

A. MULTIPLE CHOICE QUESTIONS (30%)

| | |
|----|---|
| 1 | D |
| 2 | C |
| 3 | B |
| 4 | B |
| 5 | C |
| 6 | C |
| 7 | B |
| 8 | D |
| 9 | A |
| 10 | B |

| | |
|----|---|
| 11 | C |
| 12 | C |
| 13 | B |
| 14 | C |
| 15 | A |
| 16 | B |
| 17 | A |
| 18 | D |
| 19 | C |
| 20 | B |

B. Exercises

Exercise # 1 (12%)

| | |
|---|---|
| 1 | F |
| 2 | G |
| 3 | A |
| 4 | G |

| | |
|---|--------|
| 5 | E |
| 6 | D OR G |
| 7 | D |
| 8 | C |

Exercise # 2 (14%)

| | |
|---|---|
| 1 | D |
| 2 | A |
| 3 | H |
| 4 | F |
| 5 | G |

| | |
|---|---|
| 6 | B |
| 7 | E |
| 8 | I |
| 9 | C |
| | |

Exercise # 3 (14%)

Required:

For each of the two subsequent events described above:

(i) Based on the information provided, explain whether the financial statements require amendment; and

Subsequent events Event 1 –

Fire

A fire has occurred at the largest of the company's distribution depots and property, plant and equipment in excess of \$650,000 has been damaged as well as inventory of \$25,000. The company has contacted its insurance company and they have begun to investigate the likelihood and level of any payment. This event occurred after the reporting period and is not an event which provides evidence of a condition at the year end and hence this is a non-adjusting event. Normally as the company is insured, only uninsured losses suffered by Grains 4U Co (Grains) would need to be accounted for, which in the normal course of events would be an immaterial amount.

However, the insurance company is investigating, as there is a possibility the fire was started deliberately, and this would invalidate the insurance policy. If this is the case, the total damaged assets of \$675,000 (650 + 25) would be material as they represent 8.5% (675/7,900) of profit before tax. Therefore as a material non-adjusting event, the assets should not be written down to their scrap value in the current year financial statements; however, the directors should include a disclosure note detailing the fire and the total value of assets which may be impacted due to the possibility of a lack of an insurance settlement.

The following audit procedures should be applied to form a conclusion on any amendment:

- Obtain a schedule showing the damaged property, plant and equipment and agree the net book value to the non-current assets register to confirm the total value of affected assets.
- Obtain a breakdown of the inventory stored at the distribution center on 15 February 2016 and compare to earlier records or dispatch documents to ascertain the likely level of inventory at the time of the fire.
- Review any correspondence from the insurance company confirming the amount of the claim, and the current status of their investigation into the fire and any likely payments to assess the extent of any uninsured amounts.
- Discuss with the directors whether they will disclose the effect of the fire, as a non-adjusting event, in the year-end financial statements.

Event 2 –

Inventory

Grains has identified that inventory at the year end with a cost of \$915,000 is defective, due to an excessive amount of food coloring; the scrap value of this inventory is \$50,000. This information was

obtained after the year end but provides further evidence of the net realisable value of inventory at the year end and hence is an adjusting event.

IAS 2 Inventories requires that inventory is valued at the lower of cost and net realisable value. The inventory of \$915,000 must be written down to its net realisable value of \$50,000. The write down of \$865,000 ($915 - 50$) is material as it represents 10.9% ($865/7,900$) of profit before tax. Hence, the directors should amend the financial statements by writing down the inventory to \$50,000.

(ii) Describe audit procedures which should now be performed in order to form a conclusion on any required amendment

The following audit procedures should be applied to form a conclusion on the adjustment:

- Discuss the matter with the directors and enquire if they are prepared to write down the cost of the inventory to net realisable value.
- Review the board minutes to assess whether this event was the only case of defective inventory as there could potentially be other inventory which requires writing down.
- Obtain a schedule showing the defective inventory and agree to supporting production documentation that it was produced prior to 31 December, as otherwise it would not require a write down at the year end.
- Discuss with management how they have assessed the scrap value of \$50,000 and agree this amount to any supporting documentation to confirm the value.

Exercise # 4 (30%)

Comet Publishing Co

Required:

(a) Explain the safeguards which Halley & Co should implement to ensure that the identified conflict of interest is properly managed.

Safeguards to deal with conflict of interest

- Both Comet Publishing Co and its rival competitor, Edmond Co, should be notified that Halley & Co would be acting as auditors for each company and, if necessary, consent should be obtained from each.
- Advising one or both clients to seek additional independent advice.
- The use of separate engagement teams, with different engagement partners and team members; once an employee has worked on one audit, such as Comet Publishing Co, then they would be prevented from being on the audit of the competitor for a period of time.
- Procedures to prevent access to information, for example, strict physical separation of both teams, confidential and secure data filing.
- Clear guidelines for members of each engagement team on issues of security and confidentiality. These guidelines could be included within the audit engagement letters.
- Potentially the use of confidentiality agreements signed by employees and partners of the firm.
- Regular monitoring of the application of the above safeguards by a senior individual in Halley & Co not involved in either audit.

(b) Explain the steps the auditor should take to confirm the accuracy of the purchases and payables flowcharts and systems notes currently held on file.

Steps to confirm prior year flowcharts and system notes

- Obtain the system notes from last year's audit and ensure that the documentation on the purchases and payables system covers all expected stages and is complete.
- Review the audit file for indications of weaknesses in the system and note these for investigation this year.
- Review the prior year report to management to identify any recommendations which were made over controls in this area as this may highlight potential changes which have been made in the current year.
- Obtain system documentation from the client, potentially in the form of a procedure manual. Review this to identify any changes made in the last 12 months.
- Interview client staff to ascertain whether systems and controls have changed including the stores and warehouse to ensure that the flowcharts and notes produced last year is correct.
- Perform walk-through tests by tracing a sample of transactions through the purchases and payables system to ensure that the flowcharts and systems notes contained on the audit file are accurate.
- During the walk-through tests, confirm the systems notes and flowcharts accurately reflect the control procedures which are in place and can be used to identify controls for testing.

(c) In respect of the purchases and payables system for Comet Publishing Co :

(i) Identify and explain FIVE deficiencies

(ii) Recommend a control to address each of these deficiencies, and

(iii) Describe a TEST OF CONTROL the auditor should perform to assess if each of these controls, if implemented, is operating effectively to reduce the identified deficiency.

Note: Prepare your answer using three columns headed Control deficiency, Control recommendation, and Test of control respectively.

| deficiencies of Control | Recommendation | Test of Control |
|-------------------------|----------------|-----------------|
|-------------------------|----------------|-----------------|

Control deficiencies, control recommendations and tests of control

| Deficiencies of Control | Recommendation | Test of Control |
|---|---|--|
| It is not possible for a store to order goods from other local stores for customers who request them. Instead, customers are told to contact the other stores or use the company website. Customers are less likely to | An inter-branch transfer system should be established between stores, with inter-branch inventory forms being completed for store transfers. This should help stores whose inventory levels are low but are awaiting their deliveries from the suppliers. | During the interim audit, arrange to visit a number of the stores, discuss with the store manager the process for ordering of inventory items, in particular whether it is possible to order from other branches. At each store, inspect a sample |

| Deficiencies of Control | Recommendation | Test of Control |
|---|---|--|
| <p>contact individual stores themselves and this could result in the company losing valuable sales.</p> <p>In addition, some goods which are slow moving in one store may be out of stock at another; if goods could be transferred between stores, then overall sales may be maximized.</p> | | <p>of completed inter-branch inventory forms for confirmation the control is operating.</p> |
| <p>Purchase orders below \$1,000 are not authorised be authorised and are processed solely by the purchase order clerk who is also responsible for processing invoices.</p> <p>This could result in non- order business related purchases and there is an increased fraud risk as the clerk could place orders for personal goods up to the value of \$1,000, which is significant.</p> | <p>All purchase orders should be authorised by a responsible official.</p> <p>Authorised signatories should be established with varying levels of purchase order authorisation.</p> | <p>Select a sample of purchase orders and review for evidence of authorisation, agree this to the appropriate signature on the approved signatories list.</p> |
| <p>Goods received notes (GRNs) are sent to the accounts be sent to the accounts department every two weeks.</p> <p>This could result in delays in suppliers being paid as the purchase invoices could not be agreed to a GRN and also recorded liabilities being understated.</p> <p>Additionally, any prompt payment discounts offered by suppliers may be missed due to delayed payments.</p> | <p>A copy of the GRNs should be sent to the accounts department on a more regular basis, such as daily.</p> <p>The accounts department should undertake a sequence check of the GRNs to ensure none are missing for processing.</p> | <p>Enquire of the accounts clerk as to the frequency of when GRNs are received to assess if they are being sent promptly.</p> <p>Undertake a sequence check of GRNs held by the accounts department and discuss any missing items with the accounts clerk.</p> |
| <p>GRNs are only sent to the</p> | <p>The GRN should be created in</p> | <p>Review the file of copy GRNs</p> |

| Deficiencies of Control | Recommendation | Test of Control |
|--|--|---|
| <p>accounts department.</p> <p>Failing to send a copy to the ordering department could result in a significant level of unfulfilled orders leading to a loss of sales and stock-outs.</p> | <p>three parts and a copy of the GRN should be sent to the purchase order clerk, Oliver Dancer, who should agree this to the order and change the order status to complete.</p> <p>On a regular basis he should then review for all unfulfilled orders and chase these with the relevant supplier.</p> | <p>held by the purchase ordering clerk, Oliver Dancer, and review for evidence that these are matched to orders and flagged as complete.</p> <p>Review the file of unfulfilled purchase orders for any overdue items and discuss their status with Oliver Dancer.</p> |
| <p>The purchase ordering clerk, Oliver Dancer, has responsibility for ordering goods below \$1,000 and for processing all purchase invoices for payment.</p> <p>There is a lack of segregation of duties and this increases the risk of fraud and non- business related purchases being made.</p> | <p>The roles of purchase ordering and processing of the related supplier invoices should be allocated to separate members of staff.</p> | <p>Observe which member of staff undertakes the processing of purchase invoices and confirm this is not the purchase ordering clerk, Oliver Inspect a copy of the company's organization chart to identify if these tasks have now been allocated to different roles.</p> |
| <p>The finance director authorises the bank transfer payment list for suppliers however, she only views the total amount of payments to be made.</p> <p>Without looking at the detail of the payments list, as well as supporting documentation, there risk that suppliers could be being paid an incorrect amount, or that sums are being paid to fictitious suppliers.</p> | <p>The finance director should review the whole payments list prior to authorising.</p> <p>As part of this, she should agree the amounts to be paid to supporting documentation, as well as reviewing the supplier names to identify any duplicates or any unfamiliar names. She should evidence her review by signing the bank transfer list.</p> | <p>Review the payments list for evidence of review by the finance director.</p> <p>Enquire of accounts staff what supporting documentation the finance director requests when undertaking this review.</p> |
| <p>Supplier statement reconciliations are no longer performed.</p> <p>This may result in errors in the recording of purchases and payables not being identified in a timely manner.</p> | <p>Supplier statement reconciliations should be performed on a monthly basis for all suppliers and these should be reviewed by a responsible official.</p> | <p>Review the file of reconciliations to ensure that they are being performed on a regular basis and that they have been reviewed by a responsible official.</p> |

| Deficiencies of Control | Recommendation | Test of Control |
|-------------------------|----------------|---|
| | | Re-perform a sample of the reconciliations to ensure that they have been carried out appropriately. |

(d) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Comet Publishing Co's purchases and other expenses.

Substantive procedures for purchases and other expenses

- Calculate the operating profit and gross profit margins and compare them to last year and budget and investigate any significant differences.
- Review monthly purchases and other expenses to identify any significant fluctuations and discuss with management.
- Discuss with management whether there have been any changes in the key suppliers used and compare this to the purchase day book to assess completeness and accuracy of purchases.
- Recalculate the accuracy of a sample of purchase invoice totals and related taxes and ensure expense has been included in the correct nominal code.
- Recalculate the prepayments and accruals charged at the year end to ensure the accuracy of the expense charge included in the statement of profit or loss.
- Select a sample of post year-end expense invoices and ensure that any expenses relating to the current year have been included.
- Select a sample of payments from the cash book and trace to expense account to ensure the expense has been included and classified correctly.
- Select a sample of goods received notes (GRNs) from throughout the year; agree them to purchase invoices and the purchase day book to ensure the completeness of purchases.
- Select a sample of GRNs just before and after the year end; agree to the purchase day book to ensure the expense is recorded in the correct accounting period.