

Section B

16 (a) 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) 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) Control deficiencies, control recommendations and tests of control

Control deficiency

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 contact individual stores themselves and this could result in the company losing valuable sales.

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 maximised.

Purchase orders below \$1,000 are not authorised and are processed solely by the purchase order clerk who is also responsible for processing invoices.

This could result in non-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.

Control recommendation

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.

All purchase orders should be authorised by a responsible official.

Authorised signatories should be established with varying levels of purchase order authorisation.

Test of control

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 of completed inter-branch inventory forms for confirmation the control is operating.

Select a sample of purchase orders and review for evidence of authorisation, agree this to the appropriate signature on the approved signatories list.

Control deficiency

Goods received notes (GRNs) are sent to the accounts department every two weeks.

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. Additionally, any prompt payment discounts offered by suppliers may be missed due to delayed payments.

GRNs are only sent to the accounts department. 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.

The purchase ordering clerk, Oliver Dancer, has responsibility for ordering goods below \$1,000 and for processing all purchase invoices for payment. There is a lack of segregation of duties and this increases the risk of fraud and non-business related purchases being made.

The finance director authorises the bank transfer payment list for suppliers; however, she only views the total amount of payments to be made.

Without looking at the detail of the payments list, as well as supporting documentation, there is a risk that suppliers could be being paid an incorrect amount, or that sums are being paid to fictitious suppliers.

Supplier statement reconciliations are no longer performed. This may result in errors in the recording of purchases and payables not being identified in a timely manner.

Control recommendation

A copy of the GRNs should be sent to the accounts department on a more regular basis, such as daily.

The accounts department should undertake a sequence check of the GRNs to ensure none are missing for processing.

The GRN should be created in 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. On a regular basis he should then review for all unfulfilled orders and chase these with the relevant supplier.

The roles of purchase ordering and processing of the related supplier invoices should be allocated to separate members of staff.

The finance director should review the whole payments list prior to authorising.

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.

Supplier statement reconciliations should be performed on a monthly basis for all suppliers and these should be reviewed by a responsible official.

Test of control

Enquire of the accounts clerk as to the frequency of when GRNs are received to assess if they are being sent promptly.

Undertake a sequence check of GRNs held by the accounts department, discuss any missing items with the accounts clerk.

Review the file of copy GRNs held by the purchase ordering clerk, Oliver Dancer, and review for evidence that these are matched to orders and flagged as complete.

Review the file of unfulfilled purchase orders for any overdue items and discuss their status with Oliver Dancer.

Observe which member of staff undertakes the processing of purchase invoices and confirm this is not the purchase ordering clerk, Oliver Dancer.

Inspect a copy of the company's organisation chart to identify if these tasks have now been allocated to different roles.

Review the payments list for evidence of review by the finance director. Enquire of accounts staff what supporting documentation the finance director requests when undertaking this review.

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.

Re-perform a sample of the reconciliations to ensure that they have been carried out appropriately.

(d) 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 ledger 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.

17 (a) Preconditions for the audit

ISA 210 *Agreeing the Terms of Audit Engagements* states that auditors should only accept a new audit engagement when it has been confirmed that the preconditions for an audit are present.

To assess whether the preconditions for an audit are present, Cupid & Co should have determined whether the financial reporting framework to be applied in the preparation of Prancer Construction Co's financial statements is acceptable. 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.

In addition, the firm should have obtained the agreement of Prancer Construction Co's management that it acknowledges and understands its responsibility for the following:

- Preparation of the financial statements in accordance with the applicable financial reporting framework, including where relevant their fair presentation;
- For such internal control as management determines is necessary to enable the preparation of financial statements which are free from material misstatement, whether due to fraud or error; and
- To provide Cupid & Co with access to all relevant information for the preparation of the financial statements, any additional information which the auditor may request from management and unrestricted access to personnel within Prancer Construction Co from whom the auditor determines it necessary to obtain audit evidence.

(b) Areas to be included in the audit strategy document

The audit strategy sets out the scope, timing and direction of the audit and helps the development of the audit plan. ISA 300 *Planning an Audit of Financial Statements* sets out areas which should be considered and documented as part of the audit strategy document and are as follows:

Main characteristics of the engagement

The audit strategy should consider the main characteristics of the engagement, which define its scope. For Prancer Construction Co, the following are examples of things which should be included:

- Whether the financial information to be audited has been prepared in accordance with the relevant financial reporting framework.
- Whether computer-assisted audit techniques will be used and the effect of IT on audit procedures.
- The availability of key personnel at Prancer Construction Co.

Reporting objectives, timing and nature of communication

It should ascertain the reporting objectives of the engagement to plan the timing of the audit and the nature of the communications required, such as:

- The audit timetable for reporting including the timing of interim and final stages.
- Organisation of meetings with Prancer Construction Co's management to discuss any audit issues arising.
- Any discussions with management regarding the reports to be issued.
- The timings of the audit team meetings and review of work performed.

Significant factors affecting the audit

The strategy should consider the factors which, in the auditor's professional judgement, are significant in directing Prancer Construction Co's audit team's efforts, such as:

- The determination of materiality for the audit.
- The need to maintain a questioning mind and to exercise professional scepticism in gathering and evaluating audit evidence.

Preliminary engagement activities and knowledge from previous engagements

It should consider the results of preliminary audit planning activities and, where applicable, whether knowledge gained on other engagements for Prancer Construction Co is relevant, such as:

- Results of any tests over the effectiveness of internal controls.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal controls.
- Volume of transactions, which may determine whether it is more efficient for the audit team to rely on internal controls.
- Significant business developments affecting Prancer Construction Co, such as the improvement in building practices and construction quality.

Nature, timing and extent of resources

The audit strategy should ascertain the nature, timing and extent of resources necessary to perform the audit, such as:

- The selection of the audit team with experience of this type of industry.
- Assignment of audit work to the team members.
- Setting the audit budget.

(c) Audit risks and auditor's responses

Audit risk

Prancer Construction Co is a new client for Cupid & Co. As the team is not familiar with the accounting policies, transactions and balances of the company, there will be an increased detection risk on the audit.

Prancer Construction Co is likely to have a material level of work in progress at the year end, being construction work in progress as well as ongoing maintenance services, as Prancer Construction Co has annual contracts for many of the buildings constructed.

The level of work in progress will need to be assessed at the year end. Assessing the percentage completion for partially constructed buildings is likely to be quite subjective, and the team should consider if they have the required expertise to undertake this. If the percentage completion is not correctly calculated, the inventory valuation may be under or overstated.

The August 20X7 management accounts contain \$2.1 million of completed properties; this balance was \$1.4 million in September 20X6.

The increase in inventory may be due to an increased level of pre year-end orders. Alternatively, it may be that Prancer Construction Co is struggling to sell completed properties, which may indicate that they are overvalued. IAS 2 *Inventories* requires that inventory should be stated at the lower of cost and NRV.

At the year end there will be inventory counts undertaken at all 11 of the building sites in progress.

It is unlikely that the auditor will be able to attend all of these inventory counts, increasing detection risk, and therefore they need to ensure that they obtain sufficient evidence over the inventory counting controls, and completeness and existence of inventory for any sites not visited.

Prancer Construction Co offers its customers a building warranty of five years, which covers any construction defects. A warranty provision will be required under IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. Calculating warranty provisions requires judgement as it is an uncertain amount.

The finance director anticipates this provision will be lower than last year as the company has improved its building practices and the quality of its finished properties. However, there is a risk that this provision could be understated, especially in light of the overdraft covenant relating to a minimum level of net assets and is being used as a mechanism to manipulate profit and asset levels.

Auditor's response

Cupid & Co should ensure they have a suitably experienced team. In addition, adequate time should be allocated for team members to obtain an understanding of the company and the risks of material misstatement including a detailed team briefing to cover the key areas of risk.

The auditor should discuss with management the process they will undertake to assess the percentage completion for work in progress at the year end. This process should be reviewed by the auditor while attending the year-end inventory counts.

In addition, consideration should be given as to whether an independent expert is required to value the work in progress or if a management expert has been used. If the work of an expert is to be used, then the audit team will need to assess the competence, capabilities and objectivity of the expert.

Detailed cost and net realisable value (NRV) testing to be performed at the year end and the aged inventory report to be reviewed to assess whether inventory requires to be written down.

The auditor should assess for which of the building sites they will attend the counts. This will be those with the most material inventory or which according to management have the most significant risk of misstatement.

For those not visited, the auditor will need to review the level of exceptions noted during the count and discuss with management any issues, which arose during the count.

Discuss with management the basis of the provision calculation, and compare this to the level of post year-end claims, if any, made by customers. In particular, discuss the rationale behind reducing the level of provision this year.

Compare the prior year provision with the actual level of claims in the year, to assess the reasonableness of the judgements made by management.

Audit risk

Customers who wish to purchase a property are required to place an order and a 5% non-refundable deposit prior to the completion of the building.

These deposits should not be recognised as revenue in the statement of profit or loss until the performance obligations as per the contracts have been satisfied, which is likely to be when the building is finished and the sale process is complete. Instead, they should be recognised as deferred income within current liabilities.

Management may have incorrectly treated the deferred income as revenue, resulting in overstated revenue and understated liabilities.

An allowance for receivables has historically been maintained, but it is anticipated that this will be reduced.

There is a risk that receivables will be overvalued; some balances may not be recoverable and so will be overstated if not provided for.

In addition, reducing the allowance for receivables will increase asset values and would improve the covenant compliance, which increases the manipulation risk further.

Prancer Construction Co has a material overdraft which has minimum profit and net assets covenants attached to it. If these covenants were to be breached, the overdraft balance would become instantly repayable.

If the company does not have sufficient cash to meet this repayment, then there could be going concern implications.

In addition, there is a risk of manipulation of profit and net assets to ensure that covenants are met.

Preliminary analytical review of the August management accounts shows payable days of 56 for August 20X7, compared to 87 days for September 20X6. It is anticipated that the year-end payable days will be even lower.

The forecast profit is higher than last year, indicating an increase in trade, also the company's cash position has continued to deteriorate and therefore, it is unusual for payable days to have decreased.

There is an increased risk of errors within trade payables and the year-end payables may be understated.

Auditor's response

Discuss with management the treatment of deposits received in advance, to ensure it is appropriate.

During the final audit, undertake increased testing over the cut-off of revenue and completeness of deferred income.

Review and test the controls surrounding how the finance director identifies old or potentially irrecoverable receivables balances and credit control to ensure that they are operating effectively.

Discuss with the director the rationale for reducing the allowance for receivables.

Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.

Review the covenant calculations prepared by the company at the year end and identify whether any defaults have occurred; if so, determine the effect on the company.

The team should maintain their professional scepticism and be alert to the risk that profit and/or net assets have been overstated to ensure compliance with the covenants.

The audit team should increase their testing on trade payables at the year end, with a particular focus on completeness of payables. A payables circularisation or review of supplier statement reconciliations should be undertaken.

18 (a) Steps in undertaking a positive receivables circularisation for Dashing Co

The following steps should be undertaken in carrying out a positive receivables circularisation:

- Obtain consent from the finance director of Dashing Co in advance of undertaking the circularisation.
- Obtain a list of trade receivables at the year end, cast this and agree it to the sales ledger control account total.
- Select a sample from the receivables list ensuring that a number of nil, old, credit and large balances are selected.
- Circularisation letters should be prepared on Dashing Co's letterhead paper, requesting a confirmation of the year-end receivables balance, and for replies to be sent directly to the audit team using a pre-paid envelope.
- The finance director of Dashing Co should be requested to sign all the letters prior to them being sent out by a member of the audit team.
- Where no response is received, follow this up with another letter or a phone call and where necessary alternative procedures should be performed
- When replies are received, they should be reconciled to Dashing Co's receivables records, any differences such as cash or goods in transit should be investigated further.

(b) Receivables substantive procedures

Accuracy, valuation and allocation

- Review the after date cash receipts and follow through to pre year-end receivable balances.

- Inspect the aged receivables report to identify any slow moving balances, discuss these with the credit control manager to assess whether an allowance or write down is necessary.
- For any slow moving/aged balances review customer correspondence to assess whether there are any invoices in dispute.
- Review board minutes of Dashing Co to assess whether there are any material disputed receivables.

Completeness

- Select a sample of goods despatched notes from before the year end, agree to sales invoices and to inclusion in the sales ledger and year-end receivables ledger.
- Agree the total of individual sales ledger accounts to the aged receivables listing and to the trial balance.
- Obtain the prior year aged receivables listing and for significant balances compare to the current year receivables listing for inclusion and amount due. Discuss with management any missing receivables or significantly lower balances.
- Review the sales ledger for any credit balances and discuss with management whether these should be reclassified as payables.

Rights and obligations

- Review bank confirmations and loan agreements for any evidence that receivables have been assigned as security for amounts owed by Dashing Co.
- Review board minutes for evidence that legal title to receivables has been sold onto a third party such as a factor.
- For a sample of receivables, agree the balance recorded on the sales ledger to the original name of the customer on a sales order or a contract.

Tutorial note: Marks will be awarded for any other relevant receivables tests.

(c) Substantive procedures to confirm the redundancy provision

- Discuss with the directors of Dashing Co as to whether they have formally announced their intention to close the production site and make their employees redundant, to confirm that a present obligation exists at the year end.
- If announced before the year end, review supporting documentation to verify that the decision has been formally announced.
- Review the board minutes to ascertain whether it is probable that the redundancy payments will be paid.
- Obtain a breakdown of the redundancy calculations by employee and cast it to ensure completeness and agree to trial balance.
- Recalculate the redundancy provision to confirm completeness and agree components of the calculation to supporting documentation such as employee contracts.
- Review the post year-end cash book to identify whether any redundancy payments have been made, compare actual payments to the amounts provided to assess whether the provision is reasonable.
- Obtain a written representation from management to confirm the completeness of the provision.
- Review the disclosure of the redundancy provision to ensure compliance with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*.

(d) Impact on auditor's report

The company has included a redundancy provision of \$110,000 in the draft financial statements, however, audit fieldwork testing has confirmed that the provision should actually be \$305,000. The provision is understated and profit before tax overstated if the finance director does not amend the financial statements.

The provision included is \$110,000, it should be \$305,000 hence an adjustment of \$195,000 is required which represents 7.5% of profit before tax (195/2,600) or 1.1% of total assets (195/18,000) and hence is a material matter.

If management does not adjust the redundancy provision, the auditor's report will need to be modified. As provisions are understated and profit overstated, there is a material misstatement, which is not pervasive. Therefore, a qualified opinion would be necessary, stating that the opinion is qualified 'except for'. A basis for qualified opinion paragraph would also need to be included subsequent to the opinion paragraph. This would explain the material misstatement in relation to the redundancy provision and the effect on the financial statements.

Section B	<i>Marks available</i>	<i>Marks awarded</i>
16 (a) Safeguards to deal with conflict of interest		
Notify both parties and obtain consent	1	
Advise clients to seek independent advice	1	
Separate engagement teams	1	
Prevent access to information	1	
Clear guidelines on security and confidentiality provided to client	1	
Confidentiality agreements	1	
Monitor safeguards	1	
Restricted to	<u>5</u>	
(b) Steps to confirm prior year flowcharts and system notes		
Review PY notes and confirm all stages covered	1	
Review PY file for weaknesses not actioned	1	
Review PY report to management	1	
Review client system documentation for changes	1	
Interview client staff to confirm client processes	1	
Walk-through tests to confirm notes	1	
Walk-through tests to confirm procedures	1	
Restricted to	<u>5</u>	
(c) Control deficiencies, recommendations and tests of control (only 5 issues required)		
No inter-branch transfers	3	
Not all purchase orders are authorised	3	
GRNs not processed regularly	3	
GRNs not sent to purchasing department	3	
Segregation of duties in relation to purchases	3	
Authorisation of bank payments	3	
Supplier statement reconciliations not performed	3	
Max 5 issues, 3 marks each	<u>15</u>	
(d) Substantive tests for purchases and other expenses		
Calculate operating and gross margin and compare to PY	1	
Review monthly purchases and investigate unexpected difference	1	
Discuss changes in key suppliers and compare to PL	1	
Recalculate a sample of invoices	1	
Recalculate prepayments and accruals	1	
Review post year-end invoices for pre year-end liabilities	1	
Sample of cash book payments to appropriate expense account	1	
GRNs to purchase invoice to purchase day book	1	
Cut-off testing using GRNs	1	
Restricted to	<u>5</u>	
Total marks	<u>30</u>	

	<i>Marks available</i>	<i>Marks awarded</i>
17 (a) Preconditions for the audit		
Determination of acceptable framework	1	
Agreement of management responsibilities	1	
Preparation of financial statements	1	
Internal control	1	
Access to information	1	
Restricted to	<u>3</u>	
(b) Audit strategy document		
Main characteristics of the audit	1	
Reporting objectives	1	
Significant factors affecting the audit	1	
Preliminary engagement activities	1	
Nature, timing and extent of resources	1	
Restricted to	<u>3</u>	
(c) Audit risks and responses (only 7 risks required)		
New client	2	
Work in progress	2	
Increased inventory	2	
Warranty provision	2	
Attendance at inventory counts	2	
Deferred income not correctly recognised	2	
Receivables allowance and valuation	2	
Overdraft covenants	2	
Trade payables	2	
Max 7 issues, 2 marks each	<u>14</u>	
Total marks	<u>20</u>	

	<i>Marks available</i>	<i>Marks awarded</i>
18 (a) Steps for a receivables circularisation		
Obtain consent from client	1	
Agree receivables listing to SL	1	
Select sample including nil, credit, old and large balances	1	
Prepare letters on company letterhead	1	
Sent by auditor	1	
Where no response, perform alternative procedures	1	
For replies received reconcile and investigate differences	1	
Restricted to	<u>4</u>	
(b) Receivables substantive procedures		
Accuracy, valuation and allocation tests	2	
Completeness tests	2	
Rights and obligation tests	2	
	<u>6</u>	
(c) Substantive procedures for redundancy provision		
Discuss with directors when announcement was made	1	
If before year end, agree to supporting documentation	1	
Review board minutes for details of redundancy payments	1	
Obtain a breakdown of redundancy calculations	1	
Recalculate the redundancy provision	1	
Review post y/e cash book for evidence of payments	1	
Obtain written representation	1	
Review disclosure in FS	1	
Restricted to	<u>5</u>	
(d) Impact on auditor's report		
Discussion of issue	1	
Calculation of materiality	1	
Type of auditor's report modification required	2	
Impact on auditor's report	1	
	<u>5</u>	
Total marks	<u>20</u>	



F8 Examiner's commentary on September/December 2017 sample questions

This commentary has been written to accompany the published sample questions and answers and is written based on the observations of markers. The aim is to provide constructive guidance for future candidates and their tutors, giving insight into what the marking team is looking for, and flagging pitfalls encountered by candidates who sat these questions.

Question 16

This 30-mark question was based on Comet Publishing Co, a book retailer with ten stores. This question tested candidates' knowledge of conflicts of interest, systems documentation, control deficiencies, control recommendations and tests of control as well as substantive procedures for purchases and other expenses.

Part (a) for five marks required candidates to explain safeguards the auditor should implement in order to address a potential conflict of interest created by the audit firm which also audited the main competitor of Comet Publishing Co. This question was well answered with the majority of candidates demonstrating a good knowledge of the ethical area tested.

Many candidates correctly identified safeguards such as informing both companies, separate engagement teams and keeping information confidential. A number of candidates also included the need for confidentiality agreements. Less commonly suggested safeguards included the need to seek independent advice, and monitoring of safeguards. Also where independent advice was suggested this was in the context of asking for legal advice, which was not relevant. In addition many candidates suggested monitoring of the audit work undertaken by each team rather than the application and monitoring of the ethical safeguards.

Some candidates repeated safeguards in slightly different ways, such as having separate audit teams and suggesting separate engagement partners. These are not two points and hence would have only gained one mark in total rather than two. Also some made several suggestions on how information could be kept confidential: separate offices, password protection, storing audit files in different locations. Ultimately these are all examples of the same point and so only received credit once.

Part (b) for five marks required candidates to explain the steps the auditor should take to confirm the accuracy of the flowcharts and systems notes held in the prior year audit file for the purchases and payables cycle. Performance on this question, when answered, was very disappointing.

Only a minority of candidates understood what flowcharts and system notes were and therefore recommended procedures such as discussions with management on changes to the system; observing the operation of the system or walkthrough tests and updating the systems documentation to reflect any changes. These candidates scored well in this question.

Unfortunately, the majority of candidates did not seem to understand what flowcharts and system notes were or simply saw that the question contained the words 'purchases and payables' and hence provided a long list of substantive procedures or compliance tests for auditing purchases and trade payables. This was not what was required and candidates are again reminded that it is imperative that they address the requirement set.

In addition a significant minority of candidates demonstrated a fundamental lack of understanding in relation to what a flowchart is or its purpose with suggestions of 'agreeing prior year flowcharts to those of the current year and investigating significant differences', or 'agreeing flowcharts to financial statements' and 'agree flowcharts to purchase invoices'.



Internal control is a key part of the syllabus and candidates must be prepared for both knowledge and application questions in this area. There are few knowledge areas in syllabus area C, hence candidates should have learnt these areas and practised past exam questions.

Part (c) for 15 marks, required candidates to identify and explain from the scenario five deficiencies in respect of the purchases and payables cycle, provide a recommendation to address each of these deficiencies and a test of control to assess if each control, if implemented, is operating effectively. Candidates' performance was mixed. It was pleasing that many candidates followed the instructions to set their answer out in three columns being deficiency, recommendation and test of control.

Internal control questions such as this typically require internal control deficiencies to be identified ($\frac{1}{2}$ mark each), explained ($\frac{1}{2}$ mark each) which must cover the implication of the deficiency to the company, a relevant recommendation to address the deficiency (1 mark) and a test of control (1 mark). Internal controls questions remain a highly examinable area.

The scenario in the exam contained more issues than were required to be discussed and it was therefore disappointing that some candidates did not identify the required number of issues noted in the question.

In addition it was unfortunate that a number of candidates identified facts from the scenario which were not deficiencies, and the related control recommendation and test of control would not have been relevant and therefore did not gain credit. Irrelevant points included 'the store manager raises the requisitions on his own/with no authorisation' this failed to understand that at this point it is just a request (still internal to the company) and not at order stage which is where the authorisation is needed. Also some candidates flagged that the 'warehouse team received goods from suppliers' and that this was somehow problematic as it should be a manager who received goods from suppliers. Candidates were also concerned about overstocking of books and that there was a significant risk of obsolescence or damage which was unlikely in the circumstances.

In addition, some candidates did not clearly understand/explain the implication of the deficiency. For example there was concern that the finance director reviewing the payments list resulted in a lack of segregation of duties, rather than a lack of detailed information being given to approve payments, which could result in invalid or fictitious payments.

Many candidates were able to provide good recommendations to address the deficiencies. However some of the recommendations were either poorly described, did not clearly address the specific control weakness identified or were impractical suggestions. For example in relation to the lack of supplier statement reconciliations, some recommended that the company simply hire more staff rather than recommending that the company undertake monthly reconciliations and that these should be reviewed by a responsible official.

The final part of the requirement was for tests of controls. In common with previous diets, candidates did not perform well. Many candidates confused substantive procedures for tests of control and too often tests were vague or incomplete. For example "review for supplier statement reconciliations" which is not clear about exactly what the reconciliations are being reviewed for. Also "observation" is often suggested as a test of control, while it is a valid audit procedure, it is not always the most appropriate one when testing controls and is rarely sufficient on its own. Tests of control are very commonly tested and future candidates need to ensure that they have undertaken adequate question practice.

Part (d) for five marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to purchases and other expenses. Performance on this requirement was very disappointing.



One mark was awarded for each well described procedure. The most common procedures provided by candidates included analytical review against prior year or budget, detailed tests agreeing to invoices and goods despatch notes (GDN) or cut-off tests.

However, a significant number of candidates provided procedures which were relevant to trade payables rather than purchases and expenses; these would not have gained credit as they did not answer the question asked. For example many candidates described audit procedures such as trade payable circularisations. Candidates are reminded to read the question requirement carefully and to ensure that they are answering the question set.

Following on from question 16c, candidates also gave tests of control, such as 'review for authorisation of purchase orders' rather than substantive procedures. Further, many candidates provided vague and incomplete tests. For example 'agree purchases to GDNs and invoices' would only be awarded $\frac{1}{2}$ mark as this is an incomplete test of detail as it does not follow the transaction into the books of prime entry. Further cut-off tests were incorrectly described using purchase invoices rather than GRNs, these would have only been awarded $\frac{1}{2}$ mark. Candidates are again reminded to think about the aim of the procedure when they are describing substantive tests.

Question 17

This 20-mark question was based on a property construction company, Prancer Construction Co. This question tested the areas of preconditions, the audit strategy document and audit risks and responses.

Part (a) for three marks required the steps the firm should take to confirm whether the preconditions for the audit were in place. Where it was answered, candidates performed unsatisfactorily on this question, which is disappointing as candidates did not perform well the last time this area was tested. It was clear from candidate answers that those who had studied preconditions were able to score all three marks and those who had not studied it failed to score any marks.

Those candidates who did not score well tended to focus on ethical threats or pre-acceptance procedures such as gaining professional clearance from the previous auditors, checking the audit firm had adequate resources and competence to undertake the audit.

This is a knowledge area and has been tested in previous diets. Candidates must practise past exam questions and ensure they study the breadth of the syllabus.

Part (b) for three marks required an identification of three main areas, other than audit risks, to be included within Prancer Construction Co's audit strategy document and an example for each area.

This question, where attempted, was poorly answered by most candidates. Most candidates did not answer both parts of the requirement, failing to identify the areas of an audit strategy. This is a knowledge area and demonstrated a gap in candidates' technical knowledge. Where candidates did score marks this was for providing examples, the most common answers given were around materiality, timetable and audit team.

Those candidates who did not score well either did not attempt the question or focused on audit risks, despite the question requirement clearly stating "other than audit risks" and then explained inherent, control and detection risks.

Part (c) for 14 marks required an identification and description of seven audit risks from the scenario and the auditor's response for each. Performance on this question was mixed.

Marks were awarded for identification of audit risk ($\frac{1}{2}$ mark each), explanation of audit risk by referring to the assertion and account balance impacted ($\frac{1}{2}$ mark each) and an appropriate auditor's response to each risk



(1 mark each). The scenario contained more than seven risks so it was pleasing that most candidates planned their time carefully and generally only attempted to list the required number of points.

As in previous diets, a significant number of candidates tended to only identify facts from the scenario such as “inventory has increased significantly on the prior year”; this would only have scored a maximum of ½ mark. This point did not explain the impact on the financial statements or why this was an audit risk and therefore cannot be awarded the ½ mark for explanation. To adequately explain audit risk, candidates need to state the area of the accounts impacted with either an assertion (e.g. cut off, valuation etc.), a reference to under/over/misstated, or a reference to inherent, control or detection risk.

In addition many candidates incorrectly explained the audit risk. For example they correctly identified that the auditor was not able to attend all the year-end inventory counts, this would have gained ½ mark but incorrectly stated that this would then lead to inventory being misstated. The issue is that if the auditor does not attend all counts this results in an increased detection risk. Also weaker candidates argued that the decrease in trade payable days led to a going concern risk, this was not the case, as with trade payables decreasing there was a completeness of payables risk. Many candidates incorrectly assumed the fact the company had a material overdraft was an audit risk and so focused on going concern procedures, rather than recognising that the risk actually related to the covenants attached to the overdraft and the possible manipulation of profit or assets in order to meet these.

Candidate performance in relation to auditor’s responses continues to be mixed. While an auditor’s response does not have to be a detailed audit procedure, rather an approach the audit team will take to address the identified risk, the responses given were often too weak such as ‘discuss with management’. This is not a sufficient response to deal with any identified audit risk and candidates need to be able to use their knowledge of audit procedures to provide a valid response which would adequately address the risk identified.

A minority of candidates continue to give business advice, such as recommending management charge for the free five year warranty provided or implementing improved credit control procedures to address the receivables valuation risk. In addition some responses were impractical, for example suggesting that the audit firm recruit more staff in order to attend all inventory counts.

Future candidates must take note audit risk is and will continue to be an important element of the syllabus and must be understood, and candidates must ensure that they include adequate question practice as part of their revision of this key topic.

Question 18

This 20-mark question was based on Dashing Co and tested candidates’ knowledge of performing a receivables’ circularisation, receivables and redundancy provision substantive procedures and auditor’s reports.

Part (a) for four marks required the steps the auditor should perform in undertaking a positive receivables circularisation. Performance on this requirement was disappointing. One mark was awarded for each well described step.

This was a knowledge area and a straight forward requirement. Candidates should have been able to easily describe enough steps to pass this part of the question. However, a significant minority of candidates did not seem to understand what a receivables circularisation was and so just produced a list of receivables substantive procedures. Other answers incorrectly focused on the differences between positive and negative circularisations which were not requested.



Stronger candidates were able to suggest some of the following steps: selecting a sample of receivable balances, sending a letter out, requesting a response, chasing up non-replies, undertaking alternative procedures in the event of no response and reconciling to records for those replies received.

Part (b) for six marks required substantive procedures for receivables relating to three specific assertions: (i) accuracy, valuation and allocation, (ii) completeness and (iii) rights and obligations. Candidates' performance was disappointing.

One mark was awarded for each well described substantive procedure. Hence for a six-mark requirement, candidates should have provided at least six substantive procedures. Disappointingly this was not the case, as some answers only contained one for each area and these were often not well described, resulting in maximum of ½ mark each.

In order to gain the available one mark each substantive procedure needed to be sufficiently detailed, and be clearly linked to the relevant financial statement assertion. Most candidates either structured their answers into the three sub category headings of (i), (ii) and (iii) or the tests included a reference to which assertion it addressed. Candidates' performance was most disappointing for (iii) rights and obligations, where often no answer was provided.

A significant number of candidates provided example procedures which were not related to receivables, but instead focused on revenue or on a receivables circularisation which were specifically excluded from this question requirement. This can only be due to a failure to read the question requirement properly.

In addition many procedures were vague, often not giving the source for the test, or stating 'check' or 'ensure' without explaining how the test would achieve this. In addition many tests were incomplete such as agreeing goods despatch notes (GDNs) to sales invoices but not then agreeing the invoices to the year-end sales ledger, and these GDNs and invoices should have been close to the year-end. Also many of the procedures were tests of control rather than substantive procedures.

Part (c) for five marks required substantive procedures for confirming the redundancy provision. Candidates' performance was mixed. Again one mark was awarded for each well described substantive procedure.

Many candidates were able to correctly suggest recalculation of the provision, obtaining a written representation confirming the completeness of the provision and agreeing to supporting documentation such as board minutes, employment contracts or payroll records.

However there was clear evidence of a lack of tailoring of knowledge to the specific scenario provided. Candidates have clearly learnt that all provisions should be compared to the prior year and that legal advice is required to confirm the amount of the provision. These are not relevant for a redundancy provision as it is unlikely there was a similar provision last year or that the company's lawyers would estimate the costs of redundancy. As addressed in previous examiner's reports candidates must strive to **understand** substantive procedures. Learning a generic list of tests will not translate to exam success as they must be applied to the question requirement.

The requirement verb for (a), (b) and (c) was to 'describe' therefore sufficient detail was required to score the 1 mark available per procedure. Also candidates must provide enough tests to score the marks and should assume 1 mark per valid procedure. Candidates are reminded that substantive procedures are a core topic area and they must be able to produce relevant detailed procedures.

Part (d) for five marks required a discussion of the specific issue detailed in the requirement and the impact on the auditor's report if the issue remained unresolved. The issue being that the redundancy provision was



understated by \$195,000. Performance was satisfactory on this question, with an improvement by candidates on the last time this style of question was tested.

Some candidates launched straight into assessing materiality without discussing the issue, which was that the redundancy provision should be \$305,000 rather than \$110,000 ($\frac{1}{2}$ mark). Therefore the provision was understated ($\frac{1}{2}$ mark) and hence missed out on the available 1 mark for this.

A further mark was available for the calculation and assessment of materiality. A number of candidates incorrectly used the total provision balance of \$305,000 in calculating materiality rather than the under provision of \$195,000. However, if they then stated that the balance was material they would have gained $\frac{1}{2}$ mark.

Many candidates were able to then correctly identify the type of report modification required (2 marks available), and attempt to describe the impact on the auditor's report (1 mark). Candidates answers tended to be more focused this session, rather than adopting a scatter gun approach of all possible auditor's report options.