
Answers

- 1 (a) The objectives of the internal controls that should be exercised over inventory, including inventory records are to ensure that:
- (i) Inventory records only include items that belong to the entity.
 - (ii) Inventory records only include items that exist.
 - (iii) Inventory records only include items that are held by the entity.
 - (iv) Inventory records are accurate.
 - (v) All movements of inventory are recorded.
 - (vi) Inventory is stored safely and securely.
 - (vii) Inventory is valued correctly.
 - (viii) Inventory quantities are maintained at efficient and economic levels.
- (Full marks will be awarded for stating five of the above or other objectives.)*
- (b) In order that the company's auditors may rely on the company's revised continuous inventory checking system Starling Co should ensure that:
- (i) Inventory records are kept up to date.
 - (ii) All inventory lines are counted at least once a year with higher value and desirable lines being counted more frequently.
 - (iii) The counting of inventory is carried out by suitably experienced independent individuals in a systematic and orderly manner.
 - (iv) All corrections to inventory records are authorised by a responsible official of the company.
 - (v) Any material discrepancies noted between inventory records and physical quantities are investigated immediately and reported to management for immediate further follow up as appropriate.
 - (vi) There are satisfactory procedures with regard to cut-off and receipt/issue documentation at the time of inventory counts.
- (c) The following matters should be covered in the instructions for the physical inventory count of Starling Co as at 31 January 2008:
- (i) There should be adequate supervisory controls, with one individual assuming overall responsibility for the inventory count.
 - (ii) Employees involved in the inventory count should be independent of those working in the stores and production areas, and counters should work in pairs with one counting inventory and the other recording and checking quantities counted.
 - (iii) Procedures should ensure that items are marked or tagged as 'counted' to avoid the possibility of double counting or omission.
 - (iv) There should be adequate control over the issue and returning of inventory control sheets, possibly involving the use of pre-numbered sheets with returned sheets being agreed to issued sequences for completeness.
 - (v) Inventory sheets should be completed in ink and signed by the relevant individuals involved in the counting and recording process.
 - (vi) Movement of inventory during the count should be prohibited and a special quarantine area should be created in which to store any goods received.
 - (vii) In order to minimise disruption to the production process, raw materials together with parts and finished goods inventories should be counted first with work-in-progress inventory being counted at the end of the working day.
 - (viii) There should be stringent controls over cut-off issues with careful note being made of the number of the last goods received, goods returned and goods despatched and raw materials/parts issued notes prior to the inventory count.
 - (ix) There should be adequate procedures to identify, count and record inventory that is slow moving or obsolete.
- (Full marks will be awarded for stating six of the above or other relevant matters.)*
- (d) (i) Cost is defined as being that expenditure which has been incurred in the normal course of business in bringing the inventory to its present location and condition.
- (ii) Net realisable value is defined as the actual or estimated selling price (net of trade but before settlement discounts) less:
- All further costs to completion
 - All costs to be incurred in marketing, selling and distribution.
- (iii) Starling Co should value its inventory at the lower of cost and net realisable value of the separate items of inventory or groups of similar items.

- 2 (a)** Inherent risk is the susceptibility of a financial statement assertion to a misstatement which could be material, individually or where aggregated with other misstatements, assuming that there were no related internal controls.
- (b)** The factors that would affect the initial assessment of the inherent risk include:
- (i) the geographic spread of the hotels operated by the company. The fact that each hotel has several income streams, in addition to accommodation and meals, combined with obvious expenditure requirements represents an inherent risk with regard to income and expenditure misstatement. The risk is increased significantly due to the distance of each hotel from the head office and accounts department of Finch Co.
 - (ii) the existence of cash sales. Cash is a desirable and portable asset with high inherent risk of loss due to the possibility of misappropriation by dishonest individuals.
 - (iii) the appointment of a new unqualified financial director, with only limited hotel sector experience, during the year. This could impair the preparation of the financial statements of the company due to the adoption of incorrect accounting policies or the existence of material errors in the financial statements.
 - (iv) the combination of an experienced and aggressive managing director with a potentially weak financial director. This could lead to undue pressure and influence being placed upon the financial director, by the managing director, to treat items incorrectly in the financial statements or not to include them in order to falsely represent the financial status of the company.
 - (v) the existence of profit related bonuses in the remuneration packages of the company's directors and hotel general managers. This could lead individuals to overstate income, understate expenditure, or both, in order to increase reported profits for personal gain.
 - (vi) the construction of a new hotel during the year. Such a project would involve significant levels of expenditure by the company. Inherent risk would centre around the correct disclosures in the company's financial statements as to capital expenditure and revenue expenditure and completeness of recording of any outstanding liabilities relating to the construction.
 - (vii) expenditure during the year on new restaurant and swimming pool facilities. Whilst the majority of this expenditure would be of a capital nature, it is likely that some would be categorised as revenue (repairs & maintenance) expenditure. There is an inherent risk that material amounts of expenditure may have been incorrectly categorised in the company's financial statements.
 - (viii) the existence of ongoing repairs, maintenance and replacement programmes for furnishings and equipment. As with (vii) above, inherent risk considerations will focus on the possibility that capital and revenue expenditures have been categorised incorrectly in the company's financial statements.
 - (ix) the existence of small valuable and desirable non-current asset items. The nature of the hotel business is such that plant and equipment items owned by the business are open to loss due to misappropriation or theft by dishonest individuals. This would represent an increased inherent risk in the area of non-current assets of the financial statements.
 - (x) compensation claim arising from food poisoning at a company hotel. The inherent risk associated with this event is twofold. Firstly there is a risk that the provision included in the financial statements for the payment of compensation will be materially misstated. Secondly there is the risk (possibly remote) that the food poisoning event may have a catastrophic effect on the reputation of the company's hotels generally, resulting in a downturn of activity. As such it is possible that the company was not a 'going concern' at the balance sheet date and there is a consequent risk that this fact is not reflected in Finch Co's financial statements as at 30 November 2007.
- (c)** General controls as applied to a computer-based accounting system are policies and procedures that relate to the application and support the effective functioning of applications controls by helping to ensure the continuous proper operations of information systems. Examples of such controls include those over data centres and network operations, systems software acquisition, change and maintenance, access security; and application systems acquisition, development and maintenance. The objectives of general controls are to ensure the proper development and implementation of applications, and the integrity of program and data files, and of computer operations.
- (d)** General controls that should exist to prevent unauthorised access to Finch Co's computer systems from the remote terminals located at each hotel include:
- (i) ensuring that the facilities of each hotel terminal allow only for the forwarding of specified accounting information to the central computer system.
 - (ii) Disallowing any access (read or amend) by hotel terminals to files held on the central computer system.
 - (iii) Restricting physical access to computer facilities by locating terminals at each hotel in a secure room.
 - (iv) The use of passwords to ensure that only authorised employees gain access to computer facilities.
 - (v) Rigid controls over the issue and protection of passwords.
 - (vi) Restricting access from computer terminals to the main computer to specified times convenient to the head office accounts personnel for the receipt of information.

(vii) The use of a log at each terminal to record the password identity of each user and the time of access.

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

3 (a) My firm should carry out the following tests:

(i) Disposal

- (1) check authorising documentation to ensure that the disposal was appropriately authorised and for proceeds of \$30,000.
- (2) examine the sales documentation relating to the disposal and ensure that the sale details match those in the authorising documentation.
- (3) check that accounting entries with regard to documentation are recorded correctly in the general ledger with credit being made to non-current assets disposal account.
- (4) check accounting entries in the non-current assets register and general ledger relating to disposal ensuring correct removal from non-current assets account (credit) and opposite entries in non-current assets disposal account. Also check validity of entries relating to accumulated depreciation.
- (5) check calculations of profit/loss on disposal and corresponding entries in income statement.

(Note: Three marks will be awarded for describing any of the above or other relevant audit tests.)

(ii) Additions

- (1) check authorising documentation to ensure that additions were appropriately authorised.
- (2) check cost information from purchase invoice/purchase documentation.
- (3) check accounting entries in non-current assets register and general ledger with regard to cost of additions.
- (4) check that useful life on which depreciation rates have been based is reasonable.
- (5) check accuracy of depreciation charge.
- (6) ensure existence of new machines by physically verifying at balance sheet date.

(Note: Three marks will be awarded for describing any of the above or any other relevant audit tests.)

(b) Possible reasons for the credit balances on customer accounts include:

- (i) payment being received from the customer in advance of supply being made by Owl Co.
- (ii) duplicated payment of an invoice from Owl Co.
- (iii) omission of posting of an invoice to the specified customer account.
- (iv) incorrect posting of an invoice from Owl Co to another customer account.
- (v) incorrect posting of payment received from another customer of Owl Co to the specified customer account.
- (vi) incorrect posting of a credit note or journal credit to the specified customer account.
- (vii) posting of a credit note to the specified customer account in lieu of goods paid for, being returned.
- (viii) posting of a credit note to the specified customer account on settlement of dispute.

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

(c) In order to minimise audit risk our firm should carry out extensive substantive procedures in the bank area. This is due to the high inherent risk factor associated with bank transactions and the fact that Owl Co's internal control in this area is fundamentally weak. Irrespective of the point that the cashier may be a very trusted employee of the company: the lack of segregation of duties in the bank payments, bank receipts and recording functions is of a particular concern. The fact that these functions are not segregated, considerably increases the possibility of undetected fraud and error. Consequently, in directing additional audit resources to substantive procedures in this area, my firm would be seeking to reduce the detection risk with regard to fraud and error.

(d) Evidence obtained from Owl Co's supplier statements is from a reliable source of audit evidence because the suppliers represent an independent source outside of Owl Co. Consequently by checking year-end supplier statement balances, my firm would seek to obtain reliable evidence in connection with the audit objectives of confirming:

- (i) completeness of payables – omissions from trade payable balances may become apparent following a comparison of statement balances and trade payables ledger balances.
- (ii) existence of trade payables balances – supported by equivalent balances on supplier statements.
- (iii) the valuation of trade payable balances – supported by equivalent balances on supplier statements.
- (iv) confirmation that liabilities recorded in the trade payables ledger pertain to Owl Co – in this regard supplier statements should be addressed to the company.

- 4 (a) (i)** Auditors must be independent and be seen to be independent at all times in connection with their professional work. ACCA's Code of Ethics and Conduct sets out an auditor's responsibility with regard to accepting an audit appointment to a company in which a member or their close family has a direct or material financial interest. The Code confirms that in such circumstances there is a threat to the independence in terms of familiarity and that therefore such an appointment should not be accepted.

The relationship between the auditor in question and his sister who owns all of the share capital in Eagle Co, is one of a close family relationship. It therefore follows that the auditor should not accept the audit appointment.

- (ii)** As in (i) above, with regard to their professional work, auditors must be independent and be seen to be independent at all times. ACCA's Code of Ethics and Conduct provides guidance with regard to the acceptance of an offer of gifts or hospitality from audit clients, indicating that such an offer, if it has significant value, may compromise the auditor's objectivity because it represents a threat to independence due to the self-interest threat. The Code confirms gifts or hospitality should only be accepted if the value of any benefit is modest, and therefore does not present a threat to objectivity.

The value of the free holiday accommodation offered to the auditor of Robin Co is \$1,800. This is clearly of significant value and, irrespective of the company's motivation for making the offer, would represent a threat to the objectivity and independence of the auditor. The auditor should therefore politely refuse the offer.

- (b) (i)** 'Audit sampling' is the application of audit procedures to less than 100% of the items within an account balance or class of transactions (a population) to enable the auditor to obtain and evaluate audit evidence about some characteristic of the item selected in order to form, or assist in forming, a conclusion concerning the population.

- (ii)** The advantages of using statistical sampling rather than judgemental sampling (non-statistical sampling) include:

- (1) the size of the sample is determined objectively having regard to the degree of risk associated with the area being tested.
- (2) bias is eliminated.
- (3) results of statistical sampling can be more easily justified as being representative of the population as a whole, thus increasing the level of confidence in the results of testing the sample. As a consequence of this, the conclusion drawn from the results of sample testing are more easily justified where an audit client disputes the audit conclusions.
- (4) The emphasis on risk assessment by the auditor in the determination of the sample size encourages the auditor to concentrate on significant issues (for example a high degree of control risk), which may not otherwise be considered.
- (5) In instances when there is a large population, the use of statistical sampling techniques may reduce the sample size, and therefore the amount of audit work required, as compared to the sample size that would be selected using judgement sampling methodology.
- (6) The auditor may justifiably conclude with a definite level of confidence that the conclusions drawn from the sampling test is within stated precision limits.

(Full marks will be awarded for stating four of the above or other advantages of using statistical sampling techniques.)

- (c) (i)** Examples of the working papers ordinarily contained in a typical current audit file include:

- Evidence of the planning process including audit programmes and any changes thereto.
- Evidence of the auditor's consideration of the work of internal auditing and conclusions reached.
- Analyses of transactions and balances.
- Analyses of significant ratios and trends.
- The identified and assessed risks of material misstatements at the financial statement and assertion level.
- A record of the nature, timing and extent of audit procedures performed in response to risks at the assertion level and the results of such procedures.
- Evidence that the work performed by assistants was supervised and reviewed.
- An indication as to who performed the audit procedures and when they were performed.
- Details of audit procedures applied regarding components whose financial statements are audited by another auditor.
- Copies of communications with other auditors, experts and other third parties.
- Copies of letters or notes concerning audit matters communicated to or discussed with management or those charged with governance, including the terms of the engagement and material weaknesses in internal control.
- Letters of representation received from the entity.
- Conclusions reached by the auditor concerning significant aspects of the audit, including how exceptions and unusual matters, if any, disclosed by the auditor's procedures were resolved or treated.
- Copies of the financial statements and auditor's report.

(Full marks will be awarded for listing six of the above or other relevant examples.)

(ii) The advantages of using automated working papers include:

- Working papers should be neater thus facilitating the review process.
- Where changes need to be made to working papers including those to summary schedules, automatic updating facilities should result in time savings and audit effort.
- The risk of error is reduced, for example in the casting of numeric schedules.
- Standard working paper stationery can be downloaded from remote locations at clients' premises thus reducing the need to transport voluminous files and papers.
- As completed working papers can be transmitted (for example via a modem) back to the audit office for review, there is a reduced requirement for supervising visits to clients' premises. This can result in considerable time and cost savings.

(Full marks will be awarded for stating three of the above or other advantages.)

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.

Generally, 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%.

- 1 (a)** Stating FIVE objectives of the internal controls that should be exercised over inventory.
Generally 1 mark per objective up to a maximum of (5 marks)
- (b)** Stating FIVE procedures that Starling Co will need to incorporate in its revised continuous inventory checking system.
Generally up to 1 mark per procedure up to a maximum of (5 marks)
- (c)** Describing SIX matters that should be covered by the physical inventory count instructions to facilitate an efficient and reliable count.
Generally up to 1½ marks per matter up to a maximum of (9 marks)
- (d) (i)** Definition of cost.
Generally ½ mark per point up to a maximum of (2 marks)
- (ii)** Definition of net realisable value.
Generally ½ mark per point up to a maximum of (2 marks)
- (iii)** Stating how Starling Co should value its inventory as at 31 January 2008.
Generally ½ mark per point up to a maximum of (2 marks)

(Total 25 marks)

- 2 (a)** Explanation of the term 'inherent risk'.
Generally ½ mark per point up to a maximum of (2 marks)
- (b)** Stating with reasons FIVE factors that would affect the initial assessment of inherent risk associated with the audit of the financial statements of Finch Co for the year ended 30 November 2007.
Generally up to 1 mark for identifying each factor up to a maximum of (1 x 5) (5 marks)
Up to 2 marks for stating reasons why each factor would affect the initial assessment of the inherent risk associated with the audit, with a maximum of (2 x 5) (10 marks)
- (c)** Explanation of what is meant by the term 'general controls' as applied to a computer-based accounting system.
Generally ½ mark per point up to a maximum of (2½ marks)
Stating the objectives of general controls (1½ marks)
- (d)** Stating FOUR general controls that should exist to prevent unauthorised access to Finch Co's computer systems from the remote terminals located at each hotel.
Generally up to 1 mark per control up to a maximum of (4 marks)

(Total 25 marks)

- 3 (a)** Describing THREE audit tests with regard to the disposal of the lathe machine and THREE audit tests with regard to the purchase of the two additional machines. (9 marks)
Generally up to $1\frac{1}{2}$ marks per test up to a maximum of ($1\frac{1}{2} \times 6$)
- (b)** Stating FOUR possible causes as to why credit balances could have arisen on customer accounts. (6 marks)
Generally up to $1\frac{1}{2}$ marks per cause up to a maximum of ($1\frac{1}{2} \times 4$)
- (c)** Explaining with reasons the extent of substantive procedures the audit firm should carry out in the bank area of Owl Co. (2½ marks)
Explaining risk associated with lack of segregation of duties
Generally $\frac{1}{2}$ mark per point up to a maximum of
Explanation of other points. (2½ marks)
Generally up to 1 mark per point up to a maximum of
- (d)** Brief comment on the reliability of supplier statements as a source of audit evidence. (1 mark)
Stating FOUR audit objectives of checking a sample of Owl Co's year-end supplier statements. (4 marks)
Up to 1 mark for each objective up to a maximum of (1 x 4)

(Total 25 marks)

- 4 (a) (i)** Confirming that auditor should not accept the audit appointment to Eagle Co. (1 mark)
Mention of ACCA's Code of Ethics and Conduct (1 mark)
Other commentary.
Generally $\frac{1}{2}$ mark per point up to a maximum of (2 marks)
- (ii)** Confirming that auditor should not accept the gift from Robin Co. (1 mark)
Mention of ACCA's Code of Ethics and Conduct (1 mark)
Other commentary.
Generally $\frac{1}{2}$ mark per point up to a maximum of (2 marks)
- (b) (i)** Definition of the term 'audit sampling'. (2 marks)
- (ii)** Stating FOUR advantages of using statistical sampling. (6 marks)
Generally up to $1\frac{1}{2}$ marks per stated advantage up to a maximum of ($1\frac{1}{2} \times 4$)
- (c) (i)** Listing SIX examples of the working papers ordinarily contained in a current audit file. (6 marks)
Generally up to 1 mark per example up to a maximum of (1 x 6)
- (ii)** Stating THREE advantages of using automated working papers. (3 marks)
Generally up to 1 mark per stated advantage up to a maximum of (1 x 3)

(Total 25 marks)