Mock Exam One

AAT Level 4

Audit and Internal Controls

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This practice assessment is one of a set of five AAT mock practice assessments which have been published for this subject. They are produced by our expert team of AAT tutors, giving real AAT exam style and standard tasks, that ensure the very best for exam success. All practice assessments are relevant for the current syllabus.

Our AAT tutors work extensively to produce study material that is first class and absolutely focused on passing your exam. We hope very much that you enjoy this product and wish you the very best for exam success! For feedback please contact our team aatlivelearning@gmail.com or safina@acornlive.com

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Mock Exam One

AAT Level 4

Audit and Internal Controls

Assessment information:

You have **2 hours** to complete this **Audit and Internal Controls** practice assessment.

- This assessment contains **9 tasks** and you should attempt to complete **every** task.
- Each task is independent. You will not need to refer to your answers to previous tasks.
- The total number of marks for this assessment is **100**.
- Read every task carefully to make sure you understand what is required.
- Where the date is relevant, it is given in the task data.
- Both minus signs and brackets can be used to indicate negative numbers **unless** task instructions state otherwise.
- You must use a full stop to indicate a decimal point. For example, write 100.57 **not** 100,57 or 100 57.
- You may use a comma to indicate a number in the thousands, but you don't have to. For example, 10000 and 10,000 are both acceptable.
- You will need to double click to enter values into a gapfill or cell within a table.

Task 1 (10 marks)

This task is about internal controls and their impact on organisations.

This task contains parts (a) to (e).

A company regularly performs physical inventory counts and reconciles them to inventory records.

(a) Identify the two primary objectives served by this internal control. (2 marks)

Compliance with laws and regulations.	☐
Safeguard assets.	☐
Facilitate operations.	☐
Ensure quality of internal and external reporting.	☐

An internal audit team regularly reviews payroll, purchasing, or cash handling procedures to confirm that controls are operating as intended. The board of directors or audit committee regularly oversees management and reviews control related issues.

(b) Identify the two key components of internal control demonstrated by this example. (2 marks)

The control environment.	☐
Control activities.	☐
The information system and communication.	☐
The entity's process to monitor its systems of internal control.	☐

(c) Identify the most suitable type of internal control to address each accounting weakness. (4 marks)

Accounting weakness	Internal control
Cash is stored in an unlocked drawer that is accessible to all employees.	
The company hires accounting staff without checking their qualifications, experience, or references.	
The accounting system allows invoices to be entered without validating key information such as supplier number, invoice date, or invoice amount.	
One employee creates suppliers, processes invoices, and authorises payments.	

Picklist: Personnel, Segregation of Duties, Information Processing, Physical.

(d) Identify which ONE of the following is not a limitation of internal controls. (1 mark)

- Inefficiency ☐
- Collusion ☐
- Fraud ☐

(e) Identify if the following statement is true or false. (1 mark)

	TRUE	FALSE
Organisations should implement internal controls that are appropriate to their level of risk, operational complexity, and transaction volume.	☐	☐

End of Task

Task 2 (10 marks)

This task is about control objectives, risks and control procedures.

This task contains parts (a) to (b).

A finance manager has been reviewing the company's sales system and has documented several existing control procedures in the sales and accounting departments.

(a)(i) Match each control procedure with its most likely control objective. (4 marks)

Control procedure	Control objective
Use of pre-numbered invoices and delivery notes.	
Sales invoices are raised only for approved customer orders.	
Automated calculation of pricing and VAT on sales invoices.	
Sending customer statements and reconciling them with customer accounts.	

Picklist: Sales are recorded accurately, Sales are recorded completely, Accounts receivable balances are accurate and up to date, Only valid sales are recorded.

(a)(ii) Complete the following sentence. (1 mark)

Credit checks before allowing credit sales [ ] reduce the risk of errors or omissions.

Picklist: will, will not.

The information provided below relates to a company's cash accounting system.

Cash accounting system:

- The general accounts clerk is responsible for recording and processing supplier payments made by cash, cheque, and BACS.
- The general accounts clerk records customer payments and notifies the accounts receivable department by email whenever a credit customer settles an outstanding invoice.
- Cash is stored securely in a safe, with access restricted solely to the general accounts clerk, who holds the key.
- The general accounts clerk performs regular physical cash counts and reconciles the amounts counted with the balances recorded in the cash book.

- The general accounts clerk reconciles the cash book balance with online bank statements to identify and investigate any discrepancies.
- Both the general accounts clerk and the accounts payable supervisor are authorised to prepare and sign business cheques for amounts up to £10,000. Cheques require the signatures of both individuals before they can be processed by the bank.
- The computerised cash book system has not been updated for more than three years.

(b) Complete the following sentences. (5 marks)

The general accounts clerk notifies the accounts receivable department by email whenever a credit customer settles an outstanding invoice, this increases the risk that

[▼].

Picklist: customer payments are misappropriated, customer payments are not recorded accurately or promptly, customer payments are fraudulent.

A control procedure to reduce this risk could be to [▼].

Picklist: limit access to online banking, implement an integrated accounting system, update the computerised cash book software.

If one employee handles cash and another employee performs physical cash counts and reconciliations, this reduces the risk that [▼].

Picklist: customer payments are not recorded accurately, unauthorised supplier payments are made, cash is stolen and concealed.

Dual signatures required before a cheque is processed by the bank provides

[▼] control.

Picklist: an authorisation, a supervision, a physical.

Requiring dual signatures before a cheque is processed by the bank is more likely to achieve the control objective that [▼].

Picklist: cash is physically safeguarded, only valid business payments are made, cash records are accurate.

End of Task

Task 3 (10 marks)

This task is about fraud.

This task contains parts (a) to (c).

(a) Identify the following types of fraud. (2 marks)

	Type of fraud
Stealing cash from sales before it is entered into the accounting records.	
Delaying the recording of invoices to understate expenses and make the business appear more profitable.	

Picklist: fraudulent financial reporting, misappropriation of assets.

A company aims to reduce the risk of differences between physical inventory counts and recorded inventory balances caused by fraudulent activities such as theft.

(b) Identify whether each internal control procedure relates to the monitoring, reviewing, or reporting component of the fraud risk assessment process.
(3 marks)

Internal control procedure	Component
The Inventory Manager investigates inventory variances exceeding 4% on a monthly basis.	
Any unexplained inventory variance greater than £5,000, the system automatically informs the Finance Director and Internal Audit team.	
Warehouse supervisors conduct weekly cycle counts of high-value inventory items.	

Picklist: monitoring, reviewing, reporting.

An Accounts Receivable Supervisor was dismissed after an investigation revealed that she had engaged in fraudulent activities. She had opened personal bank accounts with names closely resembling those of legitimate customers and deposited customer cheque payments into these accounts for her own personal gain. The fraud was carried out with no apparent attempts to conceal the scheme.

Her responsibilities included managing and updating customer credit accounts, as well as receiving, processing, and recording cheque payments received by post. She did not have system authority to raise sales orders, issue sales invoices or credit notes, or update the cashbook.

Following the discovery of this fraud, the Financial Controller has requested that a member of the finance team conduct a detailed investigation to determine how the fraud occurred and identify controls that could be implemented to prevent or detect similar incidents in the future.

(c)(i) Identify the type of fraud committed by the Accounts Receivable Supervisor.
(1 mark)

Teeming and lading.	☐
Fictitious customers.	☐
Payment diversion fraud.	☐

(c)(ii) Complete the following sentence. (1 mark)

The fraud was most likely caused by ▼ .

Picklist: poor user IDs and passwords, lack of segregation of duties, lack of supervision for cashbook updates.

To conceal missing customer payments in the accounts receivable system, the Accounts Receivable Supervisor may have manipulated customer account records in order to hide the absence of receipts and prevent discrepancies from being detected.

(c)(iii) Identify how the Accounts Receivable Supervisor may have concealed any missing customer payments in the accounts receivable system. (1 mark)

Transfer payment credits between customer accounts to disguise missing receipts.	☐
Ignore bank correspondence and unrecorded customer account payments.	☐
Process unauthorised credit notes to conceal outstanding customer balances.	☐

(c)(iv) Identify TWO internal control procedures that could help prevent or detect this fraud. (2 marks)

Send customer statements on a regular basis.	☐
Sales orders and invoices should require authorisation.	☐
New customer accounts should require authorisation before set-up.	☐
Two employees should open post and record all cheque receipts.	☐

End of Task

Task 4 (15 marks)

This task is about the audit and assurance framework.

This task contains parts (a) to (d).

(a) Identify if the following statements are true or false. (3 marks)

Statement	TRUE	FALSE
The mistaken belief that auditors guarantee the absence of all fraud or guarantee a company's future success is an example of limited assurance.	☐	☐
An audit is a type of assurance engagement in which an independent auditor provides reasonable assurance that the financial statements are free from material misstatement.	☐	☐
A negative expression of assurance is used in reasonable assurance engagements, such as audits.	☐	☐

(b)(i) Identify which ONE of the following is a role of the International Auditing and Assurance Standards Board (IAASB). (1 mark)

To develop global standards for sustainability-related financial disclosures.	☐
To provide the legal framework for company reporting and auditing requirements.	☐
To develop and issue International Standards on Auditing (ISAs) and other assurance standards.	☐
To regulate audits by setting ethical standards, technical guidance, and professional requirements that auditors must follow.	☐

(b)(ii) Identify whether an auditor's liability is owed to the following stakeholders of the company. (3 marks)

Auditor's liability	
The company.	
Shareholders of the company.	
Customers of the company.	

Picklist: Yes, No.

(b)(iii) Complete the following sentence. (1 mark)

Professional indemnity insurance (PII) is normally required by ______ .

Picklist: auditors, directors, shareholders.

(c)(i) Identify which ONE is not a principle of the UK Corporate Governance Code. (1 mark)

- The financial statements. ☐
- Board leadership and company purpose. ☐
- Division of responsibilities. ☐
- Audit, risk and internal control. ☐

(c)(ii) Complete the following sentence. (1 mark)

A key feature of the UK Corporate Governance Code is the ______ principle.

Picklist: follow or explain, obey or justify, comply or explain.

(c)(iii) Identify the following responsibilities of internal and external auditors in relation to fraud and errors. (2 marks)

Responsibilities	
Responsible for reviewing and improving the company's internal controls to help prevent and detect fraud and error.	
Responsible for obtaining reasonable assurance that the financial statements are free from material misstatement caused by fraud or error.	

Picklist: internal auditors, external auditors.

(d)(i) Identify TWO functions of internal audit. (2 marks)

- Conducting special investigations. ☐
- Preparing financial statements that give a true and fair view. ☐
- Reviewing systems of internal control. ☐
- Ensuring directors are accountable for how the company is managed. ☐

(d)(ii) Identify ONE risk associated with a lack of independence. (1 mark)

- The auditor's opinion may be biased or influenced by the client. ☐
- There may be inadequate oversight of management. ☐
- Ineffective decision-making leading to financial losses. ☐
- The auditor's will have to personally cover any legal claims or compensation costs. ☐

End of Task

Task 5 (10 marks)

This task is about the planning and risk assessment process for audit engagements.

This task contains parts (a) to (c).

(a)(i) Identify TWO factors that affect inherent risk. (2 marks)

Complexity of transactions.	☐
Effectiveness of internal controls.	☐
Susceptibility of assets to fraud.	☐
Quality of segregation of duties.	☐

(a)(ii) Identify which ONE of the following would be ineffective in reducing detection risk. (1 mark)

Increasing the sample size of audit testing.	☐
Using more experienced audit staff.	☐
Increasing reliance on client internal controls without additional testing.	☐
Performing more detailed substantive procedures.	☐

Company A has experienced a deterioration in its financial performance. The Finance Director informed the auditors that the company has revised its customer credit and payment terms since the previous reporting period.

	9 months ended 31 March 20X6	Year ended 30 June 20X5
	£000	**£000**
Trade receivables	1420	631
Allowance for doubtful debts	28	12.6
Net trade receivables	1392	618.4
Sales	6175	7800
Cost of sales	4940	6162
Gross profit	1235	1638
Discounts allowed	303	70
Allowance for doubtful debts - adjustment	15.4	3.5

Customer credit and payment terms:

- To attract additional business from new and existing customers, the company extended its credit terms from one month in the previous year to two months in the current period.
- To improve cash flow, the discount offered to customers for early payment was increased from 2% in the previous year to 4% in the current period.

(b)(i) Based on analytical procedures performed, indicate whether each of the following balances for the current period is likely to be understated, overstated, or neither understated nor overstated in the financial statements. (4 marks)

Item	Overstated	Understated	Neither
Cost of sales	☐	☐	☐
Discounts allowed	☐	☐	☐
Allowance for doubtful debts - adjustment	☐	☐	☐
Trade receivables	☐	☐	☐

(b)(ii) Identify which ONE of the following analytical procedures is least likely to help detect potential overstatements or understatements of bad debts in the financial statements. (1 mark)

Calculate the allowance as a percentage of trade receivables and compare it with prior years.	☐
Analyse the proportion of overdue debts that are covered by the allowance.	☐
Compare sales trends by month with prior periods.	☐
Analyse the aged receivables listing and compare the proportion of overdue balances with previous periods.	☐

(c) Identify if the following statements are true or false. (2 marks)

Statement	True	False
Materiality is used at the planning stage to determine the nature, timing, and extent of audit procedures.	☐	☐
Materiality is always set at 10% of profit before tax.	☐	☐

End of Task

Task 6 (10 marks)

This task is about internal controls and their impact on the audit approach.

This task contains parts (a) to (c).

(a) Identify TWO reasons why auditors need to understand the company's internal controls. (2 marks)

To assess the risk of material misstatement in the financial statements.	☐
To guarantee that the company will make a profit in the future.	☐
To plan the nature, timing, and extent of audit procedures.	☐
To decide the salaries and bonuses of company employees.	☐

(b)(i) Complete the following sentence. (1 mark)

[▼] focus on obtaining evidence about the accuracy, completeness, and validity of account balances and transactions to detect material misstatements in the financial statements.

Picklist: internal audit, tests of controls, substantive procedures, corporate governance procedures.

Payroll calculations are automated within the payroll system.

(b)(ii) Identify which ONE of the following errors or irregularities can be mitigated by this control procedure (1 mark)

Incorrect calculation of wages due to human arithmetic errors.	☐
Employees receiving payments after leaving the company due to poor leaver controls.	☐
Overtime payments being approved without authorisation.	☐
Fraudulent employee bank account details being entered into the system.	☐

Payroll calculations are automated within the payroll system.

(b)(iii) Identify which ONE of the following is an appropriate test of control to assess whether this control is operating effectively (1 mark)

Reperform payroll calculations manually for a sample of employees.	☐
Inspect evidence that the payroll system has been tested and approved after any changes.	☐
Compare total payroll expense to prior year and investigate significant variances.	☐
Trace employee salaries from the payroll system to the financial statements.	☐

A member of the finance team will soon be responsible for maintaining the non-current asset register. This will include recording and updating key details such as unique asset identification numbers, asset descriptions, acquisition costs, depreciation methods, useful lives, and asset locations. The individual will also ensure that all non-current assets are accurately recorded, complete, and kept up to date within the accounting system.

(c)(i) Identify whether each of the following errors or irregularities, would or would not be mitigated by the specified control procedure. (2 marks)

Control procedure	Errors or irregularities mitigated	
Each asset assigned a unique identification code and physically tagged.	Prevent duplication or omission of assets in the non-current asset register.	▼
Periodic physical inspections to confirm the existence and condition of assets.	Ensure only valid and properly supported transactions are entered.	▼

Picklist: would, would not.

(c)(ii) Identify whether each test of control is suitable or not suitable for assessing whether the specified control procedure is operating effectively. (3 marks)

Control procedure	Testing of control procedure	
All additions to the non-current asset register should be supported by authorised purchase invoices and approved capital expenditure requests.	Inspect a sample of entries in the register and trace them back to supporting documentation.	
Asset purchases should be independently approved by management before being recorded.	Inspect evidence such as signatures or approval forms for a sample of asset purchases.	
Regular reconciliations should be performed between the non-current asset register and the general ledger to ensure completeness and accuracy.	Inspect purchase invoices and capital expenditure approvals for new asset purchases.	

Picklist: suitable, not suitable.

End of Task

Task 7 (15 marks)

This task is about audit assertions, audit procedures and sampling.

This task contains parts (a) to (d).

(a)(i) Identify whether each of the following statements about assertions relating to transactions is true or false. (3 marks)

	True	False
The occurrence assertion ensures that all transactions that should have been recorded are included in the accounting records.	☐	☐
The cut-off assertion ensures that transactions are recorded in the correct accounting period.	☐	☐
The accuracy assertion ensures that transactions are recorded in the correct accounts and properly classified.	☐	☐

(a)(ii) Identify the key assertion relating to account balances in auditing for each example. (3 marks)

Example	Assertion about balances
All trade receivables at the year-end are included in the financial statements, with no invoices or customer balances omitted from the records.	▼
A bank loan repayable within 12 months is correctly classified as a current liability rather than a non-current liability.	▼
A company legally owns a machine included under non-current assets, and any loans recorded as liabilities are actual obligations the company is required to repay.	▼

Picklist: existence, rights and obligations, completeness, accuracy, classification, presentation.

(b)(i) Identify TWO appropriate audit procedures to test the existence of non-current assets. (2 marks)

- [ ] Physically inspect non-current assets such as property, plant, and equipment to confirm they exist.
- [ ] Trace non-current assets from the financial statements to supporting purchase invoices and supplier documentation.
- [ ] Review board minutes and legal documents to confirm ownership of major assets.
- [ ] Obtain written representations from management confirming that non-current assets exist at the year-end.

(b)(ii) Identify TWO appropriate items that could be inspected to test the accuracy of cash and bank balances in the financial statements. (2 marks)

- [ ] Loan agreements and overdraft facility letters confirming legal rights and obligations over bank balances.
- [ ] Bank statements for the financial period.
- [ ] Financial statement disclosure notes showing cash and bank balances, including any restrictions.
- [ ] Bank reconciliation supporting documents, such as outstanding lodgements and unpresented cheques.

(c) Identify the sampling method used in each of the following examples.

(3 marks)

Example	Sampling method
An auditor selects every 20th invoice from the sales ledger, starting from a randomly chosen point.	
An auditor selects purchase invoices from a file in a random manner without using any structured pattern or statistical technique.	
An auditor selects all invoices from a specific week or month for testing.	

Picklist: monetary unit sampling, haphazard selection, block selection, systematic selection.

(d) Complete the following sentences. (2 marks)

An audit has a low tolerable misstatement and a high expected error rate, which would result in the auditor selecting a ______ sample size.

An audit has found that internal controls are strong and operating effectively through testing, which would allow the auditor to use a ______ sample size.

Picklist: smaller, larger, similar.

End of Task

Task 8 (10 marks)

This task is about audit evidence and the use of digital techniques in auditing.

This task contains parts (a) to (b).

(a)(i) Identify the appropriate verification technique used by the auditor for each audit procedure. (3 marks)

Audit procedure	Verification technique
The auditor asks the receivables manager why there is a large overdue receivable balance and is informed that the customer is disputing the invoice.	
The auditor independently repeats a bank reconciliation prepared by the client to verify that it was carried out correctly and effectively.	
The auditor performs ratio analysis by comparing current-year figures with those of prior years to assess whether the financial information appears reasonable.	

Picklist: inspection, enquiry, observation, reperformance, analytical procedures.

An auditor is gathering audit evidence to verify the existence of bank and cash balances.

(a)(ii) Identify if the following items of evidence are reliable or not reliable.
(2 marks)

Audit evidence	
Bank confirmation received directly from the bank.	
Bank reconciliation prepared by the client.	

Picklist: reliable, not reliable.

Digital techniques or remote working can be used to test controls and interrogate an organisation's files.

(b)(i) Identify TWO drawbacks of using digital techniques. (2 marks)

Risk of cyberattacks. ☐

Requirement for specialist technical skills. ☐

Limited physical verification. ☐

Reduced team interaction. ☐

(b)(ii) Identify the type of digital technique used for each of the following audit tests. (3 marks)

Audit test performed	Type of digital technique
The auditor creates a dummy employee in the payroll system and processes test payroll transactions to check whether payroll controls are operating effectively.	
The auditor enters both valid and invalid sales orders into the system to test whether it correctly processes and rejects transactions.	
The auditor analyses sales data to identify unusual revenue spikes and detect anomalies that require further investigation.	

Picklist: data analytic tools, integrated test facilities, audit software, test data.

End of Task

Task 9 (10 marks)

This task is about audit findings.

This task contains parts (a) to (c).

A company failed to disclose fraud committed by a senior manager, even though the amount involved was relatively small.

(a)(i) Complete the following sentence. (1 mark)

This matter is [▼].

Picklist: material, not material.

(a)(ii) Identify whether the following statements are true or false. (3 marks)

	True	False
A misstatement that could influence the economic decisions of users of the financial statements is considered material.	☐	☐
A transaction processed without the required authorisation is an example of a deviation from an organisation's prescribed procedures and should be investigated further by the auditor.	☐	☐
Non-routine transactions and related party transactions are less risky than routine transactions and therefore require less audit attention.	☐	☐

A loan is granted by the company to one of its directors.

(a)(iii) Identify ONE of the following that may represent a deviation from the company's prescribed procedures. (1 mark)

Unauthorised transactions.	☐
Non-routine transactions.	☐
Related party transactions.	☐
Suspected fraud.	☐

(b) Identify which ONE of the following is a correct element of a report on deficiencies in internal control. (1 mark)

- [ ] A detailed prediction of future company profits based on the control weakness identified.
- [ ] A description of the deficiency and its potential impact on the financial statements.
- [ ] A personal opinion on the competence of individual employees involved in the control system.
- [ ] A guarantee that no further errors or fraud will occur after the audit.

The auditor identifies that several purchase orders were raised and processed without the required managerial approval.

(c)(i) Identify ONE possible impact that this control deficiency may have on the company. (1 mark)

- [ ] Unauthorised or unnecessary purchases.
- [ ] Financial loss and potential misstatement of income and assets.
- [ ] Fraudulent or invalid expenses being reimbursed to employees.
- [ ] Unauthorised access and manipulation of financial records.

(c)(ii) Identify TWO recommendations for this control deficiency. (2 mark)

- [ ] The system should be set to prevent processing until approval has been obtained.
- [ ] Duties should be separated so that different employees are responsible for recording and authorising transactions.
- [ ] Each employee should use a unique login with strong password controls and regular password updates.
- [ ] All purchase orders should require formal managerial approval before being processed.

(c)(iii) Complete the following sentence. (1 mark)

Deficiencies in internal control are reported to the [▼] .

Picklist: management and its shareholders, management only, audit committee only, management and the audit committee.

End of Task

Mock Exam One Solutions

AAT Level 4

Audit and Internal Controls

Task 1 - Solutions (10 marks)

A company regularly performs physical inventory counts and reconciles them to inventory records.

(a) Identify the two primary objectives served by this internal control. (2 marks)

Compliance with laws and regulations.	☐
Safeguard assets.	☑
Facilitate operations.	☐
Ensure quality of internal and external reporting.	☑

- The control may contribute to compliance with laws and regulations, particularly in industries where maintaining accurate inventory records is a regulatory requirement. However, compliance is not the main purpose of this control.
- Regular physical inventory counts and reconciliation to inventory records primarily help to safeguard assets. By comparing physical stock to recorded inventory balances, an organisation can identify missing, stolen, damaged, or misplaced inventory and take appropriate action to protect its assets.
- Accurate inventory records can support operational efficiency by helping management make better purchasing and planning decisions. However, facilitating operations is not the main purpose of this control.
- This control helps to ensure the quality of internal and external reporting. Reconciling physical inventory to accounting records improves the accuracy of inventory balances, resulting in more reliable financial statements.

The purpose of internal controls:

- Facilitate the efficient and effective operation of the organisation.
- Safeguard the organisation’s assets from loss, theft, or misuse.
- Prevent and detect fraud and errors.
- Ensure the accuracy, reliability, and quality of internal and external reporting.
- Promote compliance with applicable laws, regulations, and organisational policies.

An internal audit team regularly reviews payroll, purchasing, or cash handling procedures to confirm that controls are operating as intended. The board of directors or audit committee regularly oversees management and reviews control related issues.

(b) Identify the two key components of internal control demonstrated by this example. (2 marks)

The control environment.	☑
Control activities.	☐
The information system and communication.	☐
The entity's process to monitor its systems of internal control.	☑

An internal audit team regularly reviews payroll, purchasing, or cash handling procedures to confirm that controls are operating as intended. This describes the entity's process to monitor its systems of internal control and refers to the procedures used to assess whether internal controls are operating effectively and to identify any weaknesses that need to be addressed. Examples include internal audits, management reviews, supervisory reviews and exception report reviews.

The board of directors or audit committee regularly oversees management and reviews control related issues. This describes the control environment. The control environment is the foundation of the internal control system. It reflects the organisation's culture, ethics, governance, and managements attitude toward internal control. Examples include code of conduct and ethics policy, management commitment to internal controls, independent board oversight, clear organisational structure, competent employees and a zero-tolerance approach to fraud.

There are five key components of an internal control system. Together, they ensure that internal controls are well-designed, properly implemented, and effectively monitored in order to support operations, reporting, compliance, and the safeguarding of assets.

- **The control environment**. This refers to the overall "tone" of the organisation set by management and directors. It influences how seriously internal controls are taken and includes factors such as ethics, integrity, leadership style, and organisational culture.
- **The entity's risk assessment process**. This is the process by which the organisation identifies and evaluates risks that could prevent it from achieving its objectives. It involves recognising financial, operational, and compliance risks.
- **The entity's process to monitor the systems of internal control**. This is the ongoing process of reviewing whether internal controls are operating effectively. It includes activities such as internal audits and regular management reviews.

- **The information system and communication**. This refers to how information is recorded, processed, and communicated within the organisation. It ensures that financial and operational data is accurate, timely, and properly shared.
- **Control activities**. These are the specific policies and procedures used to reduce risk and achieve organisational objectives. They include segregation of duties, authorisations, reconciliations, and physical controls.

(c) Identify the most suitable type of internal control to address each accounting weakness. (4 marks)

Accounting weakness	Internal control
Cash is stored in an unlocked drawer that is accessible to all employees.	**Physical**
The company hires accounting staff without checking their qualifications, experience, or references.	**Personnel**
The accounting system allows invoices to be entered without validating key information such as supplier number, invoice date, or invoice amount.	**Information Processing**
One employee creates suppliers, processes invoices, and authorises payments.	**Segregation of Duties**

Cash is stored in an unlocked drawer that is accessible to all employees. This weakness can lead to cash being stolen or misappropriated, unauthorised access to company assets, difficulty detecting or investigating losses, and an increased risk of fraud. This is a weakness in physical controls, which are designed to protect an organisation's assets, records, and facilities from unauthorised access, theft, damage, or loss. Examples of physical controls include locked cash safes, restricted access to warehouses or secure areas, CCTV monitoring in cash-handling locations, and locked filing cabinets used to store sensitive financial records.

The company hires accounting staff without checking their qualifications, experience, or references. This weakness can result in unqualified employees making accounting errors, increased risk of fraud due to lack of background checks, inaccurate financial records, and staff being unfamiliar with company procedures or accounting standards. This is a weakness in personnel controls, which relate to ensuring employees are competent, trustworthy, and properly supervised in carrying out their duties. The purpose of this control is to ensure that staff are suitably qualified and reliable to perform their roles effectively. Examples of personnel controls include conducting background checks before hiring finance staff, verifying qualifications, experience, and references, providing professional training and ongoing development, carrying out performance evaluations, and rotating staff in key financial roles.

The accounting system allows invoices to be entered without validating key information such as supplier number, invoice date, or invoice amount. This weakness can result in incorrect data being recorded, transactions being processed with errors, and financial reports becoming inaccurate. This is a weakness in information processing controls, which are designed to ensure that transactions are processed completely, accurately, and only once. The purpose of this control is to detect and prevent errors during data entry and processing. Examples include input validation checks, mandatory fields that must be completed before processing, duplicate transaction checks, automatic sequential numbering of invoices to identify missing entries, automated calculations, batch controls, and reasonableness checks.

One employee creates suppliers, processes invoices, and authorises payments. This weakness can lead to an increased risk of fraud or misappropriation of company funds, for example the employee could create a fictitious supplier, process false invoices, and authorise payments to themselves or an accomplice. It also reduces independent review, meaning errors or fraud may go undetected, this increases the likelihood of unauthorised or duplicate payments, and weakens accountability. This is a weakness in segregation of duties, which requires different individuals to be responsible for different stages of a transaction. The purpose of this control is to reduce the risk of fraud and error by ensuring no single person has control over the entire process, typically separating responsibilities for authorisation, recording, and custody of assets.

Types of internal controls:

- **Authorisation and approval** e.g. transactions and activities must be approved by an appropriate person before they are carried out.
- **General IT controls** e.g. controls over IT systems, such as passwords, access rights, backups, and cybersecurity measures.
- **Information processing controls** e.g. controls to ensure data is processed accurately, completely, and correctly within accounting and information systems.
- **Organisational** e.g. clear reporting lines, responsibilities, and authority within the organisation.
- **Personnel** e.g. recruitment, training, performance reviews, and staff rotation to ensure competent and trustworthy employees.
- **Physical or logical controls** e.g. protect assets and information through locks, safes, CCTV, passwords, encryption, and access restrictions.
- **Reconciliations** e.g. compare two sets of records such as bank statements and cash book to identify and correct discrepancies.
- **Segregation of duties** e.g. separate responsibilities among different employees to reduce the risk of errors and fraud.
- **Supervision** e.g. managers oversee employees work to ensure procedures are followed correctly.
- **Verification** e.g. independent checking of transactions, records, or calculations to confirm their accuracy.

(d) Identify which ONE of the following is not a limitation of internal controls.

(1 mark)

Inefficiency	☑
Collusion	☐
Fraud	☐

Inefficiency is generally not considered a limitation of internal controls. A limitation of internal controls refers to factors that can prevent controls from achieving their objectives even when they are properly designed and implemented. Inefficiency, by contrast, is typically the result of weak or poorly designed controls rather than a fundamental limitation. Examples include excessive approval layers that cause delays, duplicate reviews of the same transaction, or unnecessarily complex procedures that reduce operational effectiveness.

Collusion is a key limitation of internal controls, occurring when two or more individuals work together to circumvent controls that would otherwise operate effectively. Similarly, sophisticated fraud schemes may be deliberately structured to avoid detection, allowing individuals to bypass established controls despite their design and implementation. These factors highlight why internal controls can provide only reasonable, rather than absolute, assurance that organisational objectives will be achieved.

Limitations of Internal Controls:

- Human error and mistakes.
- Collusion among employees.
- Management override of controls for personal gain.
- Cost-benefit considerations.
- Changes in business conditions that render controls ineffective.
- Fraud and deliberate circumvention of controls.
- Failure to consistently apply control procedures.

(e) Identify if the following statement is true or false. (1 mark)

	TRUE	FALSE
Organisations should implement internal controls that are appropriate to their level of risk, operational complexity, and transaction volume.	☑	☐

This statement is true. Different types of internal controls are suited to different organisations depending on their size (small, medium, or large) and their nature of operations (cash-based, credit-based, or online).

A small business may rely on owner oversight and basic control procedures, whereas a large organisation may require an internal audit department and extensive segregation of duties. Similarly, cash-based businesses need strong cash-handling controls, while online businesses require cybersecurity measures such as encryption and two-factor authentication. Therefore, internal controls should be tailored to the specific risks and operational needs of each organisation.

Task 2 - Solutions (10 marks)

This section of the exam covers control objectives within key accounting systems, including sales, purchases, payroll, inventory, non-current assets, and bank and cash systems. It also examines the risks associated with these accounting systems and the control procedures implemented to mitigate those risks and ensure accurate, reliable, and secure financial reporting.

- Internal control objectives are the goals that an organisation's internal control system is designed to achieve e.g. facilitate operations, safeguard assets, prevent and detect fraud, ensure quality of internal and external reporting, and compliance with laws and regulations.
- Risks within accounting systems are events or circumstances that may result in errors, fraud, inefficiencies, or misstatements in financial records and transactions.
- Control procedures are the measures implemented by management to help achieve internal control objectives and reduce the risks associated with accounting systems e.g. authorisation and approval, general IT controls, information processing controls, organisational, personnel, physical or logical controls, reconciliations, segregation of duties, supervision and verifications.

(a)(i) Match each control procedure with its most likely control objective. (4 marks)

Control procedure	Control objective
Use of pre-numbered invoices and delivery notes.	**Sales are recorded completely**
Sales invoices are raised only for approved customer orders.	**Only valid sales are recorded**
Automated calculation of pricing and VAT on sales invoices.	**Sales are recorded accurately**
Sending customer statements and reconciling them with customer accounts.	**Accounts receivable balances are accurate and up to date**

(a)(ii) Complete the following sentence. (1 mark)

Credit checks before allowing credit sales **will not** reduce the risk of errors or omissions.

Credit checks are control procedures designed to assess whether a customer is financially reliable and reduce the risk of bad debts. They do not directly affect whether sales are recorded correctly, or whether transactions are missed or incorrectly entered.

Revision summary for a sales accounting system:

Control objective	Control procedures
Only valid sales are recorded	- Sales invoices raised only with approved customer orders
	- Match invoices to authorised delivery notes
	- Credit checks before allowing credit sales
Sales are recorded completely (no omissions)	- Use pre-numbered invoices and delivery notes
	- Sequence checks for missing/duplicate documents
	- Ensure all dispatches are invoiced
Sales are recorded accurately	- Automated pricing and VAT calculations
	- Independent checking of invoices before posting
Cash received from customers is correctly recorded	- Daily bank reconciliations
	- Match receipts to customer accounts
	- Segregation of duties between cash handling and recording
Accounts receivable balances are accurate and up to date	- Send and reconcile customer statements
	- Prompt recording of customer payments
	- Monthly aged receivables review by management

(b) Complete the following sentences. (5 marks)

The general accounts clerk notifies the accounts receivable department by email whenever a credit customer settles an outstanding invoice, this increases the risk that **customer payments are not recorded accurately or promptly**.

Email notification is a manual and informal communication method, which increases the risk that information could be delayed, missed, or incorrectly communicated. This affects timely and accurate recording, not fraud or misappropriation (those would relate more to handling of cash or access to funds).

Fraud risk would mean someone is creating fake payments or fake customers, but the payment is already made by a credit customer, the issue is just communication of that payment. The clerk is not handling cash or bank transfers they are only sending an email notification after payment has already occurred, so there is no opportunity to steal or redirect funds in this process.

A control procedure to reduce this risk could be to **implement an integrated accounting system**.

An integrated accounting system means that when a customer payment is recorded, it is automatically updated in accounts receivable. This removes reliance on manual email communication and reduces the risk of delays, omissions, or errors in recording payments, so it directly addresses the problem of payments not being recorded accurately or promptly.

Updating the computerised cash book software improves the cash book itself, but does not fix communication between departments, the problem is not software age, but manual notification delays. Limiting access to online banking is a security control (fraud prevention), it does not improve timeliness or accuracy of recording customer receipts.

If one employee handles cash and another employee performs physical cash counts and reconciliations, this reduces the risk that **cash is stolen and concealed**.

This control procedure is designed to safeguard cash and detect cash discrepancies, because the person who has custody of the cash is not the same person who verifies the cash balance and performs reconciliations, any theft or misappropriation is more likely to be detected. This is a segregation of duties control as one employee handles cash and another independently counts and reconciles it. This reduces the opportunity for someone to steal cash and then hide the theft by manipulating records, so it directly prevents fraud involving theft and the concealment of cash.

Customer payments not recorded accurately relates more to sales recording and invoicing systems, not specifically prevented by the segregation of duties for cash handling and reconciliation. Unauthorised supplier payments made relates to the purchasing or payables system, not cash handling or reconciliation of cash receipts.

Dual signatures required before a cheque is processed by the bank provides **an authorisation** control.

Dual signatures mean the cheque must be approved by authorised individuals before payment is made (in the scenario, cheques require the signatures of both individuals before they can be processed by the bank). This ensures transactions are properly authorised before funds are released. It would not be supervision as this involves overseeing staff activities, not approving payments. It would not be a physical control as this involves safeguarding assets e.g. safes, locks, not signing cheques.

Requiring dual signatures before a cheque is processed by the bank is more likely to achieve the control objective that **only valid business payments are made**.

Dual signatures on cheques ensure that payments are reviewed and approved before being made and that only legitimate, authorised business transactions are processed. The control objective focuses on validity and authorisation of payments. Cash is physically safeguarded relates more to physical controls e.g. safes, restricted access, not cheque authorisation. Cash records are accurate relates more to recording controls e.g. reconciliations, bookkeeping accuracy, not approval of payments.

Task 3 - Solutions (10 marks)

This section of the exam covers the common types of fraud that can occur within an organisation, including fraudulent financial reporting and the misappropriation of assets. It also examines the fraud risk assessment process, which involves identifying fraud risks, evaluating their likelihood and impact, responding to risks through appropriate management or mitigation measures, ensuring compliance with legal and regulatory requirements, and continuously monitoring, reviewing, and reporting on fraud risks. In addition, the section includes the potential financial and non-financial consequences for an organisation when fraud occurs.

(a) Identify the following types of fraud. (2 marks)

	Type of fraud
Stealing cash from sales before it is entered into the accounting records.	**misappropriation of assets**
Delaying the recording of invoices to understate expenses and make the business appear more profitable.	**fraudulent financial reporting**

- Fraudulent financial reporting involves intentionally manipulating or falsifying financial statements to mislead users. This may include overstating revenues, understating expenses, or hiding liabilities in order to present a stronger financial position or better performance than actually exists.
- Misappropriation of assets involves the theft or misuse of a company's resources by employees or others. This can include stealing cash, diverting customer payments, or using company assets for personal benefit without authorisation.

A company aims to reduce the risk of differences between physical inventory counts and recorded inventory balances caused by fraudulent activities such as theft.

(b) Identify whether each internal control procedure relates to the monitoring, reviewing, or reporting component of the fraud risk assessment process.
(3 marks)

Internal control procedure	Component
The Inventory Manager investigates inventory variances exceeding 4% on a monthly basis.	**reviewing**
Any unexplained inventory variance greater than £5,000, the system automatically informs the Finance Director and Internal Audit team.	**reporting**
Warehouse supervisors conduct weekly cycle counts of high-value inventory items.	**monitoring**

- **The Inventory Manager investigates inventory variances exceeding 4% on a monthly basis.** This procedure relates to **reviewing** because it involves analysing and assessing the results of monitoring activities. When inventory variances exceed 4%, the Inventory Manager investigates the cause of the discrepancy to determine whether it resulted from errors, operational issues, or potential fraud. This review process helps management evaluate the effectiveness of inventory controls and identify areas requiring corrective action.
- **Any unexplained inventory variance greater than £5,000, the system automatically informs the Finance Director and Internal Audit team.** This procedure relates to **reporting** because it involves communicating significant issues to individuals responsible for oversight and decision-making. Automatic notification of large unexplained variances ensures that senior management and Internal Audit are made aware of potential fraud risks in a timely manner. This allows them to investigate the matter further and take appropriate corrective or disciplinary action where necessary.
- **Warehouse supervisors conduct weekly cycle counts of high-value inventory items.** This procedure relates to **monitoring** because it involves the ongoing observation and checking of inventory levels. By conducting weekly cycle counts, warehouse supervisors compare physical inventory quantities with inventory records on a regular basis. This helps to identify discrepancies promptly and detect potential theft or other fraudulent activities before significant losses occur.

This demonstrates how monitoring detects potential issues, review assesses the results, and reporting escalates significant concerns to the appropriate level of management.

(c)(i) Identify the type of fraud committed by the Accounts Receivable Supervisor.

(1 mark)

Teeming and lading.	☐
Fictitious customers.	☐
Payment diversion fraud.	☑

- Teeming and lading is a type of fraud where an employee steals a customer's payment and then conceals the theft by using receipts from other customers to cover the shortfall. Each new customer payment is used to offset a previous shortage, creating a continuous cycle of concealed misappropriation. This answer is invalid because the scenario stated that no attempt was made to conceal the fraud other than correctly processing customer payments.
- A common form of sales fraud is the use of fictitious customers, which involves creating fake customer accounts and recording sales that never actually occurred in order to inflate revenue. This answer does not match the fraud described in the

scenario and the Accounts Receivable Supervisor did not have authority to raise sales invoices.

- The Accounts Receivable Supervisor committed payment diversion fraud. She opened personal bank accounts with names that closely resembled those of legitimate customers and then diverted customer cheque payments into these accounts for her own benefit. This involved intentionally redirecting funds that were owed to the company into accounts under her control.

(c)(ii) Complete the following sentence. (1 mark)

The fraud was most likely caused by **lack of segregation of duties**.

- The use of individual user IDs and passwords is a detective and accountability control because it provides an audit trail of changes made to customer credit accounts. However, it would not have prevented the fraud, as the Accounts Receivable Supervisor was authorised to update customer accounts.
- The primary internal control weakness was the lack of segregation of duties. The Accounts Receivable Supervisor was able to both receive customer cheques and update customer accounts, allowing her to divert payments and conceal the fraud without immediate detection. This concentration of responsibilities created the opportunity for the fraud to occur.
- Supervision over cashbook updates would have limited value, because the Accounts Receivable Supervisor did not have responsibility for updating the cashbook. Also, since the cheques never reached the company's bank account, the person updating the cashbook would have no corresponding bank receipt to record, even if supervised.

To conceal missing customer payments in the accounts receivable system, the Accounts Receivable Supervisor may have manipulated customer account records in order to hide the absence of receipts and prevent discrepancies from being detected.

(c)(iii) Identify how the Accounts Receivable Supervisor may have concealed any missing customer payments in the accounts receivable system. (1 mark)

Transfer payment credits between customer accounts to disguise missing receipts.	☑
Ignore bank correspondence and unrecorded customer account payments.	☐
Process unauthorised credit notes to conceal outstanding customer balances.	☐

- The Accounts Receivable Supervisor may have concealed missing customer payments by transferring payment credits between customer accounts in order to disguise the absence of receipts and reduce outstanding balances (teeming and lading).

- Ignoring bank correspondence and failing to properly record customer payments would not effectively conceal this type of fraud because customer balances would remain outstanding even though payments had been made. Over time, customers may identify these discrepancies, particularly when they receive and review customer statements.
- Unauthorised credit notes are processed is not applicable, only because the scenario stated that the Accounts Receivable Supervisor did not have authority to issue credit notes.

(c)(iv) Identify TWO internal control procedures that could help prevent or detect this fraud. (2 marks)

Send customer statements on a regular basis.	☑
Sales orders and invoices should require authorisation.	☐
New customer accounts should require authorisation before set-up.	☐
Two employees should open post and record all cheque receipts.	☑

- **Send customer statements on a regular basis.** This would help detect the fraud because customers would be able to compare their own payment records with the statement they receive. If cheques had been diverted and not properly credited to their accounts, customers would notice missing payments or incorrect balances and raise queries with the company. This would quickly alert the business to discrepancies in the accounts receivable records, making it easier to investigate and identify the fraudulent diversion of funds.
- **Sales orders and invoices should require authorisation.** This would not help prevent or detect this fraud because the issue is not with the creation or approval of sales transactions, but with the handling of customer payments after invoicing has already taken place. Also, the supervisor did not have system authority to raise sales orders or invoices.
- **New customer accounts should require authorisation before set-up.** This would not help prevent or detect this fraud because it involved diverting payments from existing customers into fake bank accounts, not creating fictitious customer accounts.
- **Two employees should open post and record all cheque receipts.** This would help prevent the fraud because it introduces segregation of duties. If two people open the mail and immediately log all cheques received, it becomes much harder for one person to intercept cheques without detection or alter records to conceal missing payments.

Task 4 - Solutions (15 marks)

This section of the exam covers:

- The concepts and principles of audit and assurance.
- The regulatory environment.
- The role of corporate governance in the audit and assurance process.
- The role of internal audit.

(a) Identify if the following statements are true or false. (3 marks)

Statement	TRUE	FALSE
The mistaken belief that auditors guarantee the absence of all fraud or guarantee a company's future success is an example of limited assurance.	☐	☑
An audit is a type of assurance engagement in which an independent auditor provides reasonable assurance that the financial statements are free from material misstatement.	☑	☐
A negative expression of assurance is used in reasonable assurance engagements, such as audits.	☐	☑

The mistaken belief that auditors guarantee the absence of all fraud or guarantee a company's future success is an example of limited assurance. **The statement is false.** The mistaken belief that auditors guarantee the absence of all fraud or guarantee a company's future success is an example of the audit expectation gap. The audit expectation gap arises when the public expects auditors to provide assurances or guarantees that go beyond their actual responsibilities. Auditors provide reasonable assurance, not absolute assurance, and they do not guarantee future business success.

An audit is a type of assurance engagement in which an independent auditor provides reasonable assurance that the financial statements are free from material misstatement. **The statement is true.** An audit is a type of assurance engagement in which an independent auditor obtains sufficient appropriate evidence to provide reasonable assurance that the financial statements are free from material misstatement, whether caused by fraud or error. The auditor then expresses an opinion on whether the financial statements present a true and fair view.

A negative expression of assurance is used in reasonable assurance engagements, such as audits. **The statement is false.** A positive (not negative) expression of assurance is used in reasonable assurance engagements, where the auditor directly states an opinion on the financial statements ("In our opinion, the financial statements give a true and fair view."). Negative assurance is used in limited assurance engagements, where the practitioner concludes that nothing has come to their attention that indicates a material misstatement ("Nothing has come to our attention that causes us to believe the financial statements are materially misstated.").

(b)(i) Identify which ONE of the following is a role of the International Auditing and Assurance Standards Board (IAASB). (1 mark)

To develop global standards for sustainability-related financial disclosures.	☐
To provide the legal framework for company reporting and auditing requirements.	☐
To develop and issue International Standards on Auditing (ISAs) and other assurance standards.	☑
To regulate audits by setting ethical standards, technical guidance, and professional requirements that auditors must follow.	☐

To develop global standards for sustainability-related financial disclosures. This is not correct because this role belongs to the International Sustainability Standards Board (ISSB). The ISSB focuses on sustainability and ESG reporting standards, not auditing standards.

To provide the legal framework for company reporting and auditing requirements. This is not correct because this is the role of the Companies Act. The IAASB does not create laws, it issues professional auditing standards.

To develop and issue International Standards on Auditing (ISAs) and other assurance standards. This is correct because the IAASB is specifically responsible for setting global auditing and assurance standards. These ISAs guide how audits are planned, performed, and reported to ensure consistency and quality worldwide.

To regulate audits by setting ethical standards, technical guidance, and professional requirements that auditors must follow. This is not correct because this role is mainly carried out by professional accountancy bodies (such as ACCA or ICAEW). They regulate members through ethical codes, training requirements, and disciplinary systems, rather than issuing ISAs.

(b)(ii) Identify whether an auditor's liability is owed to the following stakeholders of the company. (3 marks)

Auditor's liability	
The company.	Yes
Shareholders of the company.	Yes
Customers of the company.	No

- **The company.** Yes, the auditor's liability is owed to the company. The auditor has a duty of care to the company as a legal entity, and may be liable for negligence if the audit is not carried out with reasonable skill and care.
- **Shareholders of the company.** Yes, but generally to shareholders as a whole (the body of members), not usually to individual shareholders. Liability may arise if shareholders rely on the audited financial statements and suffer loss due to auditor negligence.
- **Customers of the company.** No, the auditor's liability is generally not owed to customers. Customers are considered third parties, and auditors are only liable to them in very limited cases where specific and foreseeable reliance on the audit report can be proven.

(b)(iii) Complete the following sentence. (1 mark)

Professional indemnity insurance (PII) is normally required by **auditors**.

- **Auditors.** This is the correct answer because they are usually required to hold professional indemnity insurance (PII). This protects them if they are sued for negligence, errors, or failing to carry out an audit properly. Since auditors provide professional services and can be legally liable for mistakes, PII is essential to cover potential compensation claims.
- **Directors.** Directors are not normally required to hold PII for auditing work. Instead, they are responsible for managing the company and may have directors' and officers' (D&O) insurance, which protects them personally against claims related to their management decisions. However, this is different from auditor PII and is not related to audit liability.
- **Shareholders.** Shareholders are not required to hold PII. They are the owners of the company and do not perform professional services that expose them to negligence claims in the same way auditors do. Therefore, there is no requirement for them to have professional indemnity insurance.

(c)(i) Identify which ONE is not a principle of the UK Corporate Governance Code.
(1 mark)

The financial statements.	✅
Board leadership and company purpose.	☐
Division of responsibilities.	☐
Audit, risk and internal control.	☐

- **The financial statements.** This is not a principle of the UK Corporate Governance Code. The Code focuses on governance structure and board responsibilities, not the preparation or content of financial statements. Financial statements are governed by accounting standards and company law, not the Code itself.
- **Board leadership and company purpose.** This is a principle of the Code. It emphasises that the board should lead the company effectively and promote its long-term sustainable success.
- **Division of responsibilities.** This is a principle of the Code. It ensures a clear separation of roles within the board, such as the Chair, CEO, and other directors, to avoid concentration of power.
- **Audit, risk and internal control.** This is a principle of the Code. It focuses on maintaining effective systems for financial reporting, risk management, and internal control to protect stakeholders and ensure transparency.

(c)(ii) Complete the following sentence. (1 mark)

A key feature of the UK Corporate Governance Code is the **comply or explain** principle.

The **comply or explain principle** is a key feature of the UK Corporate Governance Code. It requires companies to either comply with the provisions of the Code or, if they choose not to, explain clearly in their annual report why they have not complied and how they are still achieving good governance in another way.

This approach provides flexibility, allowing companies to depart from specific rules if they have a valid reason, while still maintaining transparency for shareholders and other stakeholders. Investors can then decide whether they are satisfied with the explanation given or whether the company's governance is adequate.

(c)(iii) Identify the following responsibilities of internal and external auditors in relation to fraud and errors. (2 marks)

Responsibilities	
Responsible for reviewing and improving the company's internal controls to help prevent and detect fraud and error.	**internal auditors**
Responsible for obtaining reasonable assurance that the financial statements are free from material misstatement caused by fraud or error.	**external auditors**

- Internal auditors are responsible for reviewing and improving the company's internal controls to help prevent and detect fraud and error. They work as part of the organisation and continuously monitor systems, identify risks, and recommend improvements. However, they do not provide an independent opinion on the financial statements.
- External auditors are responsible for obtaining reasonable assurance that the financial statements are free from material misstatement caused by fraud or error. They plan and perform audit procedures to detect material fraud or errors, but they are not responsible for preventing fraud. Their role is to provide an independent opinion, not to guarantee that all fraud has been detected.

(d)(i) Identify TWO functions of internal audit. (2 marks)

- [x] Conducting special investigations.
- [ ] Preparing financial statements that give a true and fair view.
- [x] Reviewing systems of internal control.
- [ ] Ensuring directors are accountable for how the company is managed.

The two correct functions of internal audit are conducting special investigations and reviewing systems of internal control. Internal auditors are responsible for carrying out special investigations when specific issues arise within the organisation, such as suspected fraud, irregular transactions, or weaknesses in procedures. They examine the issue in detail, gather evidence, and report their findings along with recommendations for improvement. Internal audit also involves reviewing systems of internal control to ensure they are effective and operating as intended. This helps the organisation identify risks, prevent errors or fraud, and improve overall efficiency.

The other options are incorrect because preparing financial statements that give a true and fair view is the responsibility of directors, while ensuring directors are accountable for how the company is managed is normally the role of shareholders.

(d)(ii) Identify ONE risk associated with a lack of independence. (1 mark)

The auditor's opinion may be biased or influenced by the client.	☑
There may be inadequate oversight of management.	☐
Ineffective decision-making leading to financial losses.	☐
The auditor's will have to personally cover any legal claims or compensation costs.	☐

- **The auditor's opinion may be biased or influenced by the client.** A lack of independence means the auditor may not act objectively. This creates a risk that their judgement is influenced by the client, leading to a biased audit opinion and reduced reliability of the financial statements.
- **There may be inadequate oversight of management.** This is a risk of poor corporate governance, not independence.
- **Ineffective decision-making leading to financial losses.** This is a risk of poor management.
- **The auditor's will have to personally cover any legal claims or compensation costs.** This is a risk related to lack of professional indemnity insurance, not independence.

Task 5 - Solutions (10 marks)

This section of the exam covers:

- The components of audit risk e.g. inherent risk, control risk and detection risk.
- How auditors manage detection risk.
- The factors that affect inherent risk and control risk.
- How analytical procedures can be used to identify potential understatement or overstatement of items in the financial statements.
- Misstatements in the financial statements can arise from either fraud or error.
- Types of fraud that are relevant to the auditor.
- The concept of materiality e.g. performance materiality and materiality for the financial statements as a whole.
- The role of materiality in planning an audit and evaluating misstatements.
- Methods used to calculate materiality thresholds.
- The difference between material and material and pervasive.

(a)(i) Identify TWO factors that affect inherent risk. (2 marks)

Complexity of transactions.	☑
Effectiveness of internal controls.	☐
Susceptibility of assets to fraud.	☑
Quality of segregation of duties.	☐

Inherent risk is the susceptibility of an account balance or transaction to material misstatement before considering internal controls. Control risk is the risk that internal controls fail to prevent or detect and correct misstatements.

- **Complexity of transactions.** More complex transactions increase the likelihood of errors or misstatements, raising inherent risk.
- **Effectiveness of internal controls.** This affects control risk, not inherent risk, because inherent risk is assessed before considering controls.
- **Susceptibility of assets to fraud.** Items that are easily stolen or manipulated e.g. cash, increase the risk of material misstatement.
- **Quality of segregation of duties.** This is a control mechanism and affects control risk, not inherent risk.

(a)(ii) Identify which ONE of the following would be ineffective in reducing detection risk. (1 mark)

Increasing the sample size of audit testing.	☐
Using more experienced audit staff.	☐
Increasing reliance on client internal controls without additional testing.	☑
Performing more detailed substantive procedures.	☐

Detection risk is the risk that an auditor's procedures fail to detect a material misstatement in the financial statements, even though one exists. It is the risk that the auditor misses an error or fraud during audit testing.

- **Increasing the sample size of audit testing.** Larger sample sizes reduce sampling risk, meaning there is a lower chance that audit evidence is unrepresentative of the population.
- **Using more experienced audit staff.** More experienced auditors are better at identifying misstatements and applying professional judgement, reducing detection risk.
- **Increasing reliance on client internal controls without additional testing.** Simply relying more on internal controls does not reduce detection risk unless those controls are properly tested and proven reliable. Without additional audit work, the risk that errors go undetected remains high.
- **Performing more detailed substantive procedures.** More detailed testing increases the likelihood of detecting material misstatements, thereby reducing detection risk.

How auditors manage detection risk:

- Increase the extent of audit testing e.g. larger sample sizes.
- Use more effective and reliable audit procedures.
- Perform more substantive testing, especially detailed tests of transactions and balances.
- Assign more experienced or specialised audit staff to high-risk areas.
- Increase supervision and review of audit work.
- Carry out procedures closer to the year end to reduce the risk of misstatement going undetected.
- Introduce an element of unpredictability into audit testing.

(b)(i) Based on analytical procedures performed, indicate whether each of the following balances for the current period is likely to be understated, overstated, or neither understated nor overstated in the financial statements. (4 marks)

Item	Overstated	Understated	Neither
Cost of sales	☐	☐	☑
Discounts allowed	☑	☐	☐
Allowance for doubtful debts - adjustment	☐	☑	☐
Trade receivables	☐	☐	☑

Analytical procedures help auditors identify areas where financial statement figures appear inconsistent with expected patterns. These unusual movements do not directly prove misstatement but highlight areas where there is a risk of overstatement or understatement, requiring further detailed audit testing.

Examples

- Comparison with prior periods (trend analysis).
- Ratio analysis.
- Reasonableness testing and the relationship between financial statement items.
- Budgets, forecasts and industry comparisons.

Cost of sales

- Cost of sales as a percentage of revenue is a relative measure and is therefore not affected by the difference in the length of the two reporting periods.
- **20X5:** Cost of sales as a percentage of sales 6,162 ÷ 7,800 × 100 = 79.0%.
- **20X6:** Cost of sales as a percentage of sales 4,940 ÷ 6,175 × 100 = 80.0%.
- A slight increase in this cost ratio.
- Likely: Neither understated nor overstated.

Discounts allowed

- Discounts allowed as a percentage of revenue is a relative measure and is therefore not affected by the difference in the length of the two reporting periods.
- **20X5:** Discounts allowed as a percentage of sales 70 ÷ 7,800 × 100 = 0.9%. Discounts allowed represent reductions granted to customers for prompt payment. During the year, the discount policy provided for a 2% discount on early settlement. The actual discount rate of 0.9% of sales appears reasonable, as it indicates that only a proportion of customers paid within the discount period and qualified for the discount. If all customers had paid early, the expected discount rate would have been approximately 2% of sales. In auditing, this is an example of reasonableness testing used in analytical procedures. The purpose is to explain why an observed figure appears reasonable when compared with an expected amount. You are linking the recorded discount expense (0.9% of sales)

to the company's discount policy (2% available for early payment) and providing a logical explanation for the difference.

- **20X6:** Discounts allowed represent 4.9% of sales (303 ÷ 6,175 × 100). This is a significant increase compared with the previous year and cannot be regarded as a minor fluctuation. Furthermore, the discount rate exceeds the company's stated policy of offering a maximum discount of 4% for prompt payment, indicating a potential inconsistency that warrants further investigation.
- Likely: Overstated.

Allowance for doubtful debts – adjustment

- In 20X5, the allowance for doubtful debts represented 2% of sales (12.6 ÷ 631 × 100). In 20X6, the allowance for doubtful debts also represented approximately 2% of sales (28 ÷ 1,420 × 100). The allowance for doubtful debts has remained broadly consistent as a percentage of sales in both reporting periods.
- The allowance for doubtful debts adjustment recognised in the profit or loss for 20X6 is equal to the increase in allowance for doubtful debts during the period, being 15.4 (28.0 – 12.6). Based on the information provided, this adjustment appears to have been correctly recorded. Insufficient information is available to determine the corresponding profit or loss charge for 20X5.
- However, the reasonableness of the doubtful debt expense is dependent on the adequacy of the underlying allowance estimate. Despite significant changes in the company's credit risk profile, the allowance has remained unchanged at approximately 2% of sales.
- Credit terms have been extended from one month to two months, increasing customers' repayment periods and the associated credit risk. In addition, the company has expanded its customer base by attracting new customers, which may increase the risk of default. Given the longer credit terms, high receivables balance, and increased exposure to new customers, the risk of bad debts has increased significantly. Accordingly, the allowance for doubtful debts may not be proportionate to the increased level of credit risk and may therefore be understated, warranting further audit investigation.
- Likely: Understated.

Trade receivables

- **20X6** receivables days 1,420 ÷ 6,175 × 274 days (9 months) = 63 days (about 2 months) credit. The reporting period for 20X6 covers only nine months, so the ratio should be adjusted to reflect the shorter reporting period. A nine-month period ending 31 March 20X6 comprises 274 days (assuming a non-leap year); however, for analytical review purposes, using a nine-month adjustment rather than 274 days would be sufficiently precise.
- **20X5** receivables days 631 ÷ 7,800 × 365 days (12 months) = 30 days (about 1 month) credit.
- The increase is largely explained by extended credit terms.
- Likely: Neither understated nor overstated.

(b)(ii) Identify which ONE of the following analytical procedures is least likely to help detect potential overstatements or understatements of bad debts in the financial statements. (1 mark)

Calculate the allowance as a percentage of trade receivables and compare it with prior years.	☐
Analyse the proportion of overdue debts that are covered by the allowance.	☐
Compare sales trends by month with prior periods.	☑
Analyse the aged receivables listing and compare the proportion of overdue balances with previous periods.	☐

- **Calculate the allowance as a percentage of trade receivables and compare it with prior years.** This procedure is highly relevant for identifying potential misstatements in bad debts. By expressing the allowance for doubtful debts as a percentage of trade receivables and comparing it with previous periods, the auditor can assess whether the provision is consistent or changing appropriately. If trade receivables are increasing but the allowance percentage remains stable or falls, this may indicate that bad debts are understated.
- **Analyse the proportion of overdue debts that are covered by the allowance.** This is a very strong analytical procedure for assessing bad debt risk. It involves comparing overdue receivables (from aged receivables analysis) with the allowance for doubtful debts. If a large proportion of overdue debts is not covered by the allowance, this suggests that the provision may be understated. Conversely, if the allowance is excessively high compared to overdue balances, it may be overstated. This helps directly evaluate whether receivables are fairly valued.
- **Compare sales trends by month with prior periods.** This procedure is less useful for identifying issues with bad debts specifically. While sales trends can highlight unusual fluctuations or cut-off issues in revenue, they do not directly assess the collectability of receivables. Bad debts relate to whether customers will pay, not how much was sold or when sales occurred. Therefore, although this procedure may help identify revenue misstatements, it is not effective for assessing overstatement or understatement of bad debts.
- **Analyse the aged receivables listing and compare the proportion of overdue balances with previous periods.** This is one of the most important procedures for bad debts. The aged receivables listing shows how long debts have been outstanding, and comparing overdue balances over time helps identify deterioration in credit quality. An increase in older debts e.g. over 60 or 90 days, suggests higher risk of non-payment, meaning the allowance for doubtful debts may be understated. It is therefore a key tool for assessing whether receivables are fairly valued.

(c) Identify if the following statements are true or false. (2 marks)

Statement	True	False
Materiality is used at the planning stage to determine the nature, timing, and extent of audit procedures.	✓	
Materiality is always set at 10% of profit before tax.		✓

- **Materiality is used at the planning stage to determine the nature, timing, and extent of audit procedures.** This statement is true. At the planning stage, auditors set a materiality level which directly influences how the audit is designed. It affects the nature of audit procedures performed, the timing of when those procedures are carried out, and the extent of testing required, such as sample sizes. A lower materiality level results in more extensive and detailed audit work because even smaller misstatements may be considered significant.
- **Materiality is always set at 10% of profit before tax.** This statement is false. There is no fixed percentage or universal rule for determining materiality. Instead, auditors apply professional judgement and select appropriate benchmarks depending on the circumstances of the entity. Common benchmarks include profit before tax, revenue, total assets, or equity. The percentage applied also varies depending on factors such as risk and the nature of the business.

Task 6 - Solutions (10 marks)

This section of the exam covers:

- Why auditors need to understand the company's internal controls.
- The differences between tests of controls and substantive procedures.
- To determine when to use a mixture of tests of controls and substantive procedures or substantive procedures only.
- To identify how errors and irregularities can be mitigated by control procedures e.g. made less severe or less likely to happen.
- To identify suitable tests of control for accounting systems.

(a) Identify TWO reasons why auditors need to understand the company's internal controls. (2 marks)

To assess the risk of material misstatement in the financial statements.	✓
To guarantee that the company will make a profit in the future.	
To plan the nature, timing, and extent of audit procedures.	✓
To decide the salaries and bonuses of company employees.	

- **To assess the risk of material misstatement in the financial statements.** (Correct). Auditors evaluate internal controls to identify areas where errors or fraud could occur and affect the accuracy of the financial statements.
- **To guarantee that the company will make a profit in the future.** (Incorrect). Auditors do not predict or guarantee a company's future profitability. Their role is to express an opinion on the fairness of the financial statements.
- **To plan the nature, timing, and extent of audit procedures.** (Correct). Understanding internal controls helps auditors decide what audit tests to perform, when to perform them, and how much evidence is required.
- **To decide the salaries and bonuses of company employees.** (Incorrect) Determining employee compensation is a management responsibility and is unrelated to the auditor's.

(b)(i) Complete the following sentence. (1 mark)

Substantive procedures focus on obtaining evidence about the accuracy, completeness, and validity of account balances and transactions to detect material misstatements in the financial statements.

- **Internal audit is incorrect** because it refers to an independent function within an organisation that evaluates risk management, internal controls, and governance processes. While internal auditors may review financial information, their main purpose is not to obtain audit evidence to detect material misstatements in financial statements for an external audit opinion.

- **Tests of controls is incorrect** because these procedures are used to assess whether internal controls are properly designed and operating effectively throughout the period. They focus on the reliability of the control system rather than directly checking the accuracy, completeness, and validity of account balances and transactions.
- **Substantive procedures is correct.** These procedures are designed to obtain direct audit evidence about financial statement assertions, including the accuracy, completeness, and validity of account balances and transactions. They are used specifically to detect material misstatements and include activities such as recalculations, confirmations, inspections, and analytical procedures.
- **Corporate governance procedures is incorrect** because they relate to the overall system of direction and control of an organisation. They focus on accountability, oversight, and decision-making structures rather than testing financial records or obtaining evidence on individual transactions and balances.

The differences between tests of controls and substantive procedures:

	Tests of Controls	**Substantive Procedures**
Purpose	To evaluate whether internal controls are designed and operating effectively.	To detect material misstatements in the financial statements.
Focus	The effectiveness of the client's internal control system.	The accuracy, completeness, and validity of account balances and transactions.
When Performed	When the auditor intends to rely on internal controls to reduce substantive testing.	Performed in every audit, regardless of the effectiveness of controls.
Evidence Obtained	Evidence that controls were applied consistently throughout the period.	Direct evidence regarding financial statement assertions.
Examples	Observing segregation of duties, inspecting approval signatures, re-performing control activities, and making enquiries about control procedures.	Confirming receivable balances, inspecting supporting documents, recalculating depreciation, and performing analytical procedures.

Payroll calculations are automated within the payroll system.

(b)(ii) Identify which ONE of the following errors or irregularities can be mitigated by this control procedure (1 mark)

Incorrect calculation of wages due to human arithmetic errors.	☑
Employees receiving payments after leaving the company due to poor leaver controls.	☐
Overtime payments being approved without authorisation.	☐
Fraudulent employee bank account details being entered into the system.	☐

- **Incorrect calculation of wages due to human arithmetic errors.** This is the correct answer because automating payroll calculations removes the need for manual computation. As a result, common human errors such as incorrect addition, subtraction, or applying tax rates are significantly reduced or eliminated, improving the accuracy of wage payments.
- **Employees receiving payments after leaving the company due to poor leaver controls.** This is incorrect because automation of payroll calculations does not address employee status updates. If the system is not updated when employees leave, payments may still be made incorrectly. This issue relates to HR controls, not calculation accuracy.
- **Overtime payments being approved without authorisation.** This is incorrect because automated payroll systems calculate payments but do not ensure that overtime has been properly approved. This is a control failure related to authorisation procedures, not calculation accuracy.
- **Fraudulent employee bank account details being entered into the system.** This is incorrect because payroll automation does not prevent unauthorised or fake bank details from being entered. This risk relates to input validation and segregation of duties, not the calculation process itself.

Payroll calculations are automated within the payroll system.

(b)(iii) Identify which ONE of the following is an appropriate test of control to assess whether this control is operating effectively (1 mark)

Reperform payroll calculations manually for a sample of employees.	☐
Inspect evidence that the payroll system has been tested and approved after any changes.	☑
Compare total payroll expense to prior year and investigate significant variances.	☐
Trace employee salaries from the payroll system to the financial statements.	☐

- **Reperform payroll calculations manually for a sample of employees.** This is incorrect because it is a substantive procedure, not a test of control. Reperforming calculations is used to check whether amounts are correct, rather than to assess whether the automated control system is operating effectively as designed.
- **Inspect evidence that the payroll system has been tested and approved after any changes.** This is correct because it is a test of control. Inspecting system change approvals and testing records helps confirm that the automated payroll system is properly maintained and that changes have been authorised and tested, ensuring the control continues to operate effectively.

- **Compare total payroll expense to prior year and investigate significant variances.** This is incorrect because it is an analytical procedure, which is a type of substantive procedure. It focuses on identifying unusual trends or differences in payroll amounts rather than testing whether internal controls are operating effectively.
- **Trace employee salaries from the payroll system to the financial statements.** This is incorrect because it is also a substantive procedure. Tracing amounts to the financial statements is used to verify accuracy and completeness of reporting, not to evaluate the operating effectiveness of payroll system controls.

A member of the finance team will soon be responsible for maintaining the non-current asset register. This will include recording and updating key details such as unique asset identification numbers, asset descriptions, acquisition costs, depreciation methods, useful lives, and asset locations. The individual will also ensure that all non-current assets are accurately recorded, complete, and kept up to date within the accounting system.

(c)(i) Identify whether each of the following errors or irregularities, would or would not be mitigated by the specified control procedure. (2 marks)

Control procedure	Errors or irregularities mitigated	
Each asset assigned a unique identification code and physically tagged.	Prevent duplication or omission of assets in the non-current asset register.	**would**
Periodic physical inspections to confirm the existence and condition of assets.	Ensure only valid and properly supported transactions are entered.	**would not**

Assigning each asset a unique identification code and physically tagging it helps prevent duplication or omission of assets in the non-current asset register. This control ensures that every asset is clearly identifiable and can only be recorded once, reducing the risk of the same asset being entered multiple times or overlooked. It also improves traceability, making it easier to match physical assets to the records and maintain a complete and accurate register.

Periodic physical inspections to confirm the existence and condition of assets help ensure that the non-current asset register accurately reflects assets that actually exist. This control does not ensure that only valid and properly supported transactions are entered; instead, it identifies whether recorded assets are real, in use, and correctly recorded. It helps detect errors such as missing or incorrectly recorded assets, and irregularities such as stolen or disposed assets still being included in the register. Controls that ensure only valid and properly supported transactions are entered, would be authorisation and approval controls before recording transactions. This ensures that every transaction (such as an asset purchase) is checked and approved by a responsible manager before it is entered into the accounting system.

(c)(ii) Identify whether each test of control is suitable or not suitable for assessing whether the specified control procedure is operating effectively. (3 marks)

Control procedure	Testing of control procedure	
All additions to the non-current asset register should be supported by authorised purchase invoices and approved capital expenditure requests.	Inspect a sample of entries in the register and trace them back to supporting documentation.	**suitable**
Asset purchases should be independently approved by management before being recorded.	Inspect evidence such as signatures or approval forms for a sample of asset purchases.	**suitable**
Regular reconciliations should be performed between the non-current asset register and the general ledger to ensure completeness and accuracy.	Inspect purchase invoices and capital expenditure approvals for new asset purchases.	**not suitable**

All additions to the non-current asset register should be supported by authorised purchase invoices and approved capital expenditure requests. A suitable test of control is to inspect a sample of entries in the non-current asset register and trace them back to supporting documentation, such as authorised invoices and approved capital expenditure requests, to confirm that they exist and have been properly approved.

Asset purchases should be independently approved by management before being recorded. A suitable test of control is to inspect evidence of management approval (such as signatures, system authorisation logs, or approval forms) for a sample of asset purchases before they were recorded in the accounting system.

Regular reconciliations should be performed between the non-current asset register and the general ledger to ensure completeness and accuracy. A suitable test of control if regular reconciliations are performed between the non-current asset register and the general ledger, is to inspect evidence of performed reconciliations, such as signed reconciliation reports, and reperform the reconciliation for a sample period to confirm it was carried out accurately and on a timely basis. Inspecting purchase invoices and capital expenditure approvals for new asset purchases, is a test of the control that all additions to the non-current asset register are supported by authorised documentation. This helps ensure that only genuine and properly approved assets are included in the accounting records.

Task 7 - Solutions (15 marks)

This section of the exam covers:

- The assertions about transactions and balances. In auditing, assertions are the claims or representations made by management about the information presented in the financial statements. Auditors test these assertions to determine whether the financial statements are free from material misstatement.
- Identifying suitable audit procedures to test financial statement transactions and balances e.g. non-current assets, inventory, receivables, cash and bank, borrowings, payables, provisions, revenue, purchases, payroll and other expenses.
- Distinguishing between sampling methods and when they should be used. Statistical and non-statistical sampling methods, the advantages and disadvantages of different sampling methods e.g. stratification, value-weighted selection, random selection, systematic selection, monetary unit sampling, haphazard selection and block selection.
- Identifying factors that affect sample sizes.

(a)(i) Identify whether each of the following statements about assertions relating to transactions is true or false. (3 marks)

	True	False
The occurrence assertion ensures that all transactions that should have been recorded are included in the accounting records.	☐	☑
The cut-off assertion ensures that transactions are recorded in the correct accounting period.	☑	☐
The accuracy assertion ensures that transactions are recorded in the correct accounts and properly classified.	☐	☑

- **The first statement is false.** The occurrence assertion does not relate to completeness. Instead, it ensures that recorded transactions actually took place and relate to the entity. The statement given is incorrect because it describes the completeness assertion, not occurrence.
- **The second statement is true.** This statement is correct because the cut-off assertion ensures that transactions are recorded in the correct accounting period. For example, revenue and expenses must be recorded in the right financial year.
- **The third statement is false.** This is incorrect because the accuracy assertion ensures that transactions are recorded with the correct amounts, not that they are classified into the correct accounts. Classification is a separate assertion that deals with whether transactions are recorded in the proper accounts and categories.

The key assertions about transactions used in auditing:

- **Occurrence** e.g. transactions that have been recorded actually took place and relate to the entity.
- **Completeness** e.g. all transactions that should have been recorded have been included in the accounting records.
- **Accuracy** e.g. transactions have been recorded with the correct amounts.
- **Cut-off** e.g. transactions have been recorded in the correct accounting period.
- **Classification** e.g. transactions have been recorded in the correct accounts.
- **Presentation** e.g. transactions are appropriately presented and disclosed in the financial statements.

(a)(ii) Identify the key assertion relating to account balances in auditing for each example. (3 marks)

Example	Assertion about balances
All trade receivables at the year-end are included in the financial statements, with no invoices or customer balances omitted from the records.	**completeness**
A bank loan repayable within 12 months is correctly classified as a current liability rather than a non-current liability.	**classification**
A company legally owns a machine included under non-current assets, and any loans recorded as liabilities are actual obligations the company is required to repay.	**rights and obligations**

- **Completeness.** This assertion ensures that all trade receivables that should be recorded at the year-end are included in the financial statements. There are no missing customer balances or invoices, meaning the receivables balance is fully captured without omissions.
- **Classification.** This assertion relates to classification because the bank loan is correctly presented in the financial statements according to its nature and repayment terms. Since it is repayable within 12 months, it is properly shown as a current liability rather than a non-current liability.
- **Rights and obligations.** This assertion ensures that the company has legal ownership of the machine recorded as an asset and has a genuine obligation to repay any recorded loans. It confirms that assets and liabilities shown in the financial statements actually belong to or are owed by the entity.

The key assertions relating to account balances in auditing:

- **Existence** e.g. assets, liabilities, and equity balances actually exist at the reporting date.
- **Rights and obligations** e.g. the entity has legal rights to assets and is obligated to pay liabilities shown in the financial statements.

- **Completeness** e.g. all balances that should be recorded have been included in the financial statements.
- **Accuracy, valuation and allocation** e.g. balances are recorded at appropriate amounts and are correctly valued and allocated in accordance with accounting standards.
- **Classification** e.g. balances are presented in the correct accounts.
- **Presentation** e.g. account balances are properly presented and disclosed in the financial statements in accordance with applicable reporting standards.

(b)(i) Identify TWO appropriate audit procedures to test the existence of non-current assets. (2 marks)

Physically inspect non-current assets such as property, plant, and equipment to confirm they exist.	☑
Trace non-current assets from the financial statements to supporting purchase invoices and supplier documentation.	☐
Review board minutes and legal documents to confirm ownership of major assets.	☐
Obtain written representations from management confirming that non-current assets exist at the year-end.	☑

- **The first statement is correct.** Physical inspection of non-current assets is a key audit procedure because it provides direct evidence that the assets actually exist. For example, seeing machinery or vehicles at the client's premises confirms their physical presence at the year-end.
- **The second statement is incorrect.** Tracing non-current assets from the financial statements to purchase invoices mainly tests completeness and accuracy of recording, not existence. It shows that assets were properly recorded, but does not confirm that the assets physically exist.
- **The third statement is incorrect.** Reviewing board minutes and legal documents is more relevant to testing rights and obligations or authorisation of asset purchases, rather than confirming the physical existence of the assets themselves.
- **The last statement is correct.** Obtaining written representations from management provides supporting audit evidence that management confirms the existence of non-current assets at the year-end. However, this is weaker evidence on its own and is usually used alongside other procedures like physical inspection.

(b)(ii) Identify TWO appropriate items that could be inspected to test the accuracy of cash and bank balances in the financial statements. (2 marks)

Loan agreements and overdraft facility letters confirming legal rights and obligations over bank balances.	☐
Bank statements for the financial period.	☑
Financial statement disclosure notes showing cash and bank balances, including any restrictions.	☐
Bank reconciliation supporting documents, such as outstanding lodgements and unpresented cheques.	☑

- **Loan agreements and overdraft facility letters confirming legal rights and obligations over bank balances (Incorrect).** These documents relate to borrowing arrangements and help test rights and obligations, not accuracy. They confirm whether the entity has permission to overdraw or has loan liabilities, but they do not provide evidence about whether cash and bank balances are recorded correctly.
- **Bank statements for the financial period (Correct).** Bank statements provide independent third-party evidence of all cash movements in and out of the bank account. They allow auditors to verify that recorded cash balances are accurate and agree with actual bank activity, making them a key source of evidence for testing accuracy.
- **Financial statement disclosure notes showing cash and bank balances, including any restrictions (Incorrect).** Disclosure notes relate to presentation and reporting of cash and bank balances, including restrictions or breakdowns. While important for presentation, they do not provide detailed evidence to confirm the numerical accuracy of the cash and bank balances themselves.
- **Bank reconciliation supporting documents, such as outstanding lodgements and unpresented cheques (Correct).** Bank reconciliation items such as outstanding lodgements and unpresented cheques help auditors ensure that the cash book balance agrees to the bank statement. By verifying these reconciling items, auditors can test whether the cash and bank balances are accurately recorded.

(c) Identify the sampling method used in each of the following examples.

(3 marks)

Example	Sampling method
An auditor selects every 20th invoice from the sales ledger, starting from a randomly chosen point.	**systematic selection**
An auditor selects purchase invoices from a file in a random manner without using any structured pattern or statistical technique.	**haphazard selection**
An auditor selects all invoices from a specific week or month for testing.	**block selection**

The only answer not selected from the picklist was monetary unit sampling. An example of this would be an auditor selecting customer balances where each £1 in the population has an equal chance of being selected, meaning higher-value balances (larger receivables) are more likely to be chosen.

(d) Complete the following sentences. (2 marks)

An audit has a low tolerable misstatement and a high expected error rate, which would result in the auditor selecting a **larger** sample size.

An audit has found that internal controls are strong and operating effectively through testing, which would allow the auditor to use a **smaller** sample size.

- A low tolerable misstatement means the auditor is willing to accept only a small amount of error before concluding that the financial statements may be materially misstated. At the same time, a high expected error rate suggests that more errors are likely to be found in the population. Because the auditor requires greater assurance and expects more errors, a larger sample size is needed to obtain sufficient appropriate audit evidence.
- When testing shows that internal controls are strong and operating effectively, the auditor can place greater reliance on those controls. This reduces the risk of material misstatement and the amount of additional evidence needed from substantive testing. As a result, the auditor can use a smaller sample size while still obtaining sufficient appropriate audit evidence.

Factors affecting sample size in auditing include:

- **Risk of material misstatement** e.g. higher risk leads to a larger sample size.
- **Desired level of assurance** e.g. greater assurance requires more testing and a larger sample.
- **Tolerable error** e.g. lower tolerable error results in a larger sample size.
- **Expected error rate** e.g. if more errors are expected, the sample size increases.
- **Population size** e.g. larger populations may require larger samples, although not always proportionally.
- **Effectiveness of internal controls** e.g. weak controls increase sample size, while strong controls may reduce it.

Task 8 - Solutions (10 marks)

This section of the exam covers:

- Types of verification techniques e.g. inspection, observation, external confirmation, recalculation, reperformance, analytical procedures, and enquiry.
- Identify when it is appropriate to use each type of verification technique.
- The reliability and relevance of different sources of audit evidence.
- Types of digital techniques e.g. test data, integrated test facilities, audit software, and data analytic tools
- How digital techniques are used to test controls and interrogate the organisation's files.
- The benefits and drawbacks of digital techniques and remote auditing.

(a)(i) Identify the appropriate verification technique used by the auditor for each audit procedure. (3 marks)

Audit procedure	Verification technique
The auditor asks the receivables manager why there is a large overdue receivable balance and is informed that the customer is disputing the invoice.	**enquiry**
The auditor independently repeats a bank reconciliation prepared by the client to verify that it was carried out correctly and effectively.	**reperformance**
The auditor performs ratio analysis by comparing current-year figures with those of prior years to assess whether the financial information appears reasonable.	**analytical procedures**

- **Enquiry.** This audit procedure is an example of enquiry because the auditor obtains information and explanations by asking questions of the receivables manager. The purpose is to understand the reason for the large overdue receivable balance and to clarify any unusual matters identified during the audit.
- **Reperformance.** This procedure is an example of reperformance because the auditor independently repeats the bank reconciliation originally prepared by the client. By carrying out the procedure again, the auditor can determine whether it was performed correctly and whether the related control operated effectively.
- **Analytical Procedures**. This procedure is an example of analytical procedures because the auditor evaluates financial information by analysing relationships and trends. Comparing current-year figures with those of prior years' helps the auditor assess whether the results are reasonable and identify any unexpected fluctuations that may require further investigation.

Types of verification techniques:

- **Inspection** e.g. examine documents or assets.
- **Observation** e.g. watch procedures being performed.
- **External confirmation** e.g. obtain evidence from third parties.
- **Recalculation** e.g. check mathematical accuracy.
- **Reperformance** e.g. independently repeat procedures or controls.
- **Analytical procedures** e.g. analyse relationships and trends.
- **Enquiry** e.g. ask questions to gain understanding or explanations.

An auditor is gathering audit evidence to verify the existence of bank and cash balances.

(a)(ii) Identify if the following items of evidence are reliable or not reliable.

(2 marks)

Audit evidence	
Bank confirmation received directly from the bank.	**reliable**
Bank reconciliation prepared by the client.	**not reliable**

Reliability refers to the quality and trustworthiness of audit evidence.

- **Bank confirmation received directly from the bank.** A bank confirmation is sent directly from an independent third party (the bank), making it highly trustworthy.
- **Bank reconciliation prepared by the client.** A bank reconciliation prepared by the client is internally generated and therefore less reliable, unless independently verified and reperformed by the auditor.

The reliability of audit evidence is generally ranked as follows:

- Evidence obtained directly by the auditor rather than indirectly.
- Evidence from independent external sources rather than internal client evidence.
- Written (documentary) evidence rather than oral explanations.
- Original documents rather than copies or scans.
- Internally generated evidence is more reliable if strong internal controls exist.

Digital techniques or remote working can be used to test controls and interrogate an organisation's files.

(b)(i) Identify TWO drawbacks of using digital techniques. (2 marks)

Risk of cyberattacks.

Requirement for specialist technical skills.

Limited physical verification.

Reduced team interaction.

Digital techniques refer to the use of technology and software in the audit process to analyse data, test transactions, and improve audit procedures e.g. data analytics, audit software, automated testing. The auditor performs the work using technology. Remote auditing refers to performing audit work without being physically present at the client's premises, using online communication tools and digital access to records. The auditor performs the work from a distance.

- **Limited physical verification** is not a drawback of digital techniques because it relates to remote auditing rather than technology itself. It refers to situations where auditors are not physically present to inspect assets such as inventory, cash, or non-current assets. This reduces the ability to obtain direct, first-hand evidence, but it is caused by working remotely, not by the use of digital audit tools.
- **Reduced team interaction** is not a drawback of digital techniques. Instead, it is a disadvantage of remote auditing. When auditors work remotely, there is less face-to-face communication between audit team members and client staff. This can lead to weaker communication, misunderstandings, and reduced effectiveness in discussing and resolving audit issues.
- **Risk of cyberattacks** is a drawback of digital techniques because audit work increasingly relies on electronic systems that store and transfer large volumes of sensitive financial information. This creates opportunities for unauthorised access, cyberattacks, or data theft, which can compromise the confidentiality and integrity of audit evidence.
- **Requirement for specialist technical skills** is a drawback of digital techniques because auditors must be trained to use advanced audit software and data analytics tools effectively. Without the necessary technical knowledge, audit staff may struggle to analyse data correctly or use systems efficiently, which can increase training costs and reduce overall audit efficiency.

(b)(ii) Identify the type of digital technique used for each of the following audit tests. (3 marks)

Audit test performed	Type of digital technique
The auditor creates a dummy employee in the payroll system and processes test payroll transactions to check whether payroll controls are operating effectively.	**integrated test facilities**
The auditor enters both valid and invalid sales orders into the system to test whether it correctly processes and rejects transactions.	**test data**
The auditor analyses sales data to identify unusual revenue spikes and detect anomalies that require further investigation.	**data analytic tools**

- **Integrated test facilities** is the correct technique for the payroll example because the auditor creates a dummy employee within the client's live payroll system and processes test transactions through it. This allows the auditor to test whether payroll controls are operating effectively in a real system environment without affecting actual employee records, which is a key feature of integrated test facilities. Integrated test facilities involve creating a dummy entity or records within the client's live system so that the auditor can process test transactions alongside real data. This is used to test controls in a live environment without disrupting actual processing.
- **Test data** is the correct technique for the sales order example because the auditor inputs both valid and invalid transactions into the system to check whether it correctly accepts authorised data and rejects incorrect or unauthorised entries. This is a controlled test designed to assess whether specific application controls in the system are working properly. Test data is a digital technique where the auditor enters their own set of data into the client's system to check whether it processes transactions correctly and whether controls correctly accept valid data and reject invalid data.
- **Data analytic tools** is the correct technique for the sales analysis example because the auditor examines large volumes of sales data to identify unusual patterns, trends, or anomalies such as unexpected spikes in revenue. These tools help the auditor analyse entire datasets efficiently and highlight areas that may require further investigation. Data analytic tools are used to analyse large volumes of data to identify patterns, trends, and unusual transactions. Data analytics looks for trends and anomalies.
- **Audit software** is computer software used by auditors to examine client data. It is used to recalculate figures, extract samples, match records, and check transactions for errors or inconsistencies. Audit software interrogates and checks data. None of the examples given in the task was relevant to audit software.

Task 9 - Solutions (10 marks)

This section of the exam covers:

- Assessing misstatements for materiality.
- Identify deviations from an organisation's prescribed procedures e.g. identify matters such as unauthorised transactions, non-routine transactions, related party transactions, transactions above or below market rates, and suspected fraud.
- Elements of a report on deficiencies in internal control.
- That deficiencies in internal control are reported to management and the audit committee.
- Identify the consequences of deficiencies in internal controls and how the deficiencies can be remedied.
- Report findings.

A company failed to disclose fraud committed by a senior manager, even though the amount involved was relatively small.

(a)(i) Complete the following sentence. (1 mark)

This matter is **material**.

This matter is material. Even though the monetary amount is small, the fraud involves senior management, which makes it material due to its nature and the potential impact on users' perception of the financial statements.

Materiality	**Explanation**	**Example**
Size (quantitative)	Materiality depends on the monetary value of the misstatement compared to the financial statements as a whole. Larger errors are more likely to be material.	A £500 error is not material for a large company but may be material for a small business.
Nature (qualitative)	Some misstatements are material because of what they represent, regardless of value.	Fraud, breaches of laws or regulations, or undisclosed related party transactions.
Context	Individually small errors may become material when combined with other misstatements.	Several small errors across different accounts may be material in total.

(a)(ii) Identify whether the following statements are true or false. (3 marks)

	True	False
A misstatement that could influence the economic decisions of users of the financial statements is considered material.	✓	☐
A transaction processed without the required authorisation is an example of a deviation from an organisation's prescribed procedures and should be investigated further by the auditor.	✓	☐
Non-routine transactions and related party transactions are less risky than routine transactions and therefore require less audit attention.	☐	✓

- **A misstatement that could influence the economic decisions of users of the financial statements is considered material.** This statement is true. Materiality is assessed based on whether the misstatement, individually or in aggregate, could reasonably be expected to influence the decisions of users.
- **A transaction processed without the required authorisation is an example of a deviation from an organisation's prescribed procedures and should be investigated further by the auditor.** This statement is true. Unauthorised transactions may indicate control deficiencies, error, or potential fraud.
- **Non-routine transactions and related party transactions are less risky than routine transactions and therefore require less audit attention.** This statement is false. Non-routine and related party transactions often present a higher risk of material misstatement and require additional scrutiny.

A loan is granted by the company to one of its directors.

(a)(iii) Identify ONE of the following that may represent a deviation from the company's prescribed procedures. (1 mark)

Unauthorised transactions.	☐
Non-routine transactions.	☐
Related party transactions.	✓
Suspected fraud.	☐

Unauthorised transactions. This could be a correct answer if the loan had been approved without following the company's authorisation procedures. The scenario does not indicate that the loan lacked approval, only that it was made to a director. Therefore, there is insufficient evidence to conclude that it was an unauthorised transaction.

Non-routine transactions. Although loans to directors may occur infrequently and could be considered unusual for some businesses, the key feature highlighted in the scenario is the relationship between the company and the individual receiving the loan. The fact that the recipient is a director is more significant than whether the transaction occurs regularly.

Related party transactions is the correct answer. Directors are related parties because they have influence over the company. A loan granted to a director is therefore a related party transaction and may require specific authorisation, disclosure in the financial statements, and additional audit attention to ensure that it has been conducted appropriately and on normal commercial terms.

Related parties include more than just directors. They also include parent companies and subsidiaries, key management personnel such as senior executives, close family members of directors or senior staff, and businesses controlled by these individuals. In addition, associates and joint ventures are also considered related parties. These relationships are important because transactions between related parties may not always be conducted on normal commercial terms and therefore require careful audit attention and disclosure.

Suspected fraud. There is nothing in the scenario to suggest that fraud has occurred. A loan to a director is not automatically fraudulent. Fraud would only be suspected if there were indicators such as concealment of the transaction, lack of approval, falsified documentation, or evidence that the director intended to obtain an improper benefit.

(b) Identify which ONE of the following is a correct element of a report on deficiencies in internal control. (1 mark)

A detailed prediction of future company profits based on the control weakness identified.	☐
A description of the deficiency and its potential impact on the financial statements.	☑
A personal opinion on the competence of individual employees involved in the control system.	☐
A guarantee that no further errors or fraud will occur after the audit.	☐

- **A detailed prediction of future company profits based on the control weakness identified.** This is incorrect because an internal control deficiencies report does not include forecasts or predictions about future profitability. The auditor's role is not to estimate future performance but to report weaknesses in controls and their possible risks.
- **A description of the deficiency and its potential impact on the financial statements**. This is correct because a key element of the report is explaining what the control weakness is and how it could increase the risk of errors, fraud, or misstatements in the financial statements. This helps management understand why the issue matters.
- **A personal opinion on the competence of individual employees involved in the control system.** This is incorrect because audit reports should remain objective and should not criticise or assess individual employees. The focus is on systems and controls, not personal performance or competence.
- **A guarantee that no further errors or fraud will occur after the audit.** This is incorrect because an audit does not provide guarantees. Even if recommendations are made, there is no assurance that all errors or fraud will be eliminated, as internal controls can reduce risk but not remove it completely.

Elements of an internal control deficiency report (summary):

- Description of the internal control deficiency identified
- Explanation of how the deficiency was found e.g. audit testing.
- Risk or impact of the deficiency e.g. risk of fraud, error, or misstatement.
- Recommendation for improvement or corrective action.
- Management response to the issue (not always a required part of the report).
- Assessment of significance or priority of the deficiency e.g. high/medium/low.

The auditor identifies that several purchase orders were raised and processed without the required managerial approval.

(c)(i) Identify ONE possible impact that this control deficiency may have on the company. (1 mark)

Unauthorised or unnecessary purchases.	☑
Financial loss and potential misstatement of income and assets.	☐
Fraudulent or invalid expenses being reimbursed to employees.	☐
Unauthorised access and manipulation of financial records.	☐

- **Unauthorised or unnecessary purchases (correct).** This is the most direct impact because purchase orders were processed without managerial approval, meaning goods or services may be bought without proper authorisation or business need.
- **Financial loss and potential misstatement of income and assets (incorrect).** Purchase order issues mainly affect expenses and liabilities, not income and assets.
- **Fraudulent or invalid expenses being reimbursed to employees (incorrect).** This relates to employee expense claims, not supplier purchase orders.
- **Unauthorised access and manipulation of financial records (incorrect).** This relates to IT or system access controls, not purchasing procedures.

(c)(ii) Identify TWO recommendations for this control deficiency. (2 mark)

The system should be set to prevent processing until approval has been obtained.	☑
Duties should be separated so that different employees are responsible for recording and authorising transactions.	☐
Each employee should use a unique login with strong password controls and regular password updates.	☐
All purchase orders should require formal managerial approval before being processed.	☑

- **The system should be set to prevent processing until approval has been obtained.** This is correct because it strengthens the control by embedding approval into the system workflow. It ensures that purchase orders cannot move forward unless proper authorisation is recorded, preventing bypassing of the control.
- **Duties should be separated so that different employees are responsible for recording and authorising transactions.** The problem identified is that purchase orders are being processed without managerial approval. Segregation of duties helps reduce fraud risk overall, but it does not directly ensure that purchase orders are properly authorised before processing.
- **Each employee should use a unique login and strong password controls with regular updates.** This recommendation relates to IT system access controls rather than purchasing procedures. While it improves system security, it does not address the specific issue of missing managerial approval for purchase orders.
- **All purchase orders should require formal managerial approval before being processed.** This is correct because it directly addresses the deficiency. If managerial approval is mandatory before processing, it ensures that only authorised purchases are made, reducing the risk of unauthorised or unnecessary expenditure.

(c)(iii) Complete the following sentence. (1 mark)

Deficiencies in internal control are reported to the **management and the audit committee**.

The correct answer is management and the audit committee because internal control deficiencies are communicated to both parties, but for different reasons.

- Management is responsible for running the business and implementing improvements to internal controls. Therefore, auditors report deficiencies to management so that corrective actions can be taken to reduce the risk of errors or fraud.
- The audit committee (or those charged with governance) is responsible for overseeing the financial reporting process and monitoring management's actions. Reporting deficiencies to the audit committee ensures independent oversight and accountability, especially for more significant control weaknesses.

Incorrect answers:

- Management only is insufficient, as governance oversight would be missing.
- Audit committee only is incorrect because management must also take action to fix the issues.
- Management and its shareholders is incorrect because shareholders are not directly involved in operational control reporting.