

Introduction

Tinkerbelle Toys Co (Tinkerbelle) is a manufacturer of children's building block toys; they have been trading for over 35 years and they sell to a wide variety of customers including large and small toy retailers across the country. The company's year end is 31 May 2011.

The company has a large manufacturing plant, four large warehouses and a head office. Upon manufacture, the toys are stored in one of the warehouses until they are despatched to customers. The company does not have an internal audit department.

Sales ordering, goods despatched and invoicing

Each customer has a unique customer account number and this is used to enter sales orders when they are received in writing from customers. The orders are entered by an order clerk and the system automatically checks that the goods are available and that the order will not take the customer over their credit limit.

For new customers, a sales manager completes a credit application; this is checked through a credit agency and a credit limit entered into the system by the credit controller. The company has a price list, which is updated twice a year. Larger customers are entitled to a discount; this is agreed by the sales director and set up within the customer master file.

Once the order is entered an acceptance is automatically sent to the customer by mail/email confirming the goods ordered and a likely despatch date. The order is then sorted by address of customer. The warehouse closest to the customer receives the order electronically and a despatch list and sequentially numbered goods despatch notes (GDNs) are automatically generated.

The warehouse team pack the goods from the despatch list and, before they are sent out, a second member of the team double checks the despatch list to the GDN, which accompanies the goods.

Once despatched, a copy of the GDN is sent to the accounts team at head office and a sequentially numbered sales invoice is raised and checked to the GDN. Periodically a computer sequence check is performed for any missing sales invoice numbers.

Fraud

During the year a material fraud was uncovered. It involved cash/cheque receipts from customers being diverted into employees' personal accounts. In order to cover up the fraud, receipts from subsequent unrelated customers would then be recorded against the earlier outstanding receivable balances and this cycle of fraud would continue.

The fraud occurred because two members of staff 'who were related' colluded. One processed cash receipts and prepared the weekly bank reconciliation; the other employee recorded customer receipts in the sales ledger.

An unrelated sales ledger clerk was supposed to send out monthly customer statements but this was not performed. The bank reconciliations each had a small unreconciled amount but no-one reviewed the reconciliations after they were prepared.

The fraud was only uncovered when the two employees went on holiday at the same time and it was discovered that cash receipts from different customers were being applied to older receivable balances to hide the earlier sums stolen.

Required:

Recommend SIX tests of controls the auditor would normally carry out on the sales system of Tinkerbell, and explain the objective for each test. (12 marks)

Examiners Report

This 30-mark question was based on a toy manufacturer, Tinkerbell Toys Co (Tinkerbell), and tested candidates' knowledge of tests of controls, substantive procedures for receivables and revenue and fraud.

Part (a) for 12 marks required candidates to recommend six tests of controls for the sales cycle of Tinkerbell as well as the objective for each test.

Most candidates performed inadequately on this part of the question. The main problems encountered were that candidates struggled to differentiate between tests of control and substantive tests and hence often provided long lists of substantive procedures, which scored no marks.

In addition a significant minority of candidates did not read the question carefully, and instead of providing tests of controls, gave control procedures management should adopt. This scored no marks.

The approach candidates should have taken was to firstly identify from the scenario the controls present for Tinkerbell, they then should have considered how these controls could be confirmed by

the auditor. In addition candidates' explanations of tests were vague such as; "check that credit limits are set for all new customers."

This procedure does not explain how the auditor would actually confirm that the control for new customer credit limits operates effectively. Tests that start with "check" are unlikely to score many marks as they do not explain how the auditor would actually check the control. Future candidates should practice generating tests; both substantive and tests of controls, which do not start with the word "check".

The second part of this requirement was to explain the objective of the test of control provided. Again, this was not answered well. A common answer was to state that the objective was "to ensure that the control is operating effectively." This was far too vague. All tests of controls are looking to verify that controls are operating effectively.

Instead, candidates should have considered the aim of the specific control being tested. Therefore the objective of a test over credit limits is "to ensure that orders are not accepted for poor credit risks".

As noted in previous examiner's reports candidates are often confused with the differences between tests of controls and substantive tests. Both are methods for obtaining evidence and are key elements of the F8 syllabus.

Future candidates must ensure that they understand when tests of controls are required and when substantive procedures are needed. They need to learn the difference between them and should practice questions requiring the generation of both types of procedures.

In addition, the question asked for six tests of controls and objectives, however many candidates provided much more than the required six points. It was not uncommon to see answers which had eight to ten points.

Whilst it is understandable that candidates wish to ensure that they gain credit for six relevant points, this approach can lead to time pressure and subsequent questions can suffer. A significant number of candidates presented their answers in a columnar format and this seemed to help them to produce concise and relevant answers.