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# Answers

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- 1 (a) Three objectives of the internal controls that should be exercised over cash sales are:
- (i) to ensure that all cash to which the entity is entitled is received.
  - (ii) to ensure that all such cash is properly accounted for and recorded in the entity's records.
  - (iii) to ensure that all such cash is banked promptly and intact.

- (b) (i) The auditors of Rhodes could not rely on the controls as a basis for verifying completeness of the sales income from the culture evenings because the controls do not meet the sales system's objectives.

The major problem associated with the current procedures is the lack of segregation of duties in both the entrance kiosk and snack bar area where the cashier and snack bar manager respectively, have unsupervised responsibility to collect sales revenues from customers and to count those revenues in preparation for banking by Rhodes Co. The activities of the cashier and bar manager are not subjected to any form of contemporary internal check procedure by other employees of the company. Existing controls over both the kiosk cashier and bar manager with regard to the receipt of sales revenues are open to easy override by them, or undetected error, thus resulting in possible loss of revenue by Rhodes Co as a consequence of misappropriation or error.

In summary, irrespective of any representations to the contrary, the auditors could not rely on the current system due to the weaknesses identified above.

- (ii) I would recommend the following improvements to address the control weaknesses in the system:

#### Entry Charges

- The company should issue unique pre-numbered entry tickets to all customers on entry to the arena as a basis for the subsequent reconciliation of total kiosk takings to tickets issued on a nightly basis. The inventory of un-issued tickets should be subject to rigid control by a responsible official of Rhodes Co, and the kiosk cashier should not have access to un-issued tickets, with tickets being mechanically/automatically issued to customers.
- A secure cash register should be provided in the kiosk for use by the cashier.
- The kiosk takings and float should be counted and reconciled to tickets issued by two responsible officials of Rhodes Co (being any two from the arena manager and the assistant managers). If the company is unable to introduce an improved turnstile counting mechanism, automatically linked to the ticket issue mechanism, then entries into the arena area as recorded on the turnstile meter should be agreed to ticket issues. Any discrepancies revealed in the reconciliation and checking process should be immediately investigated.
- After counting the kiosk takings, a formal schedule should be prepared, reconciling the total kiosk takings to ticket issues and recorded turnstile entries into the arena area. The schedule should be annotated with any discrepancies for subsequent investigation and appropriate action by the management of Rhodes Co. The schedule, signed by both officials as evidence of checking, should then be put into the wallet together with the kiosk takings for the night ready for deposit into the night safe of Rhodes Co. A copy of the schedule should be retained by the arena manager, filed for future reference as appropriate.
- Procedures for the depositing of the wallet containing the kiosk takings and accompanying documentation into the night safe of Rhodes Co should ensure that both officials (above) are responsible for jointly making the deposit.
- The company should ensure that the duties allocated to responsible officials are frequently rotated around the management staff.

(Note: Full marks will be awarded for stating the above or other relevant points.)

#### Snack Bar Income

- The snack bar sales takings and float should be counted by two responsible officials of Rhodes Co (being two from the arena manager and the assistant managers). The total takings from the bar till should be compared to the total shown on the cash register listing and explanation for any discrepancy should be sought from the snack bar manager and investigated as appropriate.
- The task of emptying the takings from each vending machine should be undertaken jointly by the two responsible officials (above).
- Procedures for the removal of takings from each vending machine on a nightly basis should facilitate the formal recording of the total amount of takings removed, evidenced by the signature of both responsible officials. This record should be retained by the arena manager, and be available for inspection and comparison by senior officials of Rhodes Co.
- On completion of counting of the total cash takings, allocated between snack bar sales and vending machines, all monies should be put in a designated wallet, together with the cash register listing annotated as appropriate for any discrepancies, and a formal schedule signed by each of the responsible officials reconciling the total monies in the wallet to the snack bar sales and vending machine takings. A copy of the schedule should be retained by the arena manager, filed for future reference as appropriate.

- Procedures for the depositing of the wallet, containing the snack bar income, into the night safe of Rhodes Co should ensure that both officials (above) are responsible for jointly making the deposit.
- The company should ensure that the duties allocated to responsible officials are frequently rotated around the management staff.

(Note: Full marks will be awarded for making any six of the above or other relevant recommendations).

**(c)** The following controls should be employed by Rhodes Co over access to and the subsequent counting of income from the culture evenings:

- (i) Access to monies deposited in the night safe should be restricted to a very limited number of responsible officials of Rhodes Co, all of whom should be independent of the recording and banking functions.
- (ii) On a daily basis, two designated officials should remove both wallets containing the culture evening sales income from the safe and count the total monies contained therein. Both officials should evidence their agreement by signing the accompanying documentation forwarded by the arena employees. Any discrepancies between the cash totals and that noted on the accompanying documentation should be brought to the attention of an appropriate senior manager of the company for immediate investigation and enquiry. Similarly, discrepancies noted by the arena employees should be brought to senior management's attention, for investigation as appropriate.
- (iii) Procedures should ensure that there is a segregation of duties with regard to the recording of sales revenues in the accounting records of Rhodes Co and the banking of those revenues. Consideration should be given to the employment of a security firm to safeguard company staff and monies being transported to the company's bank.
- (iv) The underlying documentation contained in the wallets should be forwarded to the relevant person to enable sales income details to be recorded in the accounting records of Rhodes Co and for secure filing and future reference.
- (v) Monies from the wallets should be forwarded to the relevant person for the preparation of the bank paying-in slip and immediate banking.
- (vi) Procedures should ensure that a responsible official of the company independent from the recording and banking functions, verifies the amount on the bank paying-in slip to the underlying documentation – confirming sales income forwarded by the arena management.

(Note: Full marks will be awarded for stating any four of the above or other relevant controls).

**2 (a)** The use of a computer-based accounting system should benefit Malaga Co by enabling it to:

- (i) consistently apply pre-determined business rules and perform complex calculations in processing large volumes of transactions or data.
- (ii) enhance the timeliness, availability and accuracy of information.
- (iii) facilitate the additional analysis of information.
- (iv) enhance the ability to monitor the performance of the company's activities and its policies and procedures.
- (v) reduce the risk that controls will be circumvented.
- (vi) enhance the ability to achieve effective segregation of duties by implementing security controls in applications, databases and operating systems.

(Note: Full marks will be awarded for identifying any four of the above or other applicable benefits).

**(b)** A computer-based accounting system poses the following risks to an entity's internal controls:

- (i) reliance on systems or programs that are inaccurately processing data, processing inaccurate data or both.
- (ii) unauthorised access to data that may result in destruction of data or improper changes to data, including the recording of unauthorised or non-existent transactions, or inaccurate recording of transactions. Particular risks may arise where multiple users access a common database.
- (iii) the possibility of IT personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
- (iv) unauthorised changes to data on master files.
- (v) unauthorised changes to systems or programs.
- (vi) failure to make necessary changes to systems or programs.
- (vii) inappropriate manual intervention.

(Note: Full marks will be awarded for stating any six of the above or other applicable risks).

**(c)** The term 'audit software' describes the computer software used by auditors to assist them in their work, when examining the operations of, and testing the output of a computer-based accounting system.

<b>(d) Function Performed by Audit Software</b>		<b>Use by Auditors of Malaga Co</b>
Highlighting of exceptions	–	To identify exceptional wages payments outside of stated parameters, for enquiry.
Highlighting of trends	–	To highlight reported inventory movement both immediately before and after reporting dates to identify possible manipulation of inventory figures.
Performance of sequence checks	–	To verify completeness of sales reporting by ensuring that all invoices have been recorded.
Calculation checks	–	To ensure that overhead costs are totalled correctly in the general ledger.
Stratification of data	–	To subdivide the population of inventory lines with a view to examining only material balances.
Statistical analysis	–	To analyse inventory movement with a view to identifying slow moving items.
Selection of items for testing	–	To select trade receivables accounts for circularisation, to verify the existence of trade receivables.

(Note: Full marks will be awarded for identifying five of the above or other applicable functions, and for suggesting how each function could be used by the auditors of Malaga Co).

- 3 (a)** In reporting costs of \$1.62 million for wages in the financial statements of the company for the year ended 30 September 2006, the directors of Paphos Co made the following assertions:
- (i) the reported costs of \$1.62 million were properly incurred and pertain to Paphos Co.
  - (ii) the reported costs of \$1.62 million are complete and there were no other wages costs incurred during the year ended 30 September 2006.
  - (iii) the reported costs of \$1.62 million accurately reflect the total wages costs of the company for the year ended 30 September 2006.
  - (iv) the reported costs of \$1.62 million relate only to the costs incurred for the year ended 30 September 2006 by Paphos Co.
  - (v) the reported costs of \$1.62 million have been properly classified as wages costs.

(Note: Full marks will be awarded for stating four of the above or other relevant assertions).

- (b) (i) Random Selection**  
This is a method of selection in which items in a population have the same statistical probability of being selected. The method uses random numbers as a basis for selection.
- (ii) Haphazard Selection**  
This is a method of selection in which the auditor attempts to ensure that all items in a population have the same statistical probability of being selected by choosing items haphazardly.
- (iii) Systematic Selection**  
This is a method of selection in which the auditor selects items using a constant interval between selections. The first item may be selected on a random or haphazard basis, and thereafter the sampling interval is derived by the auditor, for example, by dividing the population by the sample size.

- (c)** I should carry out the following tests of control in connection with the verification of the wages costs of Paphos Co:
- (i) review a sample of employee files to verify that all starters, leavers or change of status details are authorised by a responsible official.
  - (ii) test check master file data and amendments and verifying to appropriate independent documentation authorised by a responsible official.
  - (iii) examine a sample of employees' time records to ensure authorisation by a responsible official.
  - (iv) witness master file update/amendment procedures and payroll preparation procedures to ensure adequate segregation of duties with regard to the wages function.
  - (v) test check veracity of calculations of the company payroll programme.
  - (vi) test check of payrolls for correct treatment of deductions from salaries and wages.
  - (vii) review a sample of payrolls for evidence of review and authorisation by a responsible official.

- (viii) review a sample of payroll summaries of entries to be posted to the general ledger accounts and tracing through the sample to ensure proper authorisation and entry into the appropriate accounts.
- (ix) trace a sample of net payment amounts due to employees to the company's bank statements to ensure correct and timely payment of liability due.

(Note: Full marks will be awarded for stating six of the above or other appropriate tests of control).

**4 (a)** Analytical procedures should be used by an audit firm as follows:

- (i) at the planning stage – to assist the auditor in planning the nature, timing and extent of other audit procedures. Use at this stage should add to the firm's understanding of the business and identify risk areas to which audit resources should be targeted.
- (ii) at the detailed testing stage – in most instances analytical procedures should be used in conjunction with tests of detail to achieve a particular audit objective in relation to specific financial statement assertions.
- (iii) at the final review stage – as part of the overall review of the financial statements to gain assurance that all of the audit objectives with regard to the financial statements have been met.

**(b)** The accounting ratios are:

- (i) 
$$\frac{\text{Total Sales}}{\text{Net Current Assets}}$$
- (ii) 
$$\frac{\text{Cost of Goods Sold}}{\text{Average Inventory Held}}$$
- (iii) 
$$\frac{\text{Trade Payables} \times 365}{\text{Credit Purchases in Period}}$$
- (iv) 
$$\frac{\text{Total Sales}}{\text{Total Assets}}$$
- (v) 
$$\frac{\text{Total Sales}}{\text{Non-Current Assets}}$$

**(c)** The internal audit department of a company, operating a supermarket chain, may be typically involved in the following activities:

- (i) The review and monitoring of accounting and internal control systems, and in the making of recommendations relating thereto. For example, an assignment to review and monitor the sales accounting function of the chain with the objective of recommending appropriate improvements to increase efficiency.
- (ii) The examination of financial and operating information, including carrying out detailed testing of transactions and balances. For example, the internal audit department may routinely be tasked with carrying out detailed testing of transactions and balances to verify information included in the company's monthly management accounts.
- (iii) The review of the economy, efficiency and effectiveness of the operations including non-financial controls of the company. For example, the internal auditors may be engaged to compare performance measures – including inventory-turnover and slow moving inventory ratios of individual supermarkets.
- (iv) The review of compliance with laws, other external regulations and corporate policies and directives. For example, internal auditors may be required to visit supermarkets throughout the chain to review compliance with health and safety laws and regulations.

(Note: Full marks will be awarded for stating four activities as above and relevant examples or for stating any other appropriate activities and relevant examples).

**(d)** Three areas in the financial statements of a company, operating a supermarket chain, where an audit firm may need to rely on the work of an expert are:

- (i) non-current assets – for example in the valuation of land and buildings.
- (ii) inventories – for example in the quantification or valuation of inventories held at supermarkets.
- (iii) provisions – for example in the quantification of a legal claim against the company.
- (iv) investments – for example in the valuation of financial securities or other investments as appropriate.

(Note: Full marks will be awarded for stating three areas from the above and any relevant examples or for stating other appropriate areas and examples)

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%.

**Rhodes Co**

- 1 (a)** Stating THREE objectives of the internal controls that should be exercised over cash sales.  
Generally 1 mark per point up to a maximum of (3 marks)
- (b)** Explaining why the auditors of Rhodes Co could not rely on the controls exercised over sales income received.  
Generally up to 1 mark per point up to a maximum of (7 marks)  
Recommendation of SIX improvements to address the weaknesses in the controls.  
Generally up to 1½ marks per point up to a maximum of (9 marks)
- (c)** Stating FOUR controls that Rhodes Co should employ over the subsequent recording and banking of sales income.  
Generally 1½ marks per control, up to a maximum of (6 marks)

**(Total 25 marks)**

**Malaga Co**

- 2 (a)** Stating FOUR benefits that Malaga Co should gain from using a computer-based accounting system.  
Generally 1 mark for each benefit up to a maximum of (4 marks)
- (b)** Stating SIX specific risks that the use of a computer-based accounting system poses to an entity's internal controls.  
Generally up to 1½ marks for each specific risk up to a maximum of (9 marks)
- (c)** Explanation of the term 'audit software'.  
Generally up to 1½ marks per point up to a maximum of (2 marks)
- (d)** Describing FIVE functions performed by audit software.  
Generally up to 1 mark for each function described up to a maximum of (5 marks)  
Suggesting how each function (described) could be used by the auditors of Malaga Co when auditing the company's financial statements.  
Generally up to 1 mark for each relevant suggestion up to a maximum of (5 marks)

**(Total 25 marks)**

## Paphos Co

- 3 (a)** Stating FOUR financial statement assertions made by the director of Paphos Co, in reporting wages costs of \$1.62 million in the financial statements of the company for the year ended 30 September 2006.  
Generally up to 1½ marks for each assertion up to a maximum of (6 marks)
- (b)** Explain the following terms as applied to the audit sampling methods:
- (i) Random Selection**  
Generally up to 1 mark for each point up to a maximum of (2 marks)
  - (ii) Haphazard Selection**  
Generally up to 1 mark for each point up to a maximum of (2 marks)
  - (iii) Systematic Selection**  
Generally up to 1 mark for each point up to a maximum of (3 marks)
- (c)** Stating SIX tests of control in connection with the audit of the reported wages costs.  
Generally up to 2 marks for each test stated up to a maximum of (12 marks)
- (Total 25 marks)**

## Effective Audit Procedures

- 4 (a)** Identifying the stages of an audit, during which an audit firm should use analytical procedures and explaining the purpose of them.  
Generally up to ½ mark for identifying planning, detailed testing and final review stage up to a maximum of (1½ marks)  
Then ½ mark for each relevant point with a maximum of 2 marks for each point up to a maximum of 2 marks for each stage up to a maximum of (4½ marks)
- (b)** Setting out the following (efficiency measure) accounting ratios:
- (i)** working capital turnover;
  - (ii)** average inventory turnover;
  - (iii)** payment period for trade payables;
  - (iv)** total assets turnover;
  - (v)** non-current assets turnover.
- Generally up to ½ mark for each component in each ratio up to a maximum of (5 marks)
- (c) (i)** Identifying FOUR activities in which the internal audit department of a company operating a supermarket chain may be typically involved.  
Generally up to 1 mark for each activity up to a maximum of (4 marks)
- (ii)** Providing a practical example for each activity above.  
Up to 1 mark for each example up to a maximum of (4 marks)
- (d) (i)** Identifying THREE areas in the financial statements of a company, operating as a supermarket chain, when an audit firm may need to rely on the work of an expert.  
Generally up to 1 mark for each area identified up to a maximum of (3 marks)
- (ii)** Providing a practical example for each area above.  
Up to 1 mark for each example up to a maximum of (3 marks)
- (Total 25 marks)**