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# Answers

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- 1 (a) (i) The term 'control environment' refers to the overall attitude, awareness and actions of the directors and managers of an entity concerning the entity's internal controls and its importance in the entity. The control environment influences the day to day activities of an entity. For example, in an entity with a good control environment, where management take an active role in maintaining efficient internal controls, there is likely to be a disciplined and structured approach to performing day to day administrative and accounting tasks. Conversely, an entity with a weak control environment is more likely to be less effective in performing such tasks. In addition to reflecting the function and operating style of the directors and managers, the control environment of an entity is also reflected in:
- its personnel policies and procedures, including recruitment, retention and dismissal,
  - the existence of an internal audit function,
  - methods of assigning authority and responsibility,
  - the segregation of duties in the performance of tasks.

*(Full marks will be awarded to answers including points similar to the above or other relevant points)*

- (ii) The existence of a strong control environment in Olive Co should have a positive effect on our approach to the audit of the company's financial statements.

In assessing the risk of material misstatement in the financial statements, my firm should be able to place more reliance on the internal controls of the company, than would be the case if the control environment was weak. Consequently, provided the results from tests of controls we carry out show that controls employed do meet desired objectives, we should be able to accept a higher level of detection of risk and thus carry out a reduced level of substantive procedures.

*(Full marks will be awarded to answers including points similar to the above or other relevant points).*

- (b) The objectives of the internal controls that should be exercised over a purchases and trade payables system are to ensure that:

- (i) Goods and services are procured in a timely manner.
- (ii) Goods and services are procured at the best possible price on the best possible terms.
- (iii) Goods and services received in inferior condition or of inferior quality are rejected or are accepted on negotiated terms.
- (iv) Invoices are accepted only for goods and services received for the benefit of the entity.
- (v) All liabilities pertaining to goods and services received are properly recorded in the accounting records of the entity.

- (c) Control activities should exist as follows:

**(i) Ordering of electrical goods**

- (1) Goods should be ordered only by responsible officers in the company's purchasing department, from suppliers who have been authorised to supply Olive Co by the purchasing manager. The company should ensure that each responsible officer's purchasing authority is appropriate given the level of their experience and qualifications.
- (2) All orders should be supported by official, pre-numbered multipart, company purchase order stationery raised and authorised in the purchasing department. Strict physical control should be maintained over this stationery, to ensure that unauthorised orders are not placed with suppliers.
- (3) Purchase orders raised should provide full order details including the date of the order, supplier name and address, description of goods and quantity, price, delivery address, expected delivery date, general ledger code posting reference, and the authorising signature of the responsible officer. Orders should be forwarded directly from the purchasing department to suppliers with a copy being retained and further copies being forwarded to Olive Co's goods received area and accounts department.

**(ii) Receipt of electrical goods**

- (1) Copy of the purchase orders received in the goods received area from the purchasing department, should be filed in numerical sequence, awaiting delivery of goods. These should be reviewed regularly and any orders on which there appear to be undue delays in delivery should be referred back to the purchasing department for follow up with suppliers.
- (2) Goods delivered should only be accepted against authorised purchase orders, and should be inspected for quantity, quality and condition by appropriately experienced staff.
- (3) Goods accepted should be recorded on securely stored pre-numbered, multi-part goods received notes, by the inspection personnel. These should indicate the date of receipt, the purchase order number, details of goods received and should be signed as approved by the inspection personnel. Goods received notes should then be forwarded to the accounts department for subsequent matching to purchase orders and supplier invoices. A copy of each goods received note issued, should be retained in sequential order in the goods received area for reference.
- (4) Separate procedures, including the use of multi-part goods returned note stationery, should be employed to control the return of goods, for any reason to suppliers.

**(iii) Receipt and authorisation of supplier electrical goods invoices prior to batch processing**

- (1) All invoices received by Olive Co should be forwarded to the accounts department and logged in an invoice register as received, prior to detailed checking procedures. The register should be subsequently updated to indicate the whereabouts of the invoices in the system.
- (2) Invoices should then be matched with and checked against numerically filed copy purchase orders and goods received notes, by accounting personnel, prior to being forwarded to the purchasing department for authorisation.
- (3) Invoices relating to goods received and retained but on which there appear to be discrepancies (for example casting errors), or which relate only to partially completed orders, should be highlighted as such by accounts personnel prior to being forwarded to the purchasing department.
- (4) Invoices relating to goods that have been returned should be subject to separate control procedures including, where appropriate, the issue of authorised internal debit notes to supplier accounts – thus minimising the possibility of erroneous payments.
- (5) Matched invoices received by the purchasing department, should be checked to underlying documentation including the appropriate general ledger posting code and any discrepancies should be resolved prior to authorisation for payment by a responsible senior official. This official should not have had any direct involvement in the ordering process. Authorised invoices should then be returned to the accounts department to be prepared for batch processing.
- (6) The supplier invoice register, unmatched order file and unmatched goods received note file in the accounts department should be regularly reviewed by a responsible official and any undue delays in processing should be followed up.

*(Full marks will be awarded to answers including points similar to the above or other relevant points)*

**2 (a)** The following matters should be considered when planning the audit of Palm Co's financial statements for the year ending 31 August 2007.

- (i) Specific issues arising from the previous year's audit. A review of the previous year's working papers should indicate any audit matters arising that are likely to impact on this year's audit. For example, high inherent risk areas from the previous year are likely to present similar risk profiles this year.
- (ii) Major changes in the company's operations. The significant growth experienced by Palm Co, together with the change in the internal control system will have a major impact on audit planning. As a consequence my firm will need to consider the additional audit resources required to carry out an efficient and effective audit on a company with a larger scale of operations. The requirement to ascertain, record and evaluate the company's new internal control system will also need to be considered.
- (iii) Timing requirements. We will need to liaise with the company's management to prepare a timetable for the completion of our audit. The timetable should set out the agreed dates of our attending the company to carry out our work. This should include dates for inventory count attendance, the date draft financial statements will be available for audit and the date by which the company requires us to issue our audit report. Our planning procedures should include the issue of a timetable for our work, agreed by the directors of Palm Co.
- (iv) A review of interim or management accounts prepared by the company. Our firm should review a copy of any accounts already prepared during the year to date, in order to gain an insight into Palm Co's performance and any matters arising which could have audit significance. For example, a build up of longstanding trade receivables balances could indicate the existence of bad debts not recognised by Palm Co.
- (v) Problems encountered during the year. We should meet senior management of Palm Co to identify and discuss any problems encountered by the company during the year which could impact on our audit work. For example, discussions may reveal significant repairs and maintenance expenditure was incurred following the continual breakdown of old plant and machinery. Similarly, management may update us with the outcome of discussions they may have recently had to renew the company's overdraft facility.
- (vi) Changes in legislation or accountancy practice. Palm Co's manufacturing activities are likely to be subject to stringent legislative requirements including health and safety regulations. Similarly the financial complexities involved in the day to day operations of the company are likely to require careful monitoring, to ensure that the company's financial reporting function accords with the relevant contemporary accounting standards. My firm should consider any recent changes in legislation or accounting practice relevant to Palm Co.
- (vii) Work to be carried out by the client's staff. Involvement of Palm Co's staff in preparing/supplying reconciliation and analysis schedules (for example, ageing of trade receivable balances), should facilitate a more efficient audit. Whilst we will still need to carry out specific procedures to verify information on such schedules, the provision of them should save time freeing audit resources to concentrate on more complex tasks. In order to determine the extent of assistance our firm can expect to receive from the staff at Palm Co, we should liaise with the company's management.

(viii) Audit staffing. My firm should give careful consideration to the make up of the audit team, ensuring there is an adequate balance between the number of employees to be assigned to the audit, their experience and the fee chargeable to Palm Co for carrying out the audit work. When assigning audit staff, due consideration should be given to other commitments within the firm, staff availability and work experience training issues.

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

**(b)** My firm may record the internal control system of Palm Co by employing any of the following methods:

- (i) Narrative Notes
- (ii) Flow Charts
- (iii) Internal Control Questionnaires or check lists
- (iv) Organisation Charts

*(Full marks will be awarded for stating any THREE of the above).*

**(c)** An Internal Control Questionnaire (ICQ) normally comprises a checklist of standard controls that should exist in a specified functional area (for example, sales and trade receivables or purchases and trade payables). Questions about the existence of specified controls are usually phrased to generate a 'Yes' or a 'No' answer, with an affirmative answer confirming the existence of the control and a negative answer indicating the absence of the control and a weakness in the system.

A problem associated with ICQs is that whilst they do identify areas where controls appear to be weak, they do not provide evaluation of those weaknesses. For example, whilst a 'No' answer may indicate weakness in controls, it is possible that other controls in the system, of which the auditor is unaware, may compensate for the weakness.

Internal Evaluation Questionnaires (ICEQs) provide an alternative and improved means of evaluating control systems, by asking key questions about those systems. Key questions are phrased such that answers in the positive should alert the auditor to the fact that there are deficiencies in the systems because systems objectives are not being met. ICEQs are usually designed to include a list of points that the auditor should consider before answering each key question.

**(d)** The following key questions should be included on an ICEQ relating to the purchases and trade payables system:

- (i) Can liabilities be recorded for goods or services not received by the company?
- (ii) Can unauthorised goods be ordered?
- (iii) Can unauthorised goods be accepted?
- (iv) Can liabilities be incurred but not recorded?
- (v) Can liabilities be over or understated?
- (vi) Can trade payable accounts be improperly debited or credited?
- (vii) Can unsupported payments be made to suppliers?
- (viii) Can charges be allocated to the incorrect general ledger account?

*(Full marks will be awarded for listing FOUR of the above or other relevant questions).*

**3 (a)** The following factors will influence my firm's judgement in deciding what will be sufficient appropriate evidence when auditing the financial statements of Ash Co.

- (i) Knowledge of the company and the business environment in which it operates. As Ash Co is a new audit client, it is likely that we will need more evidence to arrive at our audit conclusion than we would otherwise need for a similar longstanding audit client, in respect of whom we had built up a cumulative knowledge base.
- (ii) The assessment of audit risk. This will depend on our evaluation of inherent risk factors, of the company's control environment and of its internal control system. Ash Co is a small company and possibly has elements of a strong control environment. However, given the low number of employees it is likely that there is a lack of segregation of duties in its accounting system. In such circumstances we would need to obtain additional audit evidence from extended substantive procedures.
- (iii) The nature and materiality of the item being tested. Generally the more complex and material an item is, then the more evidence will be required to arrive at an audit conclusion in respect of that item. For example, the valuation of work-in-progress held by Ash Co at 31 May 2007 is complex because it should include an appropriate amount of overhead cost. Given that the work-in-progress value is also material, a substantial amount of audit evidence will probably be required to support the valuation.
- (iv) The persuasiveness of audit evidence obtained. This will be governed by the source and reliability of it. For example, in determining the likelihood of recovering a long standing debt from a customer, my firm will place more reliance on documentation relating to the debt (e.g. correspondence from the customer or legal representatives) than on an optimistic assertion, from a manager of Ash Co, that the debt is recoverable.

- (v) Findings from audit procedures. If our audit work, with regard to Ash Co reveals fraudulent activity or extensive errors and omissions with regard to the accounting records, we may conclude that extensive substantive procedures are required in order to reduce audit risk.

*(Full marks will be awarded for stating any THREE of the above or other relevant factors).*

**(b) (i) Observation**

Observation consists of looking at a process or procedure being performed by others.

*Examples*

Watching the opening of the mail to ensure that there is adequate control over 'money' payments received through the post.

Watching Ash Co's physical inventory count to ensure that proper control and counting procedures are being followed.

**(ii) Inquiry**

Inquiry consists of seeking information of knowledgeable persons both financial and non-financial, throughout the entity or outside the entity.

*Examples*

Speaking to the directors of Ash Co to obtain information about the company's depreciation policy.

Writing to the company's legal advisers to determine the existence of any legal claims outstanding against Ash Co.

**(iii) Confirmation**

Confirmation, which is a specific type of inquiry, is the process of obtaining a representation of information or of an existing condition directly from a third party.

*Examples*

Writing a letter to Ash Co's bank to obtain confirmation of the company's bank account balances at the balance sheet date.

Circularisation of a sample of Ash Co's suppliers during the period to confirm the existence of trade payables balances at the balance sheet date.

**(iv) Reperformance**

Reperformance is the auditor's independent execution of procedures or controls that were originally performed as part of the entity's internal control.

*Examples*

Reperforming the extraction of a trial balance from the company's general ledger.

Using computer-assisted audit techniques to re-perform the ageing of accounts receivable balances.

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

- 4 (a) (i)** The purpose of client screening procedures is to determine whether the prospective client is suitable for the firm. Following the procedures, in arriving at the decision as to whether to accept an audit appointment the firm should evaluate the potential risk to the firm of acceptance.

When a client is deemed to represent a high audit risk to the firm, the firm should carefully consider the implications arising should it fail in meeting its objective of giving an accurate audit opinion. If the firm is not confident that the benefit to be derived from accepting the appointment outweighs the potential risks (including financial and reputational risk of being sued), then the firm should decline the appointment.

- (ii)** The audit engagement partner of Oaks & Co should consider the following matters:

- The state of the computer software design commercial sector and prospects for businesses engaged in it.
- The reason for the resignation/removal of the company's previous auditor.
- The extent to which previous years' audit reports relating to Beech Co have been qualified.
- The experience and qualifications of the company's management and their attitude towards control environment issues.
- The current operating and financial position of the company.
- The directors' understanding of the role of the external auditor.
- The availability of adequate audit resources within the firm to carry out an effective audit on Beech Co's financial statements.
- The accounting policies used by Beech Co.
- Indications that Beech Co or its management may be engaged in fraudulent activity.

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

**(b) (i)** A letter of engagement helps to avoid misunderstandings between the auditors and client as to the nature of the auditors' appointment, the scope of the audit work to be carried out and the respective responsibilities of the auditors and the client. It forms the basis of the contract between the auditors and the client.

**(ii)** The following important matters should be included in a letter of engagement:

- The objective of the audit of financial statements;
- Management's responsibility for the financial statements;
- The scope of the audit, including reference to applicable legislation, regulations, or pronouncement of professional bodies to which the auditor adheres;
- The form of any reports or other communication of results of the engagement;
- The fact that because of the test nature and other inherent limitations of internal controls, there is an unavoidable risk that material misstatements may remain undiscovered;
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit;
- Arrangements regarding the planning and performance of the audit;
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit;
- Request for the client to confirm the terms of engagement by acknowledging receipt of the letter;
- Description of any other letters or reports the auditor expects to issue to the client;
- Basis on which fees are computed and any billing arrangements.

*(Full marks will be awarded for stating any FIVE of the above matters).*

**(c)** The new auditors of Beech Co will have the following rights with regard to:

**(i) Access to Records**

A right of access at all times to the books, records, accounts and documents of the company.

**(ii) Information and explanations**

A right to require from the company's officers such information and explanations as they think necessary for the performance of their duties as auditors.

The marking scheme generally indicates that up to 2 marks may be awarded for relevant points. 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  $\frac{1}{2}$  mark whilst a detailed discussion could be worth up to a maximum of 2 marks.

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 answers 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%.

**Olive Co**

- 1 (a) (i)** Explanation of the term control environment.  
Generally 1 mark per point up to a maximum of (5 marks)
- (ii)** Describing the effect that a strong control environment in Olive Co should have on my firm's audit approach.  
Generally up to 1 mark per point up to a maximum of (5 marks)
- (b)** Stating three objectives of the internal control that should be exercised over a purchases and trade payables system.  
Generally 1 mark per objective up to a maximum of (3 marks)
- (c)** Stating the control activities that should exist over the specified parts of Olive Co purchases and trade payables system.  
Generally 1 mark per point, up to a maximum of 6 marks for each specified part up to an overall maximum of (12 marks)
- (Total 25 marks)**

**Palm Co**

- 2 (a)** Identifying and explaining four matters that should be considered when planning the audit of the financial statements of Palm Co for the year ending 31 August 2007.  
Generally  $\frac{1}{2}$  mark for identifying each specific matter and up to 2 marks for explanation thereof up to a maximum of (10 marks)
- (b)** Stating three methods by which the firm may record the internal control system of Palm Co.  
Generally up to 1 mark per method up to a maximum of (3 marks)
- (c)** Explanation of how an ICQ differs in nature and design from an ICEQ.  
Generally up to 1 mark per point up to a maximum of (6 marks)
- (d)** Listing four key questions that should be included on an ICEQ.  
Generally up to  $1\frac{1}{2}$  marks per question up to a maximum of (6 marks)
- (Total 25 marks)**

Ash Co

- 3 (a) Stating three factors that generally influence an auditor's judgement in deciding what will be sufficient appropriate evidence and commenting on their relevance to Ash Co. (3 marks)  
For stating relevant factor, generally 1 mark per factor up to a maximum of (3 marks)  
For stating relevance to Ash Co of each factor.  
Generally up to 1 mark per point up to a maximum of (3 marks)
- (b) Description of each of the following procedures, used to obtain audit evidence:  
*Observation*  
Up to (1 mark)  
*Inquiry, Confirmation, Reperformance*  
Up to 1 mark per point up to a maximum of 2 marks for each procedure with overall maximum of (6 marks)  
Providing two examples of when each of the above procedures may be used during the audit of the financial statements of Ash Co.  
Generally up to 1½ marks per example up to a maximum of (1½ × 8) (12 marks)
- (Total 25 marks)**

Beech Co

- 4 (a) (i) Explaining the purpose of carrying out client screening procedures. (4 marks)  
Generally up to 1 mark per point up to a maximum of (4 marks)
- (ii) Stating six matters that the audit engagement partner should consider when screening Beech Co. (9 marks)  
Generally up to 1½ marks per example up to a maximum of (9 marks)
- (b) (i) Explaining the purpose of a letter of engagement. (3 marks)  
Generally up to 1 mark per point up to a maximum of (3 marks)
- (ii) Stating five important matters that should be included in a letter of engagement. (5 marks)  
Generally up to 1 mark per point up to a maximum of (5 marks)
- (c) Stating the rights that the new auditors of Beech Co should have with regard to: (2 marks)
- (i) Access to records – up to (2 marks)
- (ii) Information and explanations – up to (2 marks)
- (Total 25 marks)**