
Answers

Section B

Castle Courier Co

(a) Methods for documenting internal control systems

Method	Explanation	Disadvantage
Narrative notes	Narrative notes consist of a written description of the internal control system. They detail what occurs in the system at each stage including related controls which operate at each stage.	They may prove to be time-consuming and cumbersome if the internal control system is complex. It may make it more difficult to identify if any internal controls are missing in narrative notes.
Internal control questionnaires	Internal control questionnaires contain a list of questions for each major transaction cycle. They use questions designed to assess whether internal controls exist.	Internal controls may be overstated if the client is aware that the auditor is looking for a particular answer. Unusual controls may not be included on a standard questionnaire and hence may not be identified.

(b) Key controls and tests of control

Key control	Test of control
All staff members are issued with a sequentially numbered key card. Sequence checks and checks on the data recorded are carried out by the human resources (HR) supervisor. This ensures that payroll records are complete, that employees are paid for hours worked and that all hours are recorded. The clocking-in process is monitored by a camera on entry to the distribution centre and video footage is reviewed by HR every week. This will prevent staff members fraudulently clocking-in for other employees and hence employees will only be paid for actual hours worked. The payroll clerk confirms the transfer of hours and calculations has been done accurately by recalculating, for a sample of employees, their gross to net pay. This check is also reviewed by the payroll supervisor who evidences their review. This reduces the risk that errors occur in the automated transfer and calculations during the payroll processing. Any errors would be identified on a timely basis to prevent salaries being over or under paid. The payroll system is password-protected and the payroll manager changes the password on a monthly basis using a random password generator. This reduces the risk of fraud by preventing unauthorised changes being made to the standing data and unauthorised access to sensitive payroll information. Each month, the finance director carries out a payroll control account reconciliation and investigates any differences. This will ensure the payroll expense and employment tax liability is accurate and is not misstated in the year-end financial statements.	For a sample of key cards and data recorded in the clocking-in system, carry out a sequence check to identify if there are any gaps in the sequence. Review details of checks carried out by the HR supervisor to identify any gaps in the sequence and check they have evidenced their review by way of signature. For a sample of weeks, review the log of the recordings to identify who reviewed that week's footage to ensure it has been reviewed by a member of the HR department. Review the log for any gaps in the review process and discuss these findings with HR. For a sample of months, review the calculations of gross to net pay for evidence that the calculations have been performed. Confirm the signature of the payroll supervisor as evidence that they have reviewed the report. For any anomalies, enquire of the reasons and what action was taken to resolve the issue. For a sample of months, reperform the gross to net pay calculations and compare to the payroll system and the calculations prepared by the payroll clerk. Discuss any discrepancies with the payroll supervisor. Attempt to login to the payroll system using a password which should be out of date. Confirm that the system has rejected access. For a sample of months, review the control account reconciliations and make enquiries of the finance director of any errors on the control account, how they arose and what action was taken to ensure they do not arise in the future. Reperform a sample of control account reconciliations and compare results with those prepared by the finance director. Discuss any discrepancies with the finance director.

Key control

The amount due to the tax authority is calculated by the payroll supervisor who then passes it to the financial controller for review.

This ensures that the amount paid to the tax authority is correct. It also creates segregation of duties between the payroll supervisor calculating the liability and the financial controller reviewing the calculation which reduces the risk of error.

Test of control

Review a sample of calculations of the monthly employment tax liability for evidence of review by the financial controller confirming the calculation is correct and that payment can be made.

(c) Deficiencies and recommendations

Control deficiency

Department managers are required to approve all employees' holiday forms, however, this does not always occur.

This could result in employees taking unauthorised leave which could lead to operational difficulties if there are shortages of staff at critical periods. In addition, payments for untaken holiday may be made in error as holiday records may be incorrect.

The financial controller prepares the bank transfers for the payroll and also authorises these to be paid.

This lack of segregation of duties increases the risk of fraud/error as the financial controller could pay themselves or certain employees more than they are due without this being detected.

The payroll clerk amends the payroll and an edit report of changes is produced but this report is not reviewed.

As the edit report is not checked, errors made by the payroll clerk when updating the system will not be identified promptly. This may result in new employees not being paid at all, errors being made in payments to new employees or leavers being paid after they have left the company. This would lead to loss of employee goodwill and errors in accounting records for wages and salaries.

It could also result in an increased risk of fraud as fictitious employees could be added by the payroll clerk.

The HR department is responsible for processing joiners and leavers, but due to staff illness, the operations manager has processed temporary new drivers and notified payroll.

The operations manager may not carry out all the required procedures for processing temporary new drivers as the manager may not be using appropriate documentation.

This could result in temporary employees not being set up in the payroll records correctly, resulting in the late payment of wages, incorrect statutory deductions being calculated and incomplete payroll records.

Only overtime in excess of five hours per week needs authorisation by the operations manager.

This means that employees could claim to have worked up to five hours overtime without authorisation resulting in payments being made to employees for hours not worked and additional payroll costs.

Where cash wages are paid, the driver is only required to provide their name to collect their pay packet.

Payment of wages without proof of identity or signature increases the risk that wages could be paid to incorrect employees either in error or due to fraud resulting in a loss of cash.

Control recommendation

Employees should receive written confirmation when their holiday has been approved and should be informed that they will not be able to take holiday without this notification.

Any payments for unused holiday should be authorised by department managers prior to payment.

Once the bank transfer has been prepared by the financial controller, it should be passed to the finance director to be reviewed and authorised for payment. The review and authorisation should be evidenced by the finance director.

The payroll supervisor or a member of the finance team should review all edit reports and agree changes made to the details on the joiner/leavers forms. Any discrepancies should be investigated promptly and the payroll system updated for any errors or omissions.

The payroll supervisor should evidence their review on the edit report with their signature.

All staff appointments, including temporary staff, should only be processed by the HR department to ensure that correct procedures are followed.

If it is not possible for the HR department to carry out all of the detailed processing due to staff shortages, a member of the HR team should review the leaver/joiner form and authorise it before it is sent to the payroll department.

The payroll department should be notified not to accept any new joiner information unless approved by a member of HR.

All overtime, including that below five hours, should be authorised by a responsible official before being processed in the payroll. This authorisation should be evidenced by way of signature.

All drivers collecting cash pay packets should provide a form of identification to the finance staff member before the pay packet is handed to them. The driver should also be required to sign for their pay packet.

Control deficiency

The operations manager decides on the bonus to be paid to delivery drivers each quarter and there are no approved parameters for the bonus levels.

Without approved parameters, the operations manager may award excessive bonuses or pay additional sums to friends and family members resulting in additional payroll costs.

Delivery drivers must take breaks throughout the day which are not monitored.

Drivers could take longer breaks than those authorised resulting in payments being made to employees for time not worked. Conversely, if drivers do not take the required breaks, they may be in breach of law and regulations which require drivers to take regular breaks, hence the company is at risk of fines.

Control recommendation

Approved bonus parameters should be established by the board. All bonuses should be determined by a senior official, such as the sales director, in line with these parameters, who should communicate the bonus in writing to the payroll department.

The company should monitor the activity of the delivery drivers through electronic means, for example, by using tracking devices attached to their vehicles to ensure that the prescribed breaks are taken by the employees.

Data should be downloaded and reviewed by a responsible official on a regular basis.

(d) Substantive procedures on payroll expense

- Cast a sample of payroll records to confirm completeness and accuracy and agree the total wages and salaries expense per the payroll system to the trial balance.
- Recalculate the gross and net pay figures for a sample of employees and agree to the payroll records.
- For a sample of wage payments, agree the total net pay per the payroll records to the bank transfer listing and to the cash book.
- Perform a proof in total of wages and salaries, incorporating joiners and leavers and the pay increase/bonuses. Compare this to the actual wages and salaries expense in the financial statements and investigate any significant differences.
- Compare the total payroll figure this year to the prior year, identify any significant differences and discuss with management.
- Review monthly payroll charges, compare this to the prior year and budgets and discuss any significant differences with management.
- Calculate overtime costs as a percentage of total wages. Compare this to the prior year and discuss any significant differences with management.
- Agree a sample of individual wages and salaries per the payroll to personnel records and records of hours worked per the clocking-in system.
- Reperform the calculation of statutory deductions and agree to supporting documentation to confirm whether correct deductions for this year have been made in the payroll.
- Select a sample of joiners and leavers, agree their start/leaving date to supporting documentation, recalculate their first/last salary to ensure it is accurate.
- Recalculate holiday pay for a sample of employees and agree to holiday records and daily rate applied.
- Select a sample of employees from HR records and agree salaries per HR records to the payroll records to confirm the accuracy of the payroll expense.
- Agree the payroll control account reconciliation to accounting records and investigate any differences.

Corley Appliances Co

(a) Preconditions required for an audit

Auditors should only accept a new audit engagement or continue an existing audit engagement if the preconditions for an audit are present.

ISA 210 *Agreeing the Terms of Audit Engagements* requires the auditor to:

- Determine whether the financial reporting framework to be applied in the preparation of the financial statements is acceptable (for example IFRS® Standards). In considering this, the auditor should have assessed the nature of the entity, the nature and purpose of the financial statements and whether law or regulation prescribes the applicable reporting framework.
- Obtain the agreement of management that it acknowledges and understands its responsibilities for the following:
 - o preparing the financial statements in accordance with the applicable financial reporting framework;
 - o internal control necessary for the preparation of the financial statements to be free from material misstatement whether due to fraud or error; and
 - o providing the auditor with access to information relevant for the audit and access to staff within the entity to obtain audit evidence.

(b) Audit risks and auditor's responses

Audit risk	Auditor's response
<p>The company has a returns policy allowing a customer to return goods within 28 days of purchase if they are dissatisfied with the product.</p>	<p>Enquire with the finance director how the returns policy has been applied at the year end and whether the provisions in IFRS 15 have been reflected.</p>
<p>IFRS® 15 <i>Revenue from Contracts with Customers</i> requires that revenue should only be recognised to the extent that goods will not be returned. The company should recognise a refund liability for goods which are expected to be returned.</p>	<p>Review the assumptions underpinning the refund liability for reasonableness and whether they meet the historic 5% value of returns.</p>
<p>If the company has not correctly accounted for the refund liability, revenue will be overstated and the refund liability understated.</p>	<p>Compare the level of post year-end returns to the refund liability and discuss any significant differences with management.</p>
<p>The company provides a six-month warranty on its products which require defects to be repaired at Corley Appliances Co's own cost. The directors have reduced this provision during the year on the grounds they feel the products they sell are built to a high standard.</p>	<p>Review the calculation of the warranty provision and assess its reasonableness in light of the value of claims received in the period.</p>
<p>The company does not manufacture the goods (they only sell them) and therefore this is not a reasonable reason for reduction, hence if the company has reduced the warranty provision excessively at the year end, liabilities and expenses may be understated.</p>	<p>Review the assumptions underpinning the warranty provision for reasonableness.</p>
<p>The company purchases their goods from its main supplier in Asia and has responsibility for goods at the point of dispatch, the goods are in transit for up to one month.</p>	<p>Review the level of claims made under warranty post year end to assess the reasonableness of the reduced provision.</p>
<p>At the year end, there is a risk that the cut-off of purchases may not be accurate as they may not correctly recognise the goods from the point of dispatch. There is also a risk that inventory and trade payables are understated at the year end.</p>	<p>Discuss with management the point at which inventory is recorded and review the contract with the supplier to verify the requirements in place.</p>
<p>The company's central warehouse and all 20 branches will be carrying out an inventory count at the year-end date of 31 August.</p>	<p>Review the controls the company has in place to ensure that inventory is recorded from the point of dispatch.</p>
<p>It is unlikely that the auditor will be able to attend all sites which increases detection risk. It may not be possible to gain sufficient appropriate audit evidence over the inventory counting controls and completeness and existence of inventory for those sites which are not visited.</p>	<p>The audit team should undertake detailed cut-off testing of purchases of goods at the year end and the sample of shipping documentation immediately before and after the year end relating to goods from its main supplier in Asia should be increased to ensure that cut-off is complete and accurate.</p>
<p>Over the last six months, the receivables collection period has increased from 42 days to 55 days and the allowance for receivables will be at the same level as the prior year.</p>	<p>The audit team should assess which of the inventory counts they will attend. This should include the count for the central warehouse and a sample of branches which contain the most material balances of inventory and those which have historically had exceptions reported during the inventory count.</p>
<p>Some receivables may not be recoverable and if an additional allowance for receivables is not included in the financial statements, receivables will be overstated and the allowance for receivables understated.</p>	<p>For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss any issues which arose during the count with management.</p>
	<p>Review and test the controls surrounding the way in which the finance director assesses the recoverability of receivables balances and other credit control processes to ensure that they are operating effectively.</p>
	<p>Perform extended post year-end cash receipts testing and a review of the aged receivables ledger in order to assess valuation and the need for an increased allowance for irrecoverable receivables.</p>
	<p>Discuss with the finance director whether an additional allowance for receivables will be required against balances older than the company's credit terms.</p>

Audit risk

The payables ledger supervisor was dismissed in June 20X5 due to a fraud. The value of this fraud has been recognised as an expense in the draft statement of profit or loss.

If additional frauds committed by the payables ledger supervisor are not discovered, this could result in expenses being understated and payables being overstated. Control risk is also increased if the fraud has gone undetected for a period of time.

Since the dismissal of the payables ledger supervisor, purchase invoices have yet to be logged onto the payables ledger.

There is a risk that the purchases and trade payables balance at the year end will be understated if these invoices are not logged onto the payables ledger before it is closed down for the year or accrued for.

The company purchased and installed a new dispatch system. The costs which have been capitalised include staff training costs (\$0.1m).

As per IAS[®] 16 *Property, Plant and Equipment*, the cost of an asset includes its purchase price and directly attributable costs only. IAS 16 does not allow staff training costs to be capitalised as part of the cost of a non-current asset, as these costs are not directly related to the cost of bringing the asset to its working condition.

The training costs should be charged to profit or loss. Therefore property, plant and equipment (PPE) and profits are overstated.

The company breached the terms of its overdraft facility in June 20X5 and the bank will only confirm the decision whether, or not, to continue to support the business in November 20X5, which is after the auditor's report will be signed. The company is dependent on the overdraft facility.

If the bank refuses to continue to support the company, there may be doubts as to the company's ability to continue as a going concern. The uncertainties may not be adequately disclosed in the financial statements.

Auditor's response

Discuss with the finance director the details of the fraud perpetrated by the payables ledger supervisor and what procedures have been adopted to date to identify any further adjustments which are needed in the financial statements. In addition, discuss with the finance director what additional controls have been put in place to prevent any similar frauds.

The audit team should undertake additional substantive procedures over the payables balance, particularly the fictitious supplier set up on the payables ledger to ensure this has been removed.

In addition, the team should maintain professional scepticism and be alert to the risk of further fraud.

Review the unprocessed invoices file at the year end to identify any invoices which relate to the supply of pre year-end goods and ensure they have been properly accrued for in the year-end financial statements and recognised as a liability.

Discuss with the finance director the approach to be adopted to resolve the issue of unprocessed purchase invoices.

Discuss the accounting treatment with the finance director and request that the training costs are written off to profit or loss to ensure treatment is in accordance with IAS 16. If adjusted, review the journal entry for accuracy.

Discuss with the finance director the availability of alternative financing if the bank is unwilling to continue to support the company and review the adequacy of any going concern disclosures in the financial statements.

The audit team should undertake detailed going concern testing, in particular, reviewing the impact of a non-renewal of the overdraft facility.

(c) Professional scepticism and examples where professional scepticism should be applied

Professional scepticism is defined in ISA 200 *Overall Objectives of the Independent Auditor and the Conduct of an Audit in Accordance with International Standards on Auditing* as an attitude which includes a questioning mind, being alert to conditions which may indicate possible misstatement due to fraud or error, and a critical assessment of audit evidence.

Examples where the auditor should apply professional scepticism for Corley Appliances Co are as follows:

Revenue recognition

ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* contains a rebuttable presumption that fraud in relation to revenue is high risk and hence the auditor must apply professional scepticism to Corley Appliances Co's revenue recognition policies, especially in relation to the company's returns policy which due to the judgement involved may be used as a way to manipulate revenue.

Warranty provision

Accounting for warranty provisions will include an element of estimation based on previous experiences of the costs incurred by the company to repair defective goods. The auditor should maintain professional scepticism keeping in mind that warranty provisions may include management bias to either deliberately over or understate the provision. Management has reduced the warranty provision in the year on the grounds they feel the goods they sell are built to a high standard. As the company is not involved in the manufacturing of the goods they sell, it may be unreasonable to reduce the warranty provision on this basis.

Fraud

As a fraud has been committed during the year, the auditor must maintain professional scepticism recognising the fact that internal controls may be weak, hence allowing for employee manipulation of such internal control deficiencies. The auditor must also consider the possibility that other frauds may have taken place during the year through management override of the entity's internal controls.

Bank overdraft

The company is reliant on its bank overdraft due to the significant levels of expenditure which it has incurred during the year on the new dispatch system. Management may want to deliberately overstate profit and understate liabilities so that the bank renews the overdraft facility.

Receivables valuation

The receivables collection period has been increasing over the past six months, but the finance director does not envisage that an increase in the allowance for receivables is required. The auditor must apply professional scepticism in considering whether management's assessment of recoverability is reasonable, as any increase in the allowance will reduce profits.

Purrfect Co

(a) Inventory of Vego Dog

- Obtain and cast the inventory listing of Vego Dog products and agree the total cost of \$2.4m to inventory records.
- Agree the quantity of Vego Dog products shown as held at the year end to the year-end inventory count records.
- Request a breakdown of the cost calculation of each unit of this product and discuss with management how the standard cost was derived.
- Recalculate the cost calculations to confirm that the quantity multiplied by the standard cost is \$2.4m.
- For a sample of finished goods items, obtain standard cost cards and agree:
 - raw material costs to recent purchase invoices;
 - labour costs to time sheets or wage records;
 - overheads allocated to invoices and that they are of a production nature.
- Compare sales prices over time to establish if the price has been reduced because of falling demand to determine whether an allowance is required.
- Compare actual sales units per month to budgeted sales per month from before and after the year end to establish how much lower actual sales are than expected and discuss with management.
- Select a sample of items included in inventory of Vego Dog and review post year-end sales invoices to ascertain if net realisable value (NRV) is above cost or if an adjustment is required.

(b) Receivable due from Ellah Co

- Review correspondence with Ellah Co to establish if there was a discussion about payment difficulties and whether Ellah Co intends to fully settle the outstanding amount.
- Review the age of the outstanding debt with Ellah Co and discuss the circumstances with the credit controller to establish if it has exceeded the agreed credit terms and consider if an allowance is required.
- Review post year-end receipts from Ellah Co to establish how much of the debt was recovered by the audit completion date and to assess how much of the year-end balance remains outstanding.
- Inspect board minutes to identify whether there are any significant concerns in relation to payments by Ellah Co.
- Discuss with management of Purrfect Co why no allowance has been made in respect of this debt and assess the justification.

(c) Contamination – legal claims

- Review customer correspondence to establish the details of the claims and the amounts being claimed.
- Review correspondence with Purrfect Co's lawyers or, with the client's permission, contact the lawyers to establish the likely outcome of the customer claims made to date.
- Discuss with the lawyers the likelihood and amount of potential future claims.
- Inspect board minutes to establish details of the circumstances of the contamination and to ascertain management's view as to the likelihood that the existing claims will be successful and the extent of possible future claims.
- Compare levels of returns and claims to date against sales volumes of the product to assess the potential level of future claims.
- Review post-year end payments for damage settlements and compare with any amounts provided at the year end to assess the reasonableness of the provision.

- Obtain written representations from management that there have been no other contamination incidents and no other product liability claims of which management are aware and for which provision may be required.
- Review the draft financial statements to establish that the legal claims have been appropriately provided for or disclosed in accordance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(d) Issue and impact on auditor's report

According to IAS 37, the possibility of additional claims should be disclosed as a contingent liability as it is possible but not probable and quantifiable.

As the claims may be significant, this issue represents a matter which is fundamental to users' understanding of the financial statements. The impact on the auditor's report depends on whether this matter is deemed to be adequately disclosed in the financial statements.

Adequate disclosure

If Purrfect Co adequately discloses the issue, then an unmodified audit opinion should be given but the auditor's report should include an emphasis of matter paragraph. This would draw attention to the disclosure in the financial statements by cross-referencing the user to the note in the financial statements which discloses the possible claims, emphasising that the audit opinion is unmodified.

Inadequate disclosure

If there is no disclosure in the financial statements or the disclosure is considered to be inadequate, then this indicates that the financial statements are materially misstated. As this lack of adequate disclosure is likely to be material but not pervasive, then a qualified opinion will be given. A basis for qualified opinion paragraph will be added to the auditor's report discussing the matter and the opinion paragraph will be modified to state that 'except for' the failure to adequately disclose the matter, the financial statements give a true and fair view.

Section B

Marks available Marks awarded

Castle Courier Co

(a) Methods for documenting internal control systems	
Narrative notes	2
Internal control questionnaires	2
	<u>4</u>
(b) Key controls and tests of control (only 4 required)	
Sequence checks on key cards/data	2
HR review of clocking in process	2
Payroll calculations reperformed	2
Password updated monthly	2
Control account reconciliations performed	2
Tax liability calculation reviewed	2
Max 4 issues, 2 marks each	<u>8</u>
(c) Control deficiencies and recommendations (only 6 required)	
Holiday requests not authorised	2
FC prepares and authorises bank transfer	2
Edit report not checked	2
Temporary staff not processed by HR	2
Only overtime above five hours authorised	2
Cash wages collected without identification	2
No approved bonus parameters	2
Drivers breaks not monitored	2
Max 6 issues, 2 marks each	<u>12</u>
(d) Substantive procedures for payroll expense	
1 mark per well-described procedure	
Restricted to	<u>6</u>
Total marks	<u>30</u>

Corley Appliances Co

(a) Preconditions required for an audit	
1 mark per well-explained point	
Restricted to	3
(b) Audit risks and auditor's responses (only 7 required)	
Refund liability	2
Reduced warranty provision	2
Goods in transit	2
Inventory count attendance	2
Allowance for receivables	2
Fraud	2
Payables ledger backlog	2
Training costs capitalised	2
Renewal of overdraft facility	2
Max 7 issues, 2 marks each	<u>14</u>
(c) Professional scepticism and examples where professional scepticism should be applied	
Professional scepticism definition	1
Examples	2
	<u>3</u>
Total marks	<u>20</u>

Purrfect Co

<p>(a) Substantive procedures for inventory of Vego Dog 1 mark per well-described procedure Restricted to</p>	<p>6</p>
<p>(b) Substantive procedures for receivable due from Ellah Co 1 mark per well-described procedure Restricted to</p>	<p>4</p>
<p>(c) Substantive procedures for contamination – legal claims 1 mark per well-described procedure Restricted to</p>	<p>5</p>
<p>(d) Issue and impact on auditor’s report Discussion of issue Adequate disclosure Inadequate disclosure</p>	<p>1 2 2 <hr style="width: 100%;"/> 5</p>
<p>Total marks</p>	<p><hr style="width: 100%;"/> 20</p>