark per point for describing the implication of the weakness, up to a maximum of (6 marks)
Generally 1½ mark per point for recommending an improvement to address the weakness, up to a maximum of (6 marks)
- Total (25 marks)**

Brahms Co

- 2 (a)** Explanation of the term 'a risk-based approach to an audit'
Generally 1 mark per point up to a maximum of (14 marks)
- (b)** Explanation of the purpose of audit working papers.
Generally 1 mark per point up to a maximum of (4 marks)
Commentary on the matters to be considered generally in assessing the extent of working papers to be prepared.
Generally 1 mark per point up to a maximum of (3 marks)
- (c)** Listing of the information that should be included on the header of every working paper.
Generally ½ mark per point up to a maximum of (4 marks)
- Total (25 marks)**

Audit Evidence

- 3 (a)** Stating the generalisations about the reliability of audit evidence.
Generally 2 marks per point up to a maximum of (10 marks)
- (b)** Stating management assertions made about classes of transactions and events for the period under audit.
Generally 1½ marks per assertion for up to four attributes, up to a maximum of (6 marks)
- (c)** Description of substantive procedures the auditor may carry out to verify the completeness of classes of transactions, account balances or disclosures.
Generally 1½ marks per procedure up to a maximum of (9 marks)
- Total (25 marks)**

Student Enquiries

- 4 (a) Stating personal qualities a qualified external auditor should possess.
Generally $\frac{1}{2}$ mark for each quality stated up to a maximum of (2 marks)
Stating reason why auditor should possess quality.
Generally 1 mark for each reason up to a maximum of (4 marks)
- (b) Explanation of the term 'materiality' of
Generally $\frac{1}{2}$ mark per point up to a maximum of (3 marks)
- (c) (i) Identifying situations during the course of an audit where an auditor may need to obtain evidence from an expert.
Generally 1 mark for each situation identified up to a maximum of (4 marks)
(ii) Providing a practical example for each situation identified above.
Generally $\frac{1}{2}$ mark for each example up to a maximum of (2 marks)
- (d) (i) Identifying matters where management typically provide accounting estimates.
Generally up to $1\frac{1}{2}$ marks for each matter identified up to a maximum of (6 marks)
(ii) Outline the approaches that an auditor should adopt.
Generally up to $1\frac{1}{2}$ marks for each point up to a maximum of (4 marks)
- Total (25 marks)**