Answers

Section B

16 (a) Fraud responsibility

Auditors conduct an audit in accordance with ISA 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements* and are responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error.

In order to fulfil this responsibility, the auditor is required to identify and assess the risks of material misstatement of the financial statements due to fraud.

The auditor needs to obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud through designing and implementing appropriate responses. In addition, the auditor must respond appropriately to fraud or suspected fraud identified during the audit.

When obtaining reasonable assurance, the auditor is responsible for maintaining professional scepticism throughout the audit, considering the potential for management override of controls and recognising the fact that audit procedures which are effective in detecting error may not be effective in detecting fraud.

To ensure that the whole engagement team is aware of the risks and responsibilities for fraud and error, ISA 240 requires that a discussion is held within the team. For members not present at the meeting, the audit engagement partner should determine which matters should be communicated to them.

(b) Ratios

	20X5	20X4
Gross profit margin	4,500/23,200 = 19·4%	4,600/21,900 = 21%
Inventory holding period	2,100/18,700 * 365 = 41 days	1,600/17,300 * 365 = 34 days
Gearing ratio	13,000/(10,000 + 13,000) = 56·5%	11,000/(9,500 + 11,000) = 53·7%
OR	13,000/10,000 = 130%	11,000/9,500 = 116%
Interest cover	(450 + 290)/290 = 2·6	(850 + 250)/250 = 4·4

(c) Audit risks and auditor's response

Audit risk	Auditor's response
The finance director is planning on reducing the estimated return rate for goods sold on a sale or return basis to wholesale customers from 10% to 5%. IFRS® 15 *Revenue from Contracts with Customers* provides that revenue and cost of sales should only be accounted for to the extent that the company foresees that the goods will not be returned. For the goods which may be returned, the company should recognise a refund liability. If, after 60 days, the goods are not returned, then this liability is reversed and revenue is recognised. By reducing the return rate, there is a risk that revenue and cost of sales may be overstated and liabilities understated.	Discuss the basis of the revised assumption of a 5% return rate with the finance director. Review a period of 60 days to quantify the levels of return in the specified period and compare this to the assumed rate of 5%. Discuss any significant variations with the finance director.
The company purchased a patent for $800,000 at the end of the prior year which has a useful life of four years. The carrying amount in the forecast financial statements is $800,000 which is the same as the prior year. In accordance with IAS® 38 *Intangible Assets*, this intangible asset should be amortised over its four-year life. It does not appear that management has correctly accounted for the amortisation and as a result, intangible assets and profits are overstated.	Agree the useful life of the patent is four years to supporting documentation. The amortisation charge should be calculated and the appropriate journal adjustment discussed with management, in order to ensure the accuracy of the charge and that the intangible is correctly valued at the year end.
Surplus plant and machinery was sold during the year, resulting in a loss on disposal of $160,000. Significant profits or losses on disposal are an indication that the depreciation policy of plant and machinery may not be appropriate. Therefore depreciation may be understated and profit and assets overstated.	Recalculate the loss on disposal calculations and agree all items to supporting documentation. Discuss the depreciation policy for plant and machinery with the finance director to assess its reasonableness. Review for other significant gains or losses on disposal of property, plant and equipment to assess the reasonableness of the company's depreciation policies.

Audit risk	Auditor's response
Harlem Co's financial controller has allegedly carried out a number of fraudulent transactions at the company. The investigation into the extent of the fraud has only recently commenced. There is a risk that she may have undertaken a significant level of fraudulent transactions leading to an increased control risk which has not yet been identified. These would need to be written off to the statement of profit or loss. If these have not been uncovered by the year end, the financial statements could include errors resulting in the misstatement of profits.	Discuss with the finance director the details of the fraud perpetrated by the financial controller and what procedures have been adopted to date to identify any adjustments which are needed in the financial statements. Additional substantive testing should be conducted over the affected areas of the accounting records. In addition, the team should maintain their professional scepticism and be alert to the risk of further fraud and errors.
In May 20X5, the financial controller was dismissed and is threatening to sue the company for unfair dismissal. If it is probable that Harlem Co will make payment to the financial controller, a provision for unfair dismissal is required to comply with IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Harlem Co has not done this, there is a risk over the completeness of any provisions or contingent liabilities disclosures.	The audit team should discuss with management and request confirmation from the company's lawyers of the existence and likelihood of success of any claim from the former financial controller.
Harlem Co has had production problems which have affected the quality of a significant batch of tyres. In addition, the inventory holding period has increased from 34 to 41 days. Inventory may be overvalued as its net realisable value (NRV) may be below its cost. If the tyres can be rectified, the rectification costs may mean that cost exceeds net realisable value. If the tyres cannot be rectified, the inventory may need to be written off completely.	Discuss with the finance director whether any write downs will be made to the affected tyres, and what, if any, modifications may be required with regards to the quality. Testing should be undertaken to confirm cost and NRV of the affected products in inventory and that all inventory on a line-by-line basis is valued correctly.
A significant customer has been granted a six-month payment break and the receivables collection period has increased from 38 to 51 days. An allowance for receivables has historically been maintained, and it is anticipated that it will remain at the prior year level. There is a risk that receivables will be overvalued; some balances may not be recoverable and so will be overstated if not adequately provided for.	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 maintaining the allowance for receivables at the same level as the prior year, despite the increase in receivables collection period and the payment break granted to a large customer. 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 increased level of allowance for receivables.
The report to management issued after the prior year audit highlighted significant deficiencies relating to the purchases cycle. If these deficiencies have not been rectified, the controls over purchases and payables may continue to be weak leading to increased control risk and risk of misstatements arising. Cost of sales, expenses and trade payables may not be complete or accurate.	Discuss with management whether the purchases cycle recommendations suggested by Brooklyn & Co were implemented successfully this year. If so, undertake tests of these controls to assess if they are operating efficiently. If the controls are not in place or operating efficiently, adopt a fully substantive approach for confirming the completeness and accuracy of cost of sales and other expenses and trade payables.

Audit risk	Auditor's response
Harlem Co intends to restructure its debt finance after the year end. However, the interest cover has declined from 4·4 to 2·6 and the level of gearing has increased from 53·7% to 56·5%. In order to maximise the chances of securing the debt finance restructure, Harlem Co will need to present financial statements which show the best possible position and performance. The worsening interest cover and gearing ratio increases the risk that the directors may manipulate the financial statements, by overstating profits and assets and understating debt liabilities.	Brooklyn & Co should ensure that there is a suitably experienced audit team. Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of profits and assets and understatement of debt, including attendance at an audit team briefing. The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Significant estimates and judgements should be carefully reviewed in light of the misstatement risk.
Harlem Co has issued shares during the year via a bonus issue. Share capital within equity should increase by the value of the shares and a reserve should decrease accordingly. If the company has not accounted for a bonus issue before, there is a risk that it could have been incorrectly treated with equity being under or overstated. In addition, legal issues may arise if the shares have not been issued in accordance with the company's statutory constitution. Additionally, bonus issues require disclosure in the financial statements and there is a risk that these may be incomplete or inaccurate.	Review the treatment of the bonus issue and agree the increase in shares to the share register and share certificates, and agree that the corresponding reduction in reserves is correct. Review board minutes for authorisation and terms of the bonus issue and review if the transaction has been conducted in line with this approval. Review the statutory constitution documents to confirm the legality of the share issue. Review the adequacy of the bonus issue disclosures in the financial statements.

(d) Substantive procedures for valuation of trade receivables

- Discuss with the finance director the rationale for not increasing the allowance for trade receivables and review its overall adequacy.
- Obtain a breakdown of the opening allowance and consider if the receivables provided for in the prior year have been recovered to assess the reasonableness of the prior levels of allowances.
- Review the aged trade receivables ledger to identify any slow moving or old receivable balances and discuss the status of these balances with the credit controllers to assess whether they are likely to be received.
- Review whether there are any after-date cash receipts for slow moving/old receivable balances.
- Review customer correspondence with the significant customer and others to identify any balances which are in dispute or are unlikely to be paid.
- Review board minutes to identify whether there are any significant concerns in relation to payments by customers.
- Calculate the potential level of trade receivables which are not recoverable and assess whether this is material or not and discuss with management.

(e) Substantive procedures for disposals of plant and machinery

- Obtain a breakdown of disposals, cast the list and review the non-current assets register to confirm that all assets have been removed.
- Select a sample of disposals and agree sale proceeds to supporting documentation such as sundry sales invoices.
- Recalculate the profit/loss on disposal and agree to the trial balance and statement of profit or loss.
- Recalculate the depreciation charge for a sample of disposals to confirm the calculations are correctly applied as per the company policy of a pro rata basis or a full year in the year of acquisition and none in the year of disposal.
- Review the disclosure of the disposals in the draft financial statements and ensure it is in line with IAS 16 *Property, Plant and Equipment*.

17 (a) Control objectives for sales and dispatch system

- To ensure that orders are only accepted if goods are available to be processed for customers.
- To ensure that all orders are recorded completely and accurately.
- To ensure that goods are not supplied to poor credit risks.
- To ensure that goods are dispatched for all orders on a timely basis.
- To ensure that the correct quantity of goods are dispatched and they are of an adequate quality.
- To ensure that all goods dispatched are correctly invoiced at authorised prices.
- To ensure completeness of income for goods dispatched.
- To ensure that sales discounts are only provided during the valid period.

(b) Report to management

Board of directors
Amberjack Co
21 Under the Sea
Shorelife City
Shark Country

1 July 20X5

Dear Sirs,

Audit of Amberjack Co for the year ended 30 April 20X5

Please find enclosed the report to management on deficiencies in internal controls identified during the audit for the year ended 30 April 20X5. The appendix to this report considers deficiencies in the sales and dispatch system and recommendations to address those deficiencies.

Please note that this report only addresses the deficiencies identified during the audit and if further testing had been performed, then more deficiencies may have been reported.

This report is solely for the use of management and if you have any further questions, then please do not hesitate to contact us.

Yours faithfully

An audit firm

Appendix

Control deficiency	Control recommendation
Customer credit limits are set by receivables ledger clerks. Receivables ledger clerks are not sufficiently senior and so may set limits too high, leading to irrecoverable debts, or too low, leading to a loss of sales.	Credit limits should be set by a senior member of the receivables ledger department and not by receivables ledger clerks. These limits should be regularly reviewed by a responsible official.
Receivables ledger clerks record new customer details and credit limits in the customer master data file and these changes are not reviewed. There is a risk that customers could be set up incorrectly resulting in a loss of customer goodwill and sales revenue. In addition, the receivables ledger clerks are not senior enough to be given access to making changes to master file data as this could increase the risk of fraud.	Receivables ledger clerks should not be able to access the master data file to add new customers or make amendments. Any such additions/amendments to master file data should be restricted so that only supervisors and above can make changes. An exception report of changes made should be generated and reviewed by a responsible official.
Amberjack Co's credit controller is currently on secondment for six months to the internal audit department and has not been replaced. During this period, it does not appear that anyone else has been responsible for monitoring ageing receivables. This could result in an increased risk of irrecoverable debts and lead to customers not paying their outstanding balances on time, or at all, leading to reduced cash flows.	During the period of the secondment, an alternative member of the finance department should be trained in the credit control role and assigned responsibility for reviewing the aged receivables listing and following up on any overdue customers.
Goods dispatch notes (GDN) are given the same number as the order number to which they relate. The sales invoices are only raised on receipt of a GDN, and without separate sequential numbers, it is difficult for Amberjack Co to identify if any GDNs are missing as they are not likely to be raised in the same sequence as the sales orders. If GDNs are missing and the company fails to raise invoices in a timely manner, this could lead to a loss of revenue.	GDNs should all be sequentially numbered using a sequence which is different to the order number. On a regular basis, a sequence check of GDNs should be undertaken to identify any missing dispatch notes.
Once orders are processed, copies of GDNs are sent to the finance department, customer and remain in the warehouse. However, the sales order department of Amberjack Co does not receive a copy of the GDN. If the sales order department does not receive a copy of the completed GDNs, they are not able to monitor if orders are being fulfilled on a timely basis. This could result in a loss of revenue and customer goodwill.	The GDN should be amended to be at least four-part. One copy should be sent to the sales order department. Once the copy of the GDN has been received by the order department, it should be matched to the order. A regular review of unmatched orders should be undertaken by the sales order department to identify any unfulfilled orders.

Control deficiency	Control recommendation
Additional staff has been drafted in to help the sales clerks produce the sales invoices. As the extra staff will not be as experienced as the sales clerks, there is an increased risk of mistakes being made in the sales invoices. This could result in customers being under or overcharged leading to misstated revenue or dissatisfied customers.	Only the sales clerks should be able to raise sales invoices. As Amberjack Co is expanding, consideration should be given to recruiting and training more permanent sales clerks who can produce sales invoices. If this is not currently possible, temporary staff should be adequately trained and additional input checks on invoices should be introduced.
Discounts given to customers who purchased goods during the 10% off weekend are manually entered onto the sales invoices by sales clerks. This could result in unauthorised sales discounts being given as there does not seem to be any authorisation required. In addition, a clerk could forget to manually enter the discount or enter an incorrect level of discount for a customer, leading to the sales invoice being overstated and a loss of customer goodwill. Unauthorised discounts in excess of 10% would result in a loss of revenue, either due to error or fraud.	During the period of any special offers, such as the 10% off weekend, the authorised sales prices file should be updated by a responsible official. These changes should be reviewed for any input errors, this review should be evidenced. The invoicing system should confirm that orders were placed during the discount weekend. Hence the sales invoices for these periods should automatically contain the reduced prices. The invoicing system should be amended to prevent sales clerks from being able to manually enter sales discounts onto invoices.
Customer statements are no longer being generated and sent to customers. If statements are not sent regularly, this increases the likelihood of errors and any disputed invoices not being quickly identified and resolved by Amberjack Co. This could lead to cash flow issues.	Amberjack Co should produce monthly customer statements for all customers and send them out promptly.
The receivables ledger control account is only reconciled at the end of April in order to verify the year-end balance. If the receivables ledger is only reconciled annually, there is a risk that errors will not be spotted promptly and receivables may be misstated.	The receivables ledger control account should be reconciled on a monthly basis to identify any errors which should be investigated and corrected. The reconciliations should be reviewed by a responsible official and they should evidence their review by way of signature.

18 (a) Exceptions in the receivables circularisation

The following steps should be undertaken in regard to the exceptions arising in the positive receivables circularisation:

Albacore Co

- For the non-response from Albacore Co, with the client's permission, the team should arrange to send a follow-up circularisation.
- If Albacore Co does not respond to the follow up, then with the client's permission, the auditor should telephone the customer and ask whether they are able to respond in writing to the circularisation request.
- If there is still no response, then the auditor should undertake alternative procedures to confirm the balance owing from Albacore Co. Such as detailed testing of the balance by agreeing to sales invoices and goods dispatched notes (GDN).

Flounder Co

- For the response from Flounder Co, with a difference of $5,850 the auditor should identify any disputed amounts, and identify whether these relate to timing differences or whether there are possible errors in the records of Triggerfish.
- If the difference is due to timing, such as cash in transit, this should be agreed to post year-end cash receipts in the cash book.
- If the difference relates to goods in transit, then this should be agreed to a pre year-end GDN.

Menhaden Co

- The reason for the credit balance with Menhaden should be discussed with the credit controller or finance department to understand how a credit balance has arisen.
- Review the payables ledger to identify if Menhaden is a supplier as well as a customer; if so, a purchase invoice may have been posted in error to the receivables rather than payables ledger.
- If the difference is due to credit notes, this should be agreed to pre year-end credit notes dispatched around the year-end date.
- The receivables ledger should be reviewed to identify any possible mis-postings as this could be a reason for the difference with Menhaden Co.

(b) Substantive procedures for allowance for trade receivables

- Discuss with the finance director the rationale for not providing against any receivables and consider the reasonableness of the allowance.
- Obtain a breakdown of the opening allowance of $125,000 and consider if the receivables provided for in the prior year have been fully recovered as a result of the additional credit control procedures or if they have now been fully written off.

- Inspect the aged trade receivables ledger to identify any slow moving or old receivable balances and discuss the status of these balances with the credit controllers to assess whether they are likely to be received.
- Review whether there are any after-date cash receipts for identified slow moving/old receivable balances.
- Review customer correspondence to identify any balances which are in dispute or are unlikely to be paid and confirm if these have been considered when determining the allowance.
- Inspect board minutes to identify whether there are any significant concerns in relation to payments by customers and assess if these have been considered when determining the allowance.
- Recalculate the potential level of trade receivables which are not recoverable and compare to allowance and discuss differences with management.

(c) Going concern indicators

Marlin Co has paid some of its suppliers considerably later than usual and only after many reminders; hence some of them have withdrawn credit terms meaning the company must pay cash on delivery. This suggests that the company was struggling to meet their liability as they fell due and will also put significant additional pressure on the company's cash flow, because the company will have to pay for goods on delivery but is likely to have to wait for cash from its receivables due to credit terms.

Marlin Co's main supplier who provides over 60% of the company's specialist equipment has just stopped trading. If the equipment is highly specialised, there is a risk that Marlin Co may not be able to obtain these products from other suppliers which would impact on the company's ability to trade. More likely, there are other suppliers available but they may be more expensive or may not offer favourable credit terms which will increase the outflows of Marlin Co and worsen the cash flow position.

Marlin Co's overdraft has grown significantly during the year and is due for renewal within the next month. If the bank does not renew the overdraft and the company is unable to obtain alternative finance, then it may not be able to continue to meet its liabilities as they fall due, especially if suppliers continue to demand cash on delivery, and the company may not be able to continue to trade.

In order to conserve cash, Marlin Co has decided not to pay a final dividend for the year ended 30 April 20X5. This may result in shareholders losing faith in the company and they may attempt to sell their shares; in addition, they are highly unlikely to invest further equity, and Marlin Co may need to raise finance to repay their overdraft.

(d) Going concern procedures

- Obtain the company's cash flow forecast and review the cash in and outflows. Assess the assumptions for reasonableness and discuss the findings with management to understand if the company will have sufficient cash flows.
- Perform a sensitivity analysis on the cash flows to understand the margin of safety the company has in terms of its net cash in/outflow.
- Evaluate management's plans for future actions, including their contingency plans in relation to ongoing financing and plans for generating revenue, and consider the feasibility of these plans.
- Review the company's post year-end sales and order book to assess if the levels of trade are likely to increase and if the revenue figures in the cash flow forecast are reasonable.
- Review any agreements with the bank to determine whether any covenants have been breached, especially in relation to the overdraft.
- Review any bank correspondence to assess the likelihood of the bank renewing the overdraft facility.
- Review post year-end correspondence with suppliers to identify if any have threatened legal action or any others have refused to supply goods.
- Inspect any contracts or correspondence with suppliers to confirm supply of the company's specialist equipment. If no new supplier has been confirmed, discuss with management their plans to ensure the company can continue to meet customer demand.
- Enquire of the lawyers of Marlin Co as to the existence of any litigation.
- Perform audit tests in relation to subsequent events to identify any items which might indicate or mitigate the risk of going concern not being appropriate.
- Review the post year-end board minutes to identify any other issues which might indicate further financial difficulties for the company.
- Review post year-end management accounts to assess if in line with cash flow forecast.
- Consider whether any additional disclosures as required by IAS 1 *Presentation of Financial Statements* in relation to material uncertainties over going concern should be made in the financial statements.
- Consider whether the going concern basis is appropriate for the preparation of the financial statements.
- Obtain a written representation confirming the directors' view that Marlin Co is a going concern.

Section B

			Marks available	Marks awarded
16	**(a)**	**Auditor's responsibility for fraud**		
		Obtain reasonable assurance that financial statements are free from material misstatement	1	
		Identify and assess risk of misstatement due to fraud	1	
		Obtain sufficient and appropriate evidence	1	
		Respond appropriately to fraud or suspected fraud	1	
		Maintain professional scepticism	1	
		Discuss risk of fraud with engagement team	1	
		Restricted to	4	
	(b)	**Ratios**		
		Gross profit margin	1	
		Inventory holding period	1	
		Gearing	1	
		Interest cover	1	
			4	
	(c)	**Audit risks and responses** (only 8 required)		
		Sale or return assumption	2	
		Intangible asset amortisation	2	
		Significant losses on disposal	2	
		Financial controller dismissal	2	
		Unfair dismissal claim	2	
		Inventory valuation	2	
		Recoverability of receivables	2	
		Purchases cycle control deficiencies	2	
		Intention to restructure finance	2	
		Bonus issue of shares	2	
		Max 8 issues, 2 marks each	16	
	(d)	**Substantive procedures – Valuation of trade receivables**		
		Discuss with management adequacy of allowance for trade receivables	1	
		Outcome of prior year allowance	1	
		Review aged trade receivables listing to identify old balances	1	
		Cash after-date testing	1	
		Review customer correspondence for evidence of disputes	1	
		Recalculate potential irrecoverable balances and assess adequacy of provision	1	
		Restricted to	3	
	(e)	**Substantive procedures – Disposal of plant and machinery**		
		Obtain breakdown of disposals, cast and agree removal to non-current asset register	1	
		Select sample of disposals and agree sales proceeds to invoice	1	
		Recalculate the profit/loss on disposal and agree to trial balance	1	
		Recalculate depreciation to confirm applied on a pro rata basis	1	
		Review disclosures and confirm in line with accounting standards	1	
		Restricted to	3	
	Total marks		30	

			Marks available	Marks awarded
17	**(a)**	**Control objectives for sales and dispatch system**		
		Orders only accepted if goods are available	1	
		All orders are recorded completely and accurately	1	
		Goods are not supplied to poor credit risks	1	
		Goods are dispatched for all orders	1	
		Quantity and quality of goods dispatched appropriate	1	
		All goods dispatched are invoiced for correctly	1	
		Completeness of income for goods dispatched	1	
		Sales discounts are only given during valid period	1	
		Restricted to	**4**	
	(b)	**Control deficiencies and recommendations** (only 7 required)		
		Customer credit limits	2	
		Customer master data not reviewed	2	
		Credit controller not replaced	2	
		Goods dispatch notes (GDNs) not sequentially numbered	2	
		Insufficient copies of GDN	2	
		Sales invoice processing	2	
		Manual recording of discounts	2	
		Customer statements no longer raised	2	
		Receivables ledger control account only reconciled annually	2	
		Max 7 issues, 2 marks each and 2 marks available for covering letter	**16**	
	Total marks		**20**	

		Marks available	Marks awarded
18	**(a) Audit procedures – Trade receivables circularisation**		
	Albacore Co	3	
	Flounder Co	3	
	Menhaden Co	3	
	Restricted to	**8**	
	(b) Substantive procedures – Allowance for trade receivables		
	Discuss the rationale and reasonableness with the finance director	1	
	Obtain breakdown of opening allowance and confirm recovered	1	
	Inspect the aged receivables listing and discuss old or slow moving balances	1	
	Perform cash after-date testing on identified slow moving and old balances	1	
	Review customer correspondence for evidence of disputed balances	1	
	Inspect board minutes for balances which may not be recovered	1	
	Recalculate potential level of irrecoverable balance and compare to allowance and discuss differences	1	
	Restricted to	**4**	
	(c) Going concern indicators		
	Withdrawal of credit – impact explained	1	
	Loss of main supplier – impact explained	1	
	Overdraft facility due for renewal – impact explained	1	
	No final dividend – impact explained	1	
	Restricted to	**3**	
	(d) Going concern procedures		
	Obtain cash flow forecast and assess assumptions	1	
	Perform sensitivity analysis on cash flow forecast	1	
	Evaluate management's plans for future actions	1	
	Review post year-end order book to assess levels of trade	1	
	Review agreements with the bank to determine whether any covenants breached	1	
	Review bank correspondence for evidence of renewal	1	
	Review correspondence with suppliers for dispute/legal action	1	
	Inspect contracts with supplier to confirm supply	1	
	Obtain confirmation from company lawyers about any legal action	1	
	Review post year-end board minutes for any indications of financial difficulties	1	
	Review management accounts to assess if in line with cash flow	1	
	Review financial statement disclosure	1	
	Consider if going concern basis is appropriate	1	
	Obtain a written representation	1	
	Restricted to	**5**	
	Total marks	**20**	

AA Examiner's commentary on September/December 2019 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 Harlem Co, a car tyre manufacturer. This question tested candidates' knowledge of responsibilities for fraud and error, calculation of ratios, audit risks and responses and substantive procedures. Performance was satisfactory.

Part (a) for four marks required candidates to describe the auditor's responsibilities for fraud and error. One mark was available for each well described point. This is a knowledge area that has been tested in previous diets. Performance was satisfactory.

A significant number of candidates were able to detail in sufficient depth the auditor's responsibilities, however some candidates did not fully relate the responsibilities back to fraud and error. In addition, some candidates described management's responsibilities and no credit was awarded for these points.

Part (b) for four marks required a calculation of four specified ratios for both the current and prior year. Most candidates were able to generate enough marks to pass this part of the requirement, however few received full marks.

Candidates were able to confidently calculate the gross profit margin and inventory holding period. However, candidates struggled in particular to calculate interest cover and some miscalculated the gearing ratio. The calculation of interest cover required candidates to add back finance costs to the profit before tax. Many failed to do this correctly and this may explain the weaker performance on this ratio. Candidates must ensure that they are able to calculate a range of key ratios used in analytical procedures.

Part (c) for 16 marks required candidates to identify and describe eight audit risks and to explain the auditor's response to each in planning the audit of Harlem Co. Performance was satisfactory.

Marks were awarded for the identification of an audit risk (½ mark each), explanation of the audit risks (½ mark each) and an appropriate auditor's responses to each risk (1 mark each).

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

Candidates generally identified the risks well. However, having correctly identified the relevant fact from the scenario a significant number did not understand the associated audit risk. For example, the company's intention to restructure the debt finance post year end gave rise to a manipulation risk in the current year financial statements. Many candidates incorrectly stated that the company had taken out a new loan and therefore the risk of classification needed to be addressed. This was incorrect, as Harlem Co had not taken out any loans in the current year.

In addition, the risk arising on the amortisation of the intangible asset was poorly answered by candidates. Many failed to appreciate that the asset was purchased in the prior year, therefore audit work confirming the cost would have been undertaken in the prior year. For the current year the auditor needed to focus on whether the amortisation had been appropriately charged. Candidates must take the time to carefully read the scenario, noting dates and other relevant information, to ensure that they correctly understand the audit risks arising.

As in previous diets, many candidates did not adequately explain the risk. To explain the risk candidates need to state the specific area of the financial statements impacted with an assertion (for example cut off, valuation etc), or, a reference to over/under/misstated, or a reference to inherent/ control/ detection risk. A reference to a balance being misstated was only awarded credit if it was clear the balance could be either over/understated.

A significant minority of candidates did not clearly state the specific area of the financial statement impacted. For example, for the issue relating to the loss on disposal of surplus plant and machinery, answers which noted 'assets could be overstated' were not awarded credit. Candidates must clearly state the specific area of the financial statements, for example 'property plant and equipment could be overstated' to be awarded the ½ implication mark.

Candidates' performance in relation to auditor's responses continues to be mixed. While an auditor's response does not have to be a detailed procedure, rather an approach the audit team will take to address the identified risk, the responses given were often too weak or not related to the actual audit risk. For example, in response to the quality control issue with inventory, the response 'inspect the tyres' was not sufficient to gather evidence over the NRV of these tyres. Candidates needed to explain how they would confirm the valuation, for example by 'discussing with management whether the tyres will be written down'.

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

Part (d) for three marks required candidates to describe substantive procedures the auditor should perform in relation to the valuation of trade receivables. One mark was available for each well-described procedure. Performance on this requirement was satisfactory.

Many candidates were able to provide an appropriate number of well described audit procedures such as after date cash receipts testing and analytical review procedures. Some candidates suggested procedures which would not address the risk of valuation such as, undertaking a receivables circularisation or agreeing the receivables balance to the financial statements. Procedures unrelated to valuation were not awarded credit.

Part (e) for three marks required candidates to describe substantive procedures the auditor should perform in relation to the disposal of plant and machinery. One mark was available for each well-described procedure. Performance on this requirement was disappointing.

Many candidates failed to provide procedures focused on disposals, instead they gave a list of generic property, plant and equipment procedures. This wasted time and often meant that candidates only scored one to two marks at best. Candidates who scored well focused on recalculation of the loss on disposal, confirming the plant and machinery had been removed from the asset register and calculation of depreciation to the point of sale.

Candidates are reminded they must take the time to read the question requirements carefully and spend time thinking about what is needed prior to writing their answers rather than listing out generic tests.

Question 17

This 20-mark question was based on Amberjack Co, a manufacturer and distributor of car tyres. This question tested candidates' knowledge of control objectives for the sales cycle and control deficiencies and recommendations. Candidates overall performance was satisfactory.

Part (a) for four marks required candidates to list four control objectives for the sales and dispatch system. Performance, in this knowledge-based question, was mixed.

Those candidates who clearly understood what a control objective was often scored full marks. However, in common with previous diets, many candidates provided an example of a control or tests of control rather than an objective. Some simply listed assertions such as completeness and accuracy. Where objectives were given there was often considerable overlap and repetition of points or answers strayed outside the scope of the sales and dispatch system.

Candidates are reminded once again that questions in this syllabus area usually contain a knowledge-based requirement. These are straightforward and candidates should be able to score well, provided they spend the necessary time and practise past questions.

Part (b) for 16 marks required candidates to provide a report to management which identified and explained from the scenario seven deficiencies and controls to address each of these deficiencies. Candidates were also required to provide a covering letter. Performance was satisfactory.

Internal control deficiency questions such as this typically require internal control deficiencies to be identified (½ mark each), explained (½ mark each) which must cover the implication of the deficiency to the company and a relevant recommendation to address the deficiency (1 mark).

The scenario in the exam contained more issues than were required to be discussed. The majority of candidates were able to identify seven deficiencies as required.

However, a significant minority of candidates identified irrelevant or incorrect deficiencies. For example, many candidates were concerned about sales prices only being updated every six months or that sales invoices were prepared using quantities from goods dispatch notes. These are not deficiencies and therefore were not awarded any credit.

Some candidates did not clearly understand/explain the implication of the deficiency. Candidates are required to explain the implication to the business to be awarded credit. For example, a candidate who correctly identified the deficiency ‘discounts are manually entered onto sales invoices’ (identification ½ mark awarded), would not have received credit for the explanation ‘discounts could be unauthorised’. Candidates must clearly explain the implication to the business, for example that ‘this could result in a loss of revenue or loss of customer goodwill’, to be awarded the ½ explanation mark.

Candidates were able to provide recommendations to address the deficiencies identified however often the recommendations were not described in enough detail. For example, the recommendation that ‘credit limits should be set by senior members of the sales department, rather than the clerks’ was only awarded ½ mark. Candidates needed to also recommend that ‘these limits should be regularly reviewed’ to be awarded the full 1 mark.

It was disappointing that few candidates provided a covering letter, and of these, few letters contained suitable disclaimer statements. An example disclaimer stating that ‘this report only addressed deficiencies identified during the audit and if further testing had been undertaken more deficiencies may have been reported’ was required.

Internal control questions remain a highly examinable area and future candidates need to ensure that they have undertaken adequate question practice of all examinable control systems.

Question 18

This 20-mark question was based on Spadefish Co, an audit firm undertaking the audits of Triggerfish Co, a manufacturer of hair products and Marlin Co a distributor of electronic goods. This question tested candidates' knowledge of substantive procedures for receivables. The question also tested candidates' knowledge of going concern indicators and audit procedures. Overall performance was disappointing.

Part (a) for eight marks required candidates to describe procedures the auditor should perform to resolve exceptions noted during a receivables circularisation for Triggerfish Co. Performance on this requirement was very disappointing. One mark was awarded for each well-described audit procedure.

Candidates were provided with three customer balances as per Triggerfish's receivables ledger and the response from the receivables circularisation. It was disappointing to see that a significant minority of candidates did not even attempt this requirement or simply provided one very brief procedure for each of the three exceptions.

Of the three customer balances, Albacore Co was best attempted by candidates. Well prepared candidates gained marks for procedures such as after date cash receipts testing as an alternative procedure, chasing the customer to request a response or sending a follow up circularisation request.

The second balance in respect of Flounder Co related to a potential overstatement or timing difference. The third balance in respect of Menhaden Co was a credit balance in the receivables ledger but a debit balance in the circularisation response. Candidates seemed to really struggle with these exceptions and other than suggesting 'discuss the reason for the difference with management' they could not provide many other relevant procedures. Candidates incorrectly focused on 'agreeing to sales invoices and goods dispatched notes' or trying to understand how the credit balance in Menhaden Co may have occurred, without providing any procedures.

For the balance with Flounder Co, candidates needed to focus their tests on items which could have been in transit at the year end to have caused the difference. Procedures around cash in transit or goods in transit were required. For the balance with Menhaden Co, procedures should have focused on credit notes or identifying mis-postings.

A significant minority of candidates produced very repetitive responses, providing audit procedures for Albacore Co and then simply copying these tests for each of the other two exceptions. Candidates should note that duplicating tests will not result in credit being awarded more than once.

Candidates are reminded that substantive procedures are an important part of the syllabus and it is imperative they are able to attempt different types of question requirements.

Part (b) for four marks required candidates to describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Triggerfish Co's allowance for receivables. Performance on this requirement was also very disappointing. One mark was awarded for each well-described audit procedure.

It was disappointing that despite the question requiring procedures for the allowance for receivables, a significant number of candidates listed generic procedures for trade receivables such as receivables circularisation, cut off testing and reviewing disclosure. The majority of these procedures were not awarded any credit as they were not focused on the allowance. Candidates must carefully read the requirement of the question and tailor their answers accordingly.

Where candidates did attempt to audit the allowance, many of the procedures were not relevant. For example, undertaking analytical review of the allowance when the scenario stated it had been significantly reduced in the year, and reviewing board minutes for authorisation of the allowance were not awarded credit as they were not valid.

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 requirements.

Part (c) for four marks required the candidate to identify and explain indicators that Marlin Co was not a going concern. Questions such as this typically require indicators to be identified (½ mark each) and explained (½ mark each). Performance was satisfactory.

The scenario contained more issues than were required to be discussed. The majority of students were able to identify three going concern indicators as required.

A number of candidates incorrectly identified that 'suppliers being paid later than usual' was a going concern indicator. Many companies choose to pay suppliers late in order to maximise working capital, and on its own this would not be enough to raise concerns over going concern. Instead credit was awarded for 'suppliers having withdrawn credit or requiring cash on delivery.'

The explanation of the indicators caused difficulties for some candidates, with generic answers being given such as 'this will cause cash flow problems for the company'. In order to be awarded the second ½ mark, candidates needed to explain <u>how</u> the indicator could cause cash flow issues for Marlin Co.

Those candidates who did not score well provided going concern indicators which were not in the scenario such as ‘sale of significant assets’, these had clearly been learnt as a generic list of indicators of going concern.

Part (d) for five marks required candidates to describe audit procedures to assess whether Marlin Co was a going concern. Performance was satisfactory on this requirement.

One mark was awarded for each well described substantive procedure. Those candidates who had practiced past questions scored well, noting procedures such as reviewing the cash flow forecast, discussions with management regarding future plans, reviewing board minutes and obtaining a written representation.

Those candidates who did not score well provided procedures which lacked sufficient detail, for example, ‘discuss with management’ without explaining what was to be discussed. Vague procedures such as this are not awarded any credit. In addition, some candidates provided irrelevant procedures such as undertaking ratio analysis or reviewing bank statements. These procedures would not provide evidence as to whether the company was a going concern or not and so were not awarded any credit.