

QUESTION TWO

(a)

Auditors have a responsibility under ISA 265 (UK and Ireland) *Communicating deficiencies in internal control to those charged with governance and management*, to communicate deficiencies in internal controls. In particular SIGNIFICANT deficiencies in internal controls must be communicated in writing to those charged with governance.

Required:

Explain examples of matters the auditor should consider in determining whether a deficiency in internal controls is significant.

(11 marks)

(b)

Green Glass Co (Green) is a glass manufacturer, which operates from a large production facility, where it undertakes continuous production 24 hours a day, seven days a week. Also on this site are two warehouses, where the company's raw materials and finished goods are stored. Green's year end is 31 December.

Green is finalising the arrangements for the year-end stock count, which is to be undertaken on 31 December 2012. The finished windows are stored within 20 aisles of the first warehouse. The second warehouse is for large piles of raw materials, such as sand, used in the manufacture of glass. The following arrangements have been made for the stock count:

The warehouse manager will supervise the count as he is most familiar with the stock. There will be ten teams of counters and each team will contain two members of staff, one from the finance and one from the manufacturing department. None of the warehouse staff, other than the manager, will be involved in the count.

Each team will count an aisle of finished goods by counting up and then down each aisle. As this process is systematic, it is not felt that the team will need to flag areas once counted. Once the team has finished counting an aisle, they will hand in their sheets and be given a set for another aisle of the warehouse. In addition to the above, to assist with the stock counting, there will be two teams of counters from the internal audit department and they will perform stock counts.

The count sheets are sequentially numbered, and the product codes and descriptions are printed on them but no quantities. If the counters identify any stock which is not on their sheets, then they are to enter the item on a separate sheet, which is not numbered. Once all counting is complete, the sequence of the sheets is checked and any additional sheets are also handed in at this stage. All sheets are completed in ink.

Any damaged goods identified by the counters will be too heavy to move to a central location, hence they are to be left where they are but the counter is to make a note on the stock sheets detailing the level of damage.

As Green undertakes continuous production, there will continue to be movements of raw materials and finished goods in and out of the warehouse during the count. These will be kept to a minimum where possible.

The level of work-in-progress in the manufacturing plant is to be assessed by the warehouse manager. It is likely that this will be an immaterial balance. In addition, the raw materials quantities are to be approximated by measuring the height and width of the raw material piles. In the past this task has been undertaken by a specialist; however, the warehouse manager feels confident that he can perform this task.

REQUIREMENT:

(a) For the stock count arrangements of Green Glass Co:

- (i) Identify and explain SIX deficiencies; and**
- (ii) Provide a recommendation to address each deficiency.**

(24 marks)

(TOTAL 35 MARKS)

QUESTION TWO

(a)

ISA 265 *Communicating deficiencies in internal control to those charged with governance and management* states that a significant deficiency in internal control is a deficiency or combination of deficiencies in internal control that, in the auditor's professional judgement, is of sufficient importance to merit the attention of those charged with governance.

Examples of matters the external auditor should consider in determining whether a deficiency in internal controls is significant include:

- The likelihood of the deficiencies leading to material misstatements in the financial statements in the future.
- The susceptibility to loss or fraud of the related asset or liability.
- The subjectivity and complexity of determining estimated amounts.
- The financial statement amounts exposed to the deficiencies.
- The volume of activity that has occurred or could occur in the account balance or class of transactions exposed to the deficiency or deficiencies.
- The importance of the controls to the financial reporting process.
- The cause and frequency of the exceptions detected as a result of the deficiencies in the controls.
- The interaction of the deficiency with other deficiencies in internal control.

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(b)

Stock count arrangements

(1)

Deficiency

The warehouse manager is planning to supervise the stock count. Whilst he is familiar with the stock, he has overall responsibility for the stock and so is not independent. He may want to hide inefficiencies and any issues that arise so that his department is not criticised.

Recommendation

An alternative supervisor who is not normally involved with the stock, such as an internal audit manager, should supervise the stock count. The warehouse manager and his team should not be involved in the count at all.

(2)

Deficiency

There are ten teams of counters, each team having two members of staff. However, there is no clear division of responsibilities within the team. Therefore, both members of staff could count together rather than checking each other's count; and errors in their count may not be identified.

Recommendation

Each team should be informed that both members are required to count their assigned stock separately. Therefore, one counts and the second member checks that the stock has been counted correctly.

(3)

Deficiency

The internal audit teams are undertaking stock counts rather than reviewing the controls and performing sample test counts. Their role should be focused on confirming the accuracy of the stock counting procedures.

Recommendation

The internal audit counters should sample check the counting undertaken by the ten teams to provide an extra control over the completeness and accuracy of the count.

(4)

Deficiency

Once areas are counted, the teams are not flagging the aisles as completed. Therefore there is the risk that some areas of the warehouse could be double counted or missed out.

Recommendation

All aisles should be flagged as completed, once the stock has been counted. In addition, internal audit or the count supervisor should check at the end of the count that all 20 aisles have been flagged as completed.

(5)

Deficiency

Stock not listed on the sheets is to be entered onto separate sheets, which are not sequentially numbered. Therefore the supervisor will be unable to ensure the completeness of all stock sheets.

Recommendation

Each team should be given a blank sheet for entering any stock count which is not on their sheets. This blank sheet should be sequentially numbered, any unused sheets should be returned at the end of the count, and the supervisor should check the sequence of all sheets at the end of the count.

(6)

Deficiency

The sheets are completed in ink and are sequentially numbered, however, there is no indication that they are signed by the counting team. Therefore if any issues arise with the counting in an aisle, it will be difficult to follow up as the identity of the counting team will not be known.

Recommendation

All stock sheets should be signed by the relevant team upon completion of an aisle. When the sheets are returned, the supervisor should check that they have been signed.

(7)

Deficiency

Damaged goods are not being stored in a central area, and instead the counter is just noting on the stock sheets the level of damage. However, it will be difficult for the finance team to decide on an appropriate level of write down if they are not able to see the damaged goods. In addition, if these goods are left in the aisles, they could be inadvertently sold to customers or moved to another aisle.

Recommendation

Damaged goods should be clearly flagged by the counting teams and at the end of the count appropriate machinery should be used to move all damaged windows to a central location. This will avoid the risk of selling these goods. A senior member of the finance team should then inspect these goods to assess the level of any write down or allowance.

(8)

Deficiency

Green Glass Co (Green) undertakes continuous production and so there will be movements of goods during the count. Stock records could be under/overstated if goods are missed or double counted due to movements in the warehouse.

Recommendation

It is not practical to stop all stock movements as the production needs to continue. However, any raw materials required for 31 December should be estimated and put to one side. These will not be included as raw materials and instead will be work-in-progress. The goods which are manufactured on 31 December should be stored to one side, and at the end of the count should be counted once and included within finished goods. Any goods received from suppliers should be stored in one location and counted once at the end and included as part of raw materials. Goods to be despatched to customers should be kept to a minimum for the day of the count.

(9)

Deficiency

The warehouse manager is to assess the level of work-in-progress and raw materials. In the past, a specialist has undertaken this role. It is unlikely that the warehouse manager has the experience to assess the level of work-in-progress as this is something that the factory manager would be more familiar with.

Recommendation

A specialist should be utilised to assess both work-in-progress and the quantities of raw materials

(10)

Deficiency

In addition, whilst the warehouse manager is familiar with the raw materials, if he makes a mistake in assessing the quantities then stock could be materially misstated.

Recommendation

With regards to the warehouse manager, he could estimate the raw materials and the specialist could check it. This would give an indication as to whether he is able to accurately assess the quantities for subsequent stock counts.