Answers

1 **(a)** The objectives of the internal controls that should be exercised over a non-current assets system are to ensure that non-current assets:

(i) are acquired only when necessary.
(ii) are acquired on the most economic terms.
(iii) are acquired only when authorised.
(iv) are properly recorded in the accounting records.
(v) are protected from loss and damage.
(vi) are disposed of only when necessary.
(vii) are disposed of only when authorised.
(viii) are disposed of at the best possible price.

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

(b) Recruitment Co's non-current asset register should provide an up to date inventory of all non-current assets owned by the company. The format of the register should allow for the groups of assets (e.g. motor vehicles, office furniture, office equipment) as reflected in the company's general ledger, to be identified by individual asset such that at any point in time reference may be made to individual assets as appropriate. Specific information relating to each individual asset as recorded in the register will normally include asset description, location, date of acquisition, cost, expected useful life, depreciation rate, depreciation charged and written down value.

Such information above should facilitate the directors of the company in maintaining control over the use, safe custody and replacement of assets, some of which will be transportable, valuable and desirous and by their nature possibly subject to misuse or misappropriation. However, in order to maintain effective control, it is important that existence and condition checks are regularly carried out on the non-current assets of the company. Checks should be made in both directions from the register to assets and from assets to the register, by a responsible individual of the company, who is independent from the acquisition custodian, disposal and recording functions. Similarly, it is important that any discrepancies and damage noted when checking are brought to management's attention and promptly resolved.

(Full marks may be awarded to answers which do not contain all of the above points.)

(c) **(i)** Given that most of Recruitment Co's employees are provided with a company car and that each car is replaced bi-annually, there is a relatively high frequency of car disposals by the company. This, combined with the value of each 'executive type' vehicle increases the risk of loss to the company in this area. Owing to the nature of each new car purchased, it is probable that there is a significant loss in value over each two year period of ownership as compared to the purchase price. However, because vehicles for disposal are likely to be highly desirable to prospective purchasers (both third party and employee) the disposal process should be carefully managed to ensure that losses are minimised.

(Full marks may be awarded to answers which include only some of the points referred to above.)

(ii) Recruitment Co should exercise the following internal controls over the disposal of cars:

– there should be formal written instructions as authorised by the board of directors, governing the company's policy and procedures to be followed on the disposal of cars.

– a responsible official should authorise the disposal of cars in accordance with company policy. The individual should be independent of the purchasing function and of recording in the company's accounting records.

– when cars are two years old, sealed bids to purchase should be obtained from at least three reputable independent car dealers in addition to bids from interested employees.

– sealed bids should be forwarded to the responsible official for scrutiny, subsequent contact with the successful bidder and authority to dispose of the relevant car. Disposal should be to the highest bidder and all bid documents should be retained for future reference as appropriate.

– by the authority of the responsible official, Recruitment should raise fully detailed invoices for the sale of the cars. Invoices should be checked for completeness and accuracy before issue. Given the possible loss to the company as a consequence of non-payment, cars should be released to buyers only when the company has received cleared funds in respect of sales. Procedures should encompass appropriate and clear lines of communication in this regard.

– details of disposals of cars should be promptly and accurately recorded in the company's accounting records, including the non-current assets register. These tasks should be carried out by personnel who are independent of the purchase and disposal functions, and should be subject to verification by an appropriate company official, for example, the company's financial director.

– the board of directors of the company should monitor the profits/losses arising on the disposal of cars as reported in the monthly management accounts to assess the appropriateness of the company's depreciation policy and to oversee the effectiveness of the company's disposal procedures, for example, by seeking detailed explanations as to the reasons for any particularly large losses on disposal.

(Full marks will be awarded for suggesting any FIVE of the above indicative controls or other appropriate controls.)

(d) (i) Recruitment Co should have reflected the transaction in its accounting records as an addition (at cost) of $30,000 to non-current assets (office furniture) and made an appropriate accrual of $30,000 in respect of the supplier's invoice not received at the balance sheet date.

(ii) To verify the date of delivery the auditors should:

– confirm the date of receipt recorded on the supplier's delivery note.

– confirm the date of receipt recorded on goods received documentation issued by Recruitment Co.

– confirm the date of delivery as stated on the supplier's invoice, subsequently received.

– make verbal enquiries to appropriate employees of Recruitment.

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

2 (a) The director's statement is invalid. It is the responsibility of the directors of Sweet Scents Co to prepare the annual financial statements for audit and to ensure that the financial statements show a true and fair view (or are presented fairly, in all material respects). Consequently, it is their responsibility to ensure that the amount at which inventories are reported in the financial statements represents inventories, which are physically in existence and are valued in accordance with generally accepted accounting principles and accounting standards. Arranging for Sweet Scents Co's employees to count and value the company's inventories is only part of the directors' obligation in meeting their responsibility with regard to the financial statements. Whilst the auditors of Sweet Scents Co may attend the physical count and carry out tests to determine the accuracy of the count and subsequent valuation, the responsibility of the company's directors in this regard is not reduced.

(b) Storage of Inventories

(i) The auditors should be concerned as to whether the company's procedures with regard to the counting and valuation of inventories will be sufficiently thorough to ensure that the value of inventories is not materially mis-stated in the company's financial statements. The fact that inventories are stored in sealed cardboard boxes presents risks to the process of ensuring that inventories are accurately quantified and valued. Much of the company's inventory (cosmetic, beauty and perfumery products) will be of a perishable nature, as well as being valuable, easily transportable and desirous. Consequently there is a high inherent risk of inventory loss due to perishing goods and misappropriation throughout the year.

(ii) It is particularly important that there are sufficiently robust procedures at the company's inventory count to identify inventories which are near (or past) their sell by date, as special attention will need to be applied to these inventories in valuing them at the lower of cost and net realisable value.

Similarly, counters who should be independent of the inventory and warehouse functions should be alerted to the possibility that the contents of the sealed boxes may not be as labelled and therefore contents should be checked at random. Any boxes which arouse suspicion as to their actual contents (for example, boxes on which original seals appear to have been broken) should be opened and the contents checked thoroughly.

Flood Damaged Inventories

(i) The auditors should be concerned that a large proportion of the company's inventory as at 30 June 2005 has been flood damaged, and at present the directors of the company would appear to be unaware or be ignoring the impact that the damage will have on the value of inventory to be reported in the company's financial statements. Inventory should be valued at the lower of cost and net realisable value in the company's financial statements and the water damage caused to some product lines is likely to be such that their net realisable value is significantly lower than cost. There is therefore a risk that the company inventory valuation could be materially overstated in the financial statements if the issue regarding flood damaged inventories is not fully addressed by the directors.

(ii) The inventory count instructions should make full provision for the identification and separation of flood damaged inventory items. This should allow for the unpacking of all flood damaged boxes so that the extent of damage to individual items can be accurately assessed in order to subsequently attribute appropriate values to them for reporting in the company's financial statements. The values to be placed on these items will vary depending on the extent of damage but will possibly be reflected as follows:

– perished inventory – at no value;

– partially damaged inventory – at net realisable value;

– undamaged inventory – at cost.

Worthless Inventories

(i) The auditors should be concerned that the directors' intentions to value worthless inventories at cost do not follow the standard accounting treatment that should be adopted in the preparation of the company's financial statements. Standard accounting treatment dictates that inventories should be valued at the lower of cost and net realisable value – consequently worthless inventories should be reported as having a nil value in the financial statements for the year ending 30 June 2005. Given that approximately five per cent of the company's inventory value would be represented by the Fleurs Bleu perfumery products if included at cost, such a valuation would appear to represent a material overstatement of reported inventory values (and profit) in the company's financial statements.

(ii) To overcome the auditors' concerns, the company should ensure that all inventory items represented by Fleurs Bleu perfumery products are separated and clearly identified at the forthcoming inventory count, before the recording on inventory count sheets. Given the relative material value of these items it is particularly important that this aspect of the inventory count is well supervised.

Having identified the Fleurs Bleu inventory items, the company's management should ascertain whether in fact they have any sale value at all. If they have, and this value is lower than cost then they should be valued at net realisable value. If the inventory items are worthless then they should be given a nil value in the valuation process.

(c) To check sales cut off:

(i) When attending the warehouse for the inventory count on 30 June 2005 the auditors should select a sample of goods despatched notes for despatches made on that day. They should then select further goods despatched notes for despatches both soon before and soon after the year end date.

(ii) The sample of goods despatched notes should be traced to the associated sales invoices to ensure that sales invoices have been posted as sales in the correct accounting period. The auditors would be concerned to ensure that sales were not overstated due to the fact that goods despatched after the year end had been included as sales for the prior period, and conversely that goods despatched up to and including those on 30 June 2005 were not omitted from reported sales.

(ii) The auditors should also carry out similar tests on sales invoices raised on and around the year end date by checking from sales invoice entries back to goods despatched notes.

3 (a) At the audit visit in March 2005, audit staff should have:

(i) ascertained the company's systems of internal control recording any changes, as compared to the previous year, in the company's permanent audit file.

(ii) evaluated the adequacy of the systems to meet control objectives.

(iii) carried out tests of control to determine whether controls identified in the systems evaluation process had been operated effectively throughout the accounting year to the date of the audit visit.

(iv) designed and carried out tests in areas where controls were weak, to determine the extent to which records in these areas could be relied upon.

(v) formed a judgement as to the extent that the company's systems of internal control, to the date of the audit visit, could be relied upon as a basis for reducing the level of detailed testing at the final audit stage.

(b) The following matters should be discussed at the audit briefing meeting:

(i) findings from the audit visit in March, for example new systems, areas of weakness.

(ii) areas of the audit which appear to have a high audit risk, for example, inventory.

(iii) the audit approach to be adopted.

(iv) the audit programme to be used, for example, the firm's standard programme, or a modified or specific programme.

(v) the assignment of audit staff to specific audit areas.

(vi) the timing of the audit work, including the deadline date for the provision of audited financial statements.

(vii) Any special circumstances applying to working methods when carrying out the audit work at Jip Co's premises.

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

(c) (i) Events after the balance sheet date

– cash received after the year end – to verify the value of a debt.

– invoices received after the year end – to verify the value of an accrual.

– payment of an insurance premium after the year end – to verify the existence of a non-current asset.

– sale of inventory after the year end – to verify the value of inventory.

(ii) Satisfactory internal control procedures

- regular reconciliation of the trade payables ledger – to verify the value of trade payables.
- issue of sequentially controlled goods despatched notes – to verify the completeness of sales.
- authorisation of purchase invoices – to verify the value of purchases.
- strong system of perpetual inventory controls – to verify the value of inventories.

(iii) Written confirmation from third parties

- direct confirmation of a trade receivables balance – to verify the existence of a trade receivables balance.
- a bank certificate confirming the terms of charges held against the company's assets – to verify the existence of charges held against company assets.
- letter from a loan company, confirming the balance outstanding on a loan – to verify the loan liability of the company.
- a certificate from a specialist, confirming the value of specific inventories held – to verify the valuation of inventories.

(Full marks will be awarded for providing examples as above or any other appropriate examples.)

4 (a) Under the going concern assumption, an entity is ordinarily viewed as continuing in business for the 'foreseeable future' with neither the intention nor the necessity of liquidation, cessation of trading or seeking protection from creditors pursuant to laws or regulations. Accordingly, assets and liabilities are recorded on the basis that the entity will be able to realise its assets and discharge its liabilities in the normal course of business.

The term 'foreseeable future' refers to a period which should be at least, but is not limited to, twelve months from the balance sheet date.

(Full marks will be awarded for answers containing points similar to the above.)

(b) Financial indicators of risk that the continuance of an entity as a going concern may be questionable include:

- where there is a net liability or net current liability position.
- where there are fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- indications of withdrawal of financial support by debtors and other creditors.
- negative operating cash flows indicated by historical or prospective financial statements.
- adverse key financial ratios.
- substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- arrears or discontinuance of dividends.
- inability to pay creditors on due dates.
- inability to comply with the terms of loan agreements.
- change from credit to cash-on-delivery transaction with suppliers.
- inability to obtain financing for essential new product development or other essential investments.

Operating or other indicators of risk that the continuance of an entity as a going concern may be questionable include:

- loss of key management without replacement.
- loss of a major market, franchise, licence, or principal supplier.
- labour difficulties or shortages of important supplies.
- non-compliance with capital or other statutory requirements.
- pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- changes in legislation or government policy expected to adversely affect the entity.

(Full marks will be awarded for stating EIGHT financial and FOUR operating or other indicators of risk.)

(c) Procedures that auditors may carry out to obtain evidence as to the appropriateness of the going concern assumption for an entity include:

– analysing and discussing cash flow, profit and other relevant forecasts with management.

– analysing and discussing the entity's latest available interim financial statements.

– reviewing the terms of debentures and loan agreements and determining whether any have been breached.

– reading minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.

– inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.

– confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.

– considering the entity's plans to deal with unfulfilled customer orders.

– reviewing events after the period end to identify those that either mitigate against or otherwise affect the entity's ability to continue as a going concern.

(Full marks will be awarded for stating SIX audit procedures that auditors may carry out.)

The marking scheme generally indicates that 1 mark or $1^1/_2$ 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 $^1/_2$ 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%.

Recruitment Co

1 **(a)** Stating objectives of the internal controls exercised over non-current assets.

Generally 1 mark per objective up to a maximum of (4 marks)

(b) Explanation of how the company's non-current assets register may be used as a means of facilitating control.

Generally 1 mark per point up to a maximum of (4 marks)

(c) **(i)** Explanation of why there should be strong internal controls over the disposal of cars by Recruitment Co.

Generally 1 mark per point up to a maximum of (3 marks)

(ii) Suggesting internal controls that Recruitment Co should employ over the disposal of cars.

Generally 1 mark per point up to a maximum of 2 marks for each control with an overall maximum of (2 x 5) (10 marks)

(d) **(i)** Stating correct accounting treatment of purchase of office furniture.

Generally up to 1 mark for each accounting entry up to a maximum of (2 marks)

(ii) Description of audit procedures to verify delivery date of office furniture.

Generally up to 1 mark for each procedure up to a maximum of (2 marks)

Total (25 marks)

Sweet Scents Co

2 **(a)** Commentary on validity of financial director's statement.

Conclusion that the statement is invalid (1 mark)

Reasoning of conclusion.

Generally 1 mark per point up to a maximum of (4 marks)

(b) **(i)** Identification of audit concerns with regard to the accuracy of the inventories figure to be reported in the company's financial statements.

(ii) Stating action the company should take to overcome concerns.

Generally up to 1 mark for each point, with a maximum of 3 marks for (i) and 3 marks for (ii) applied to each statement with an overall maximum for the whole section of (15 marks)

(c) Description of audit procedures to be carried out on goods despatched notes and sales invoices to test sales cut-off at the year end date.

Generally 1 mark per point up to a maximum of (5 marks)

Total (25 marks)

Jip Co

3 **(a)** Detailing work that the audit team should have carried out in March 2005.

Generally 1 mark per point up to a maximum of 2 marks for each procedure detailed up to a maximum of (8 marks)

(b) Stating matters that should be discussed at final audit planning, briefing meeting.

Generally 1 mark per point up to a maximum of (5 marks)

(c) Providing examples of how audit team members may rely on each source of audit evidence.

Generally up to 1 mark for each example provided with a maximum of 4 marks for each type of evidence up to a maximum of (4 x 3) (12 marks)

Total (25 marks)

Going Concern Workshop

4 **(a)** Explanation of the underlying assumption applying to an entity when its financial statements are prepared on a going concern basis.

For mention of and clarification of the term 'foreseeable future' up to (1 mark)

Other points – generally 1 mark per point up to a maximum of (3 marks)

(b) Stating indications of risks that the continuance of an entity as a going concern may be questionable.

Financial indicators – generally up to 1 mark per point up to maximum of (8 marks)

Operating or other indicators – generally up to 1 mark per point up to a maximum of (4 marks)

(c) Stating procedures that auditors may carry out to obtain evidence that the going concern assumption is appropriate for an entity.

Generally 1 mark per point up to a maximum of 2 marks for each procedure – with an overall maximum of (9 marks)

Total (25 marks)