Answers

1 (a) As with any operating company, in order for Rose Co to function successfully the directors of the company must ensure that the company's operations are effective and efficient, that it complies with applicable laws and regulations and that it has a reliable financial reporting system. If the company does not have an effective system of internal control, then it is probable that corporate objectives, with regard to these matters, will not be met thus adversely affecting the successful functioning of the company.

(NOTE: Full marks will be awarded to answers containing the above or other appropriate points.)

(b) Specific control activities and examples of how each may be employed on a day to day basis to control the sales accounting function of Rose Co include:

(i) Authorisation

Example

The authorisation of an increased credit limit for an existing customer, prior to updating the customer master file date.

(ii) Performance Reviews

Example

Regular review of the company's aged receivables list by a senior manager of the company to monitor the effectiveness of the company's credit control procedures.

(iii) Information Processing

Example

The daily processing of customer sales invoices through an integrated general and account receivables ledger system.

(iv) Physical Controls

Example

The restriction of access to computer terminals to authorised users only.

(v) Segregation of Duties

Example

Division of duties in the sales accounting function to ensure that individuals who accept orders from customers do not have any part in the processing of sales invoices or the receipt or processing of cash receipts from customers.

(NOTE: Full marks will be awarded for stating FOUR of the above or other activities together with appropriate examples.)

(c) Internal controls, no matter how well designed and operated, can provide an entity with only reasonable assurance about achieving the entity's financial reporting objectives. The likelihood of achievement is affected by limitations inherent to internal control. These include the realities that human judgement in decision-making can be faulty and that breakdowns in internal control can occur because of human failures, such as simple errors or mistakes. Errors also may occur in the use of information produced by IT. For example, automated controls may be designed to report transactions over a specified amount for management review, but individuals responsible for conducting the review may not understand the purpose of such reports and, accordingly, may fail to review them or investigate unusual items.

Additionally, controls can be circumvented by the collusion of two or more people or inappropriate management override of internal control. For example, management may enter into side agreements with customers that alter the terms and conditions of the entity's standard sales contracts, which may result in improper revenue recognition. Also, exception checks in a software program that are designed to identify and report transactions that exceed specified credit limits may be overridden or disabled.

Further inherent limitations in any system of internal control include the possibility that procedures may become inadequate due to changes in conditions – for example, in a company experiencing rapid growth in sales, existing control activities may be inadequate to cope with the volume of sales transactions. Additionally, there is an inherent weakness in any internal control system that is directed at routine transactions rather than non-routine transactions. For example, an accounting system which does not incorporate sufficient controls to properly identify and process transactions relating to the purchase of non-current assets, is inherently weak.

(NOTE: Full marks will be awarded to answers not necessarily containing all of the above points.)

(d) The amount of money defrauded from the company of $9,682 during the year ended 31 January 2006 represents less than 1% of reported net profit and is therefore not material in the context of the disclosures made in the financial statements of Rose Co. However the fact that the fraud was committed is indicative of a problem with the day to day systems of control within the company and the directors are therefore justified in having concerns about this.

From the auditors' perspective, unless their audit of Rose Co's financial statements revealed evidence to the contrary, they were entitled to assume that there was no fraudulent activity during the year. The purpose of an audit was to enable auditors to express an opinion on the financial statements and not to detect fraud. However they should have planned and performed their audit procedures with an attitude of professional scepticism recognising that conditions or events could be found indicating fraudulent activity. Should the auditors identify any unusual transaction or activity during the course of the audit, the procedures should be extended to confirm or dispel the suspicion.

It is generally recognised that it is often difficult to detect fraudulent activity when it is perpetrated by two senior managers of a company who collude to conceal the losses consequently incurred. Given that the total sum defrauded from Rose Co amounts to $9,682 over a six month (mid-year) period, it is probable that the fraud was carefully orchestrated by the financial director and the senior manager, so that only small individual amounts were targeted for fraud at a time when it was unlikely that the auditors would be present at the company. Given these factors and the immateriality of the sum involved, then providing a review of the auditors' working papers does not reveal inadequacies in their audit procedures, it is unlikely that the auditors would be found to have been negligent in not detecting the fraud. Consequently the directors' assertion appears to be unjustified.

(NOTE: Full marks will be awarded to answers not necessarily containing all of the above points.)

2 (a) When evaluating the control environment of an entity, an auditor should consider the following matters:

(i) Communication and enforcement of integrity and ethical values – essential elements which influence the effectiveness of the design, administration and monitoring of controls.

(ii) Commitment to competence – management's consideration of the competence levels for particular jobs and how those levels translate into requisite skills and knowledge.

(iii) Management's philosophy and operating style – management's approach to taking and managing business risks, and management's attitudes and actions towards financial reporting, information processing and accounting functions and personnel.

(iv) Organisational structure – the framework within which an entity's activities for achieving its objectives are planned, executed, controlled and reviewed.

(v) Assignment of authority and responsibility – how authority and responsibility for operating activities are assigned and how reporting relationships and authorisation hierarchies are established.

(vi) Human resources policies and practices – recruitment, orientation, training, evaluating, counselling, promoting, compensating and remedial actions.

(NOTE: Full marks will be awarded for identifying FOUR of the above or other appropriate matters.)

(b) (i) The areas on which my firm should obtain detailed information include:

- The various income streams of Tulip Co. These may include for example, income from the provision of accommodation and from the sale of meals, refreshments and souvenirs.
- Information about the market in which Tulip Co operates, for example, the size of the market, major competitors, the company's market share, pricing policies and the marketing strategy and objectives of the company.
- Information about the way the company conducts its operations for example, the range of adventure holidays offered, advance booking incentives for customers and details of expanding and declining activities.
- The extent of the company's involvement in electronic commerce, including internet sales and marketing activities.
- The geographic spread of the activities of the company and the type and extent of activity at each location.
- Employment practices within the adventure holiday sector generally and within the company. For example, the employment of specialist staff, use of temporary 'seasonal staff', staff training issues and remuneration levels within the sector.
- Details of the company's cost structures, including accommodation costs, employment costs, indemnity insurance costs and those relating to general administration.
- Details of any alliances or joint venture activities entered into by the company together with details of any activities outsourced to third parties.

(NOTE: Full marks will be awarded to answers identifying any SIX of the above or other relevant matters.)

(ii) When adopting a risk based approach to an audit, auditors should direct their substantive procedures to areas of the financial statements where there is an unacceptably high risk of material misstatement. This risk is a function of inherent risk and control risk as assessed by the auditor and can normally be reduced to an acceptably low level by using properly directed substantive procedures. For example, an auditor who has assessed an unacceptably high level of risk of material misstatement in the purchases area of a company's financial statements may reduce this risk by employing properly directed substantive procedures on purchases transactions.

(iii) The benefits of using document flowcharts to record a company's accounting and internal control systems are that they:

- enable the systems to be recorded in a standard format which is easily understood by specialist and non-specialist audit staff.
- present systems information in a logical sequence.
- highlight relationships between different parts of a system.
- provide an overview of a system such that superfluous documents, bottlenecks and weaknesses are more easily identified.
- Encourage a disciplined approach to the recording of a system in that the originator of a flowchart must have a good understanding of the system being recorded.

(NOTE: Full marks will be awarded for stating FOUR of the above or other perceived advantages.)

3 (a) The following matters should be confirmed in the confirmation from the company's bank:

(i) titles and account numbers of all bank accounts held in the name, joint name or trade name of Bluebell Co as at 30 June 2006, together with confirmation of balances held in those accounts.

(ii) full titles and dates of closure of all accounts closed in the name, joint name or trade name of Bluebell Co during the year ending 30 June 2006.

(iii) full details of interest charged or received on accounts held during the year if not specified on bank statements.

(iv) particulars of any written acknowledgement of set-offs relating to accounts and balances held on behalf of the company.

(v) details of overdrafts and loans repayable on demand together with details of other loans and facilities.

(vi) details of any assets of Bluebell Co which are held as security by the bank.

(vii) details of any other assets held by the bank, for example share certificates, documents of title or deed boxes.

(viii) full details of any contingent liabilities, for example the total of any bills discounted with recourse, for Bluebell Co.

(NOTE: Full marks will be awarded for stating SIX of the above or other relevant matters.)

(b) The minutes of the directors' board meetings of Bluebell Co should provide useful evidence with regard to the authorisation of and further information on:

(i) the purchase of development land during the year by the company including the purchase terms.

(ii) contracts entered into by the company during the year for the development of land.

(iii) sale and rental agreements in connection with completed development projects during the year.

(iv) the purchase of the office building during the year including the purchase terms.

(v) the financing of the purchase of the office building including the further issue of ordinary shares and the acquiring of the loan from the finance company. The minutes should confirm the authority for these transactions together with information on the related costs arising.

(vi) the capital expenditure program of the company during the year, including capital commitments as at 30 June 2006.

(vii) appointments of senior employees during the year.

(viii) the company's pay structure including the authorisation of general pay increases to employees.

(ix) the payment for significant material items of overhead expenditure during the year – for example special advertising costs to find tenants for a completed commercial building.

(x) the valuation of work-in-progress to be reflected in the company's financial statements for the year ending 30 June 2006.

(NOTE: Full marks will be awarded for stating SIX of the above or other appropriate matters.)

(c) My firm should carry out the following procedures to verify the ownership and existence of the office building purchased during the year:

– examine purchase documentation, probably from legal representatives, confirming purchase of property during the year.

– verify title to property by inspecting land registration document or obtain confirmation of title from company legal representatives.

– verify existence by physical inspection of property.

– obtain corroborative evidence of existence and ownership by vouching payments in relation to insurance of property, repairs to premises and utility bills.

– examine entry in the company's non-current assets register to ensure consistency with ownership and existence.

– scrutinise minutes of directors' board meetings of the company to obtain evidence of actions consistent with ownership/existence of the building.

– obtain loan confirmation with details of asset pledge if office building has be pledged.

(d) My firm should carry out the following procedures to verify the amount of the loan from the finance company and its disclosure in the financial statements together with that of the related interest charges.

(i) examine the loan agreement to verify the amount of the loan, the rate of interest chargeable, the security provided and the repayment terms.

(ii) confirm the actual amount of the loan received by vouching receipt into the company's accounting records and by the company bank. If applicable examine property purchase documentation to verify direct payment of loan funds to third party seller of commercial property.

(iii) check the accuracy and disclosure of interest charge payments and accruals in the company's profit and loss account.

(iv) verify the amount of the loan outstanding at the balance sheet date and ensure that this is accurately stated and fully disclosed in the company's balance sheet. The amount of the loan outstanding should be disclosed as repayable within 12 months and repayable after 12 months from the balance sheet date.

(v) Check the note to the company's financial statements to ensure that full disclosure is made with regard to the security for the loan, interest rate and repayment items.

4 **(a)** **(i)** Qualified opinion – A qualified opinion is expressed when the auditor concludes that an unqualified opinion cannot be expressed but that the effect of any disagreement with management, or limitation on scope is not so material and pervasive as to require an adverse opinion or a disclaimer of opinion.

(ii) Disclaimer of opinion – A disclaimer of opinion is expressed when the possible effect of a limitation on scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and accordingly is unable to express an opinion on the financial statements.

(iii) Adverse opinion – An adverse opinion is expressed when the effect of a disagreement is so material and pervasive to the financial statements that the auditor concludes that a qualification of the report is not adequate to disclose the misleading or incomplete nature of the financial statements.

(b) The extent of reliance that the auditor places on the results of analytical procedures is determined by the following factors:

(i) materiality of the items involved, for example, when inventory balances are material, the auditor does not rely only on analytical procedures in forming conclusions. However, the auditor may rely solely on analytical procedures for certain income and expense items when they are not individually material;

(ii) other audit procedures directed toward the same audit objectives for example, other procedures performed by the auditor in reviewing the collectibility of accounts receivable, such as the review of subsequent cash receipts, might confirm or dispel questions raised from the application of analytical procedures to an ageing of customers' accounts;

(iii) accuracy with which the expected results of analytical procedures can be predicted. For example, the auditor will ordinarily expect greater consistency in comparing gross profit margins from one period to another than in comparing discretionary expenses, such as research or advertising;

(iv) assessments of inherent and control risks, for example, if internal control over sales order processing is weak and therefore control risk is high, more reliance on tests of details of transactions and balances than on analytical procedures in drawing conclusions on receivables may be required.

(c) A letter on internal control (also referred to as a management letter or letter of weakness) is a letter usually forwarded by an auditor to the senior management of a company. The letter should normally be forwarded immediately following the completion of the tests of control and before the commencement of substantive procedures. It should also be issued at the conclusion of an audit to report additional findings noted in the process of the substantive testing.

The letter contains weaknesses identified in the entity's system of internal control as identified by the auditor or members of his audit team, when performing tests of control and the purpose of the letter is to bring these weaknesses to the attention of management. The weaknesses identified in the main body of the letter should be those which could lead to fraud or material error in or omission from the company's financial statements, and will be classified as those relating to:

(i) the design of the systems of accounting and internal control.
(ii) the operation of the systems of accounting and internal control.

For both categories the implication(s) of the weakness(es) should be identified. However minor control issues which the auditor would wish to bring to the attention of the company's senior management should be included in an appendix to the letter of weakness or in a supplementary report.

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 given 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%.

ROSE CO

1 **(a)** Explaining the importance of an effective system of internal control.
Generally 1 mark per point up to a maximum of (3 marks)

(b) **(i)** Stating four types of control activity.
Generally 1 mark for each control activity up to a maximum of (4 marks)

(ii) Providing an example of the employment of each control activity.
Generally 1 mark for each relevant example up to a maximum of (4 marks)

(c) Explaining why any system of internal control can provide only reasonable assurance that financial reporting objectives will be achieved.
Generally 1 mark per point up to a maximum of (8 marks)

(d) Briefly commenting on the directors' assertion that the company's auditors were negligent in not detecting the fraud perpetrated.
Generally 1 mark per point up to a maximum of (6 marks)

Total (25 marks)

TULIP CO

2 **(a)** Identifying and explaining four matters that an auditor should consider when evaluating the control environment of an entity.
Generally 1 mark for each matter identified and 1 mark for explanation up to a maximum of (4 x 2 marks) (8 marks)

(b) **(i)** Identifying six areas of the business operations of Tulip Co on which an audit firm should obtain detailed knowledge.
Generally up to $1^1/_2$ marks for each matter identified up to a maximum of (9 marks)

(ii) Explaining the term 'properly directed substantive procedures' in the context of a risk based audit approach.
Generally up to 1 mark per point up to a maximum of (4 marks)

(iii) Identifying four benefits of using document flowcharts to record a company's accounting and internal control systems.
Generally up to 1 mark for each advantage identified up to a maximum of (4 marks)

Total (25 marks)

BLUEBELL CO

3 **(a)** Identifying six specific matters with regard to the financial statements of Bluebell Co which should be confirmed in the confirmation letter from the company's bank.
Generally up to $1^1/_2$ marks for each matter stated up to a maximum of (9 marks)

(b) Identifying six specific matters in respect of which the minutes of the directors' board meetings of Bluebell Co should provide useful evidence in the audit of the company's financial statements.
Generally up to 1 mark for each matter stated up to a maximum of (6 marks)

(c) Stating the audit procedures that the firm should carry out to verify the ownership and existence of the office building.
Generally up to 1 mark for each procedure stated up to a maximum of (5 marks)

(d) Stating the audit procedures that the firm should carry out to verify the amount of loan from the finance company and its disclosure together with that of the related interest charges in the financial statements of Bluebell Co for the year ending 30 June 2006.
Generally up to 1 mark for each procedure stated up to a maximum of (5 marks)

Total (25 marks)

FINANCIAL STATEMENTS OF A COMPANY

4 **(a)** Describing the circumstances in which the following should be expressed in an auditor's report:

(i) Qualified opinion
(ii) Disclaimer of opinion
(iii) Adverse opinion

Generally 1 mark for each point in respect of each of the above up to a maximum of (3 x 3) (9 marks)

(b) Explaining four factors that determine the extent of reliance that auditors may place on analytical procedures to reduce detection risk.
Generally up to 1 mark per point with a maximum of up to 3 marks for each factor, with an overall maximum of (10 marks)

(c) Explaining the nature and purpose of a letter on internal control and stating when and to whom it should be issued.
Generally up to 1 mark for each point up to a maximum of (6 marks)

Total (25 marks)