LEBANESE ASSOCIATION OF
CERTIFIED PUBLIC ACCOUNTANTS

AUDIT

JULY 2015

MULTIPLE CHOICE QUESTIONS (30%)

1. Relationship between control risk and detection risk is ordinarily:
    a- Parallel
    b- Inverse
    c- Direct
    d- Equal

2. Which of the following would an auditor most likely use in determining the auditor's preliminary judgment about materiality?
    a- The anticipated sample size of the planned substantive tests
    b- The entity's annualized interim financial statements
    c- The results of the internal control questionnaire
    d- The contents of the management representation letter

3. Which of the following is not a type of attest engagement?
    a- Agreed-upon procedures
    b- Compilation
    c- Examination
    d- Review

4. Proper segregation of functional responsibilities calls for separation of the functions of
    a- Authorization, execution, and payment
    b- Authorization, recording, and custody
    c- Custody, execution, and reporting
    d- Authorization, payment, and recording

5. An auditor may compensate for a weakness in internal control by increasing the
    a- Level of detection risk
    b- Extent of tests of controls
    c- Preliminary judgment about audit risk
    d- Extent of analytical procedures

6. Which of the following types of audit evidence is the most persuasive?
    a- Pre-numbered client purchase order forms
    b- Client work sheets supporting cost allocations
    c- Bank statements obtained from the client
    d- Client representation letter

7. During an audit of an entity's stockholders' equity accounts, the auditor determines whether there are restrictions on retained earnings resulting from loans, agreements, or laws. This audit procedure most likely is intended to verify management's assertion of

a- Existence or occurrence
b- Completeness
c- Valuation or allocation
d- Presentation and disclosure

8. Which of the following conditions or events most likely would cause an auditor to have substantial doubt about an entity's ability to continue as a going concern?
   a- Cash flows from operating activities are negative
   b- Research and development projects are postponed
   c- Significant related party transactions are pervasive
   d- Stock dividends replace annual cash dividends

9. An auditor who qualifies an opinion because of an insufficiency of evidential matter should describe the limitations in an explanatory paragraph. The auditor should also refer to the limitation in the

	Scope paragraph	Opinion paragraph	Notes to the financial statements
a.	Yes	No	Yes
b.	No	Yes	No
c.	Yes	Yes	No
d.	Yes	Yes	Yes

10. Only _____ involve physical examination and confirmation.
   a- tests of controls
   b- tests of transactions
   c- tests of balances
   d- analytical procedures

11. An exception in a test of control indicates the _____ misstatements.
   a- the amount
   b- the likelihood
   c- the amount, likelihood, and classification
   d- the amount and the classification

12. An auditor tests account receivable for completeness by
   a- Confirmation.
   b- Preparing an aging schedule.
   c- Testing inventory shipping cutoffs.
   d- Inquiring as to the pledging of inventories.

13. Of the following ratios, the one most useful in the audit of revenue and expense would be

a- Return on investment.
b- Income tax expense to net income before income taxes.
c- Current ratio.
d- Debt to equity ratio.

14. When an acquisition is on an FOB origin basis, the inventory and related accounts payable must be recorded in the current period if the goods were
    a- Received prior to the balance sheet date.
    b- Shipped prior to the balance sheet date.
    c- Both shipped and received prior to the balance sheet date.
    d- Paid for in advance.

15. If the client fails to record disposals of property, plant, and equipment, both the original cost of the asset account and the net book value will be incorrect.
    a- Both will be overstated indefinitely.
    b- The original cost will be overstated indefinitely, and the net book value will be overstated until the asset is fully depreciated.
    c- The original cost will be overstated indefinitely, and the net book value will be understated indefinitely.
    d- The original cost will be overstated indefinitely, and the net book value will be understated until the asset is fully depreciated.

16. Which of the following explanations might satisfy an auditor who discovers significant debits to an accumulated depreciation account?
    a- Extraordinary repairs have lengthened the life of an asset.
    b- Prior years' depreciation charges were enormously understated.
    c- A reserve for possible loss on retirement has been recorded.
    d- An asset has been recorded at its fair value.

17. A list of related parties identified by the auditor should be maintained in the:
    a- Current audit file.
    b- Permanent audit file.
    c- A weak financial position.
    d- Articles of incorporation.

18. An audit to determine whether an entity is following specific procedures or rules set down by some higher authority is classified as a(n):
    a- audit of financial statements.
    b- compliance audit.
    c- operational audit.
    d- production audit.

19. The most important consideration in developing the audit plan and audit program is the:
    - a- client's size
    - b- client's history
    - c- audit firm's available personnel
    - d- the audit risk model used in its planning form

20. Which of the following audit tests is usually the least costly to perform?
    - a- Analytical procedures
    - b- Tests of control
    - c- Tests of balances
    - d- Substantive tests of transactions

21. When the auditor decides to select less than 100 percent of the population for testing, the auditor is said to use:
    - a- audit sampling
    - b- representative sampling
    - c- poor judgment
    - d- estimation sampling

22. Auditors can use flowcharts in their work in order to
    - a- analyze the causal factors of process dispersion
    - b- understand the overall process or system being audited
    - c- distinguish variations in a process over time
    - d- determine process capability and uniformity

23. Which TWO of the following should be included in an audit engagement letter?
    (1) Objective and scope of the audit
    (2) Results of previous audits
    (3) Management's responsibilities
    (4) Need to maintain professional skepticism

    - a- 1 and 2
    - b- 1 and 3
    - c- 2 and 4
    - d- 3 and 4

24. Which of the following is NOT a responsibility of the auditor?
    - a- To provide an opinion on the truth and fairness of the financial statements
    - b- To conduct an audit in accordance with International Standards on Auditing
    - c- To express an opinion on the company's going concern status

25. Which of the following procedures are TESTS OF CONTROL an auditor should perform in testing the inventory cycle of their client whilst attending the inventory count?
    (1) Observe whether the client's staff are following the inventory count instructions
    (2) Review inventory present in the warehouse for evidence of damage or obsolescence
    (3) Obtain a sample of the last goods received notes and goods despatched notes and follow through to ensure inclusion in the correct accounting period
    (4) Inspect and review management's inventory count instructions

    a- 2 and 3
    b- 1 and 4
    c- 1 and 2
    d- 3 and 4

26. During the audit of ABC Groceries SAL, the auditor discovered that $40,000 in repairs should have been capitalized but instead were expensed in full on the income statement, thus understating income and assets. The auditor's estimate of materiality is $75,000. Assuming that the likely aggregate misstatement is $50,000 and that the further possible misstatement is $15,000, what type of audit opinion is required?
    a- Adverse
    b- Denial
    c- Qualified
    d- Unqualified

27. When an auditor is gathering information to assist in understanding the client's business, which of the following would most likely suggest a potential problem?
    a- Consistent profits
    b- Bonuses based on financial results of the company
    c- Emphasis on quantified targets that are linked to management compensation
    d- Aggressive management attitude in financial reporting

28. Which of the following reflects increased inherent risk?
    a- Increase in risk of business failure due to poor economic conditions
    b- Increase in risk to the auditor of an incorrect audit opinion
    c- Increase in risk due to material misstatements found during last year's audit
    d-Increase in risk to the auditor from selecting a non-representative sample

29. Which of the following best illustrates the concept of sampling risk?
    - a- A randomly chosen sample may not be representative of the population as a whole on the characteristic of interest
    - b- An auditor may select audit procedures that are not appropriate to achieve the specific objective
    - c- An auditor may fail to recognize errors in the documents examined for the chosen sample
    - d- The documents related to the chosen sample may not be available for inspection

30. A number of factors influence the sample size for a substantive test of details of an account balance. All other factors being equal, which of the following would lead to a larger sample size?
    - a- Greater reliance on internal control
    - b- Greater reliance on analytical procedures
    - c- Smaller expected frequency of errors
    - d- Smaller measure of tolerable misstatement

<u>TRUE & FALSE (10%)</u>

Audit planning involves developing an overall strategy for the expected conduct and scope of the audit and involves auditor consideration of a number of matters.

For each of items 1 through 5 listed below, indicate whether the item is TRUE in that it is normally a planning procedure, or FALSE if it is not normally a planning procedure.

__F___ 1. Select accounts to be confirmed.

___ T__ 2. Identify financial statement items likely to require adjustment.

__ T ___ 3. Consider the nature of the audit reports expected to be rendered.

___ T __ 4. Consider the risk of the existence of related party transactions.

__ F ___ 5. Consider the risk of the existence of reportable controls.

Items 6 through 11 represent statements concerning an auditor's responsibility to evaluate whether there is substantial doubt about a client's ability to continue as a going concern. For each statement, indicate whether it is TRUE or FALSE.

__ **F** ___. 6. The time frame for the judgment is normally one year beyond the date of the auditor's report
___ **F** __. 7. A sudden increase in sales is an example of an event which would lead the auditor to believe there is substantial doubt
___ **F** __. 8. An audit report modified as to substantial doubt is considered a "subject to" qualified report
__ **T** ___. 9. A disclaimer of opinion may be issued when substantial doubt exists
__ **F** ___. 10. A going concern modification is generally appropriate when a company is in the process of liquidation
_ **F** ____. 11. The opinion paragraph of an audit report modified as to substantial doubt must include the terms "substantial doubt" and "going concern"

_**T**___ 12. Typically, analytical procedures are the primary means of verifying income statement accounts resulting from allocations.
_**T**__ 13. Often auditors base their anticipated reliance on the internal control structure on prior year findings.
_**T**__14. Auditors would seldom plan an audit without having any idea of where the potential misstatements may exist in the financial statement.
_**T**__ 15. Normally, auditors obtain evidence of inventory obsolescence by observation and inquiry.
_**F**__ 16. If after delivering an audit report an auditor determines that a necessary audit procedure was omitted, he or she should perform it in the next audit.
_**T**__17. Substantive tests are those tests which are designed to identify monetary errors in the financial statements.
_**T**__18. Audit procedures on the sample item will not vary as a result of using either statistical or nonstatistical sampling.
_**F**__19. Audit risk is a function of two components, inherent and control risk.
_**F**_____ 20. It is auditor's responsibility to maintain adequate accounting system incorporating various internal controls.

SHORT QUESTIONS (40%)

I - Answer briefly to the following:

A. Suggest **three** substantive audit evidence for addition to plant and equipment

a-

1- Completeness: Review repairs and renewals a/cs in general ledger (for expense of capital nature).
Trace a sample of fixed asset purchases to receiving reports and the fixed asset register.

2- Occurrence: Agree a sample of fixed asset purchases to the receiving report and invoice.

3- Classification: Examine a sample of significant charges to repairs and maintenance for items that should have been capitalized (also a completeness test).

Review lease transactions for proper classification as operating or finance.
4- Cut-off: Review fixed asset purchases from shortly before and after year-end for recording in the proper period.
5- Accuracy: Recalculate depreciation expense, revaluation losses and surplus, and impairment losses.

B. Suggest **four** audit procedures for trade receivables.

1- Analytical procedure: Calculate and compare average collection period (monthly).
2- Inquire: Ask credit controller, "What problems are being experienced in collecting amounts receivable?"
3- Inspect: Sales orders/ sales invoices/ remittance advices/ cash book receipts—alternative procedures.
4- Observe: Goods dispatch to customers/ mail opening procedures.
5- Recalculation: Sales' ledger balance (and control account balance)—use of CAATs.
6- Confirmation: Receivables circularization.

C. List the information you would expect to find in a tangible fixed asset register.
Fixed Asset Register

- **Identification number (eg.) registration/ serial number).**
- **Description and manufacture's name.**
- **Gross cost or valuation.**
- **Estimated useful life.**
- **Depreciation method/ annual charge.**
- **Depreciation provision.**
- **Carrying amount (net book value).**
- **Location of asset.**

D. List **four** specific matters that should be included in a client representation letter.

1. **Management's acknowledgment of its responsibility for the fair presentation in the statements of financial position, results of operations, and cash flows in conformity with generally accepted accounting principles or other comprehensive basis of accounting.**
2. **Availability of all financial records and related data.**
3. **Completeness and availability of all minutes of meetings of stockholders, directors, and committees of directors.**
4. **Information concerning related-party transactions and related amounts receivable or payable.**
5. **Plans or intentions that may affect the carrying value or classification of assets or liabilities.**

6. **Disclosure of compensating balances or other arrangements involving restrictions on cash balances, and disclosure of line-of-credit or similar arrangements**.

II - Items 1 through 11 present various internal control strengths or internal control deficiencies. For each item, select from the list below the appropriate response.

A. Internal control strength for the revenue cycle (including cash receipts)
B. Internal control deficiency for the revenue cycle (including cash receipts)
c. Internal control strength not related to the revenue cycle

Items to be answered as A, B, or C

1. Credit is granted by a credit department. ---**A**------

2. Sales returns are presented to a sales department clerk who prepares a written, pre-numbered shipping report. ---- **B** -----

3. Statements sent monthly to customers. ---- **A** -----

4. Write-offs of accounts receivable are approved by the controller. --- **B** ------

5. Cash disbursements over $10,000 require two signatures on the check. ----**C**-----

6. Cash receipts received in the mail are received by a secretary with no recordkeeping responsibility. ----- **A** ----

7. Cash receipts received in the mail are forwarded unopened with remittance advices to accounting. ---- **B** -----

8. The cash receipts journal is prepared by the treasurer's department. ---- **B** -----

9. Cash is deposited weekly. ---- **B** -----

10. Support for disbursement checks is canceled after payment by the treasurer. -- **C** ---

11. Bank reconciliation is prepared by individuals independent of cash receipts recordkeeping. ---- **A** -----

III - Adam.com SAL is a website design company whose year end was 31 October 2014. The audit is almost complete and the financial statements are due to be signed shortly. Revenue for the year is $11·2 million and profit before tax is $3·8 million. A key customer, with a receivables balance at the year end of $283,000, has just notified Adam.com SAL that they are experiencing cash flow difficulties and so are unable to make any payments for the foreseeable future. The finance director has notified the auditor that he will write this balance off as an irrecoverable debt in the 2015 financial statements.

Required:
(i) Explain whether or not the 2014 financial statements require amendment; and

i) A key customer of Adam.com has just notified the company that they are experiencing cash flow difficulties and are unlikely to make any payments for the foreseeable future. This information was received after the year end but provides further evidence of the recoverability of the receivable balance at the year end. If the customer is experiencing cash flow difficulties just a few months after the year end, then it is highly unlikely that the year-end receivable was recoverable as at 31 October and hence is an adjusting event.
The receivables balance is overstated and consideration should be given to adjusting this balance, if material, through the use of an allowance for receivables or by being written off. The total amount outstanding at the year end was $283,000 and is material as it represents 7·4% (0·283/3·8m) of profit before tax and 2·5% (0·283/11·2m) of revenue. Hence, the directors should amend the 2014 financial statements by writing down or writing off the receivable balance.

(ii) Describe audit procedures which should be performed in order to form a conclusion on any required amendment.

ii) The following audit procedures should be applied to form a conclusion as to the level of the adjustment:
– The correspondence with the customer should be reviewed to assess whether there is any likelihood of payment.
– Discuss with management as to why they feel an adjustment is not required in the 2014 financial statements.
– Review the post year-end period to see if any payments have been received from the customer.

IV- You are an audit senior of ABC & Co and have been allocated to the audit of Star Sands Co (Star), a listed company which has been an audit client for eight years and specialises in manufacturing musical instruments.

Badia Othman was the audit engagement partner for Star and as she had completed seven years as the audit engagement partner, she has recently been rotated off the audit engagement. The current audit partner, Fadi Khalil, has suggested that in order to maintain a close relationship with Star, Badia should undertake the role of independent review partner this year. In addition Star has requested that Badia assist them by attending their audit committee meetings, as a non-executive director has recently left the company.

Star has also asked Fadi and the other partners at ABC & Co to help them in recruiting a new non-executive director.

The total fees received by ABC & Co for last year equated to 16% of the firm's total fee income. The current year's audit fee has not yet been confirmed, but along with taxation and other possible non-audit fees the total income from Star this year could be greater than for last year. Last year's audit fee was being paid monthly by Star but no payments have been made for the last three months.

The audit manager for Star has just announced that he is leaving ABC & Co to join Star as the financial controller.

Required:

Identify and explain FIVE ethical threats which may affect the independence of ABC & Co's audit of Star Sands Co

Internal control components

ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* considers the components of an entity's internal control. It identifies the following components:

Control environment
The control environment includes the governance and management functions and the attitudes, awareness, and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.

Badia Othman was the audit engagement partner of Star Sands Co. for the last seven years and has recently rotated off the audit. It has been proposed that she should now become the independent review partner. This represents a **familiarity threat** as the partner will have been associated with Star for a long period of time and so may not retain professional skepticism and objectivity.

As Star is a listed company, **then Badia Othman should not serve as the independent review partner for a period of two years**. An alternative review partner should be appointed instead.

Star has requested the previous engagement partner, Badia Othman, attend audit committee meetings as a non-executive director of Star has recently left. This represents a **self-interest threat** as the audit firm may be perceived as performing the role of management by attending these meetings and this threatens objectivity.

The firm should politely decline this request from Star, as it **represents too great a threat to independence.**

A non-executive director of Star has recently left and the management of Star have asked whether the partners of ABC & Co can assist them in recruiting to fill this vacancy.

This represents a **self-interest threat** as the audit firm cannot undertake the recruitment of senior management of Star, especially as non-executive directors have a key responsibility in appointing the audit firm. ABC & Co is able to assist Star in that they can undertake roles such as reviewing a shortlist of candidates. However, they must ensure that they are not seen to undertake management decisions and so must not make the final decision on who is appointed.

The total fees received from Star for last year equated to 16% of the firm's total income. The fees for this year have not been finalised, but it is anticipated that they could be greater than 16%.

There is a potential **self-interest threat as the total fees** could represent a significant proportion of ABC & Co's income. ABC & Co should assess whether audit and non-audit fees would represent more than 15% of gross practice income for two consecutive years.

If the recurring fees are likely to exceed 15% of annual practice income this year, additional consideration should be given as to whether the taxation and non-audit assignments should be undertaken by the firm.

In addition, if the fees do exceed 15% then this should be disclosed to those charged with governance at Star .

Last year's audit fee was being paid monthly, however, the last three months' payments are outstanding.

A **self-interest threat** can arise if the fees remain outstanding, as ABC & Co may feel pressure to agree to certain accounting adjustments in order to have the previous year and this year's audit fee paid. In addition, outstanding fees could be **perceived as a loan to a client** which is strictly prohibited.

ABC & Co should discuss with those charged with governance the reasons why the last three months' payments have not been made. They should agree a revised payment schedule which will result in the fees being settled before much more work is performed for the current year audit.

The audit manager of Star is leaving ABC & Co to become the financial controller at Star. This represents a **self-interest and familiarity threat as the audit manager is familiar with the audit plan which is to be adopted at Star and he may also have commenced work on this ye**ar's audit.

A new audit manager should be appointed to Star and any work already undertaken by the previous manager should be independently reviewed. In addition, it would be advisable to modify the audit plan so that the manager would not be overly familiar with the approach to be adopted.

CASE (20%)

The auditors' report below was drafted by Sami, a staff accountant of J&M auditors, at the completion of the audit of the financial statements of a Company for the year ended December 31, 2014. The report was submitted to the engagement partner who reviewed the audit working papers and properly concluded that an unqualified opinion should be issued. In drafting the report, Sami considered the following:

During fiscal year 2014, the Company changed its depreciation method. The engagement partner concurred with this change in accounting principle and its justification and Sami included an explanatory paragraph in the auditors' report.

The 2014 financial statements are affected by an uncertainty concerning a lawsuit, the outcome of which cannot presently be estimated. Sami has included an explanatory paragraph in the auditors' report.

The financial statements for the year ended December 31, 2013, are to be presented for comparative purposes. J&M auditors previously audited these statements and expressed an unqualified opinion.

Independent Auditors' Report

To the Board of Directors of the Company,

We have audited the accompanying statements of financial position of the Company as of December 31, 2014, and 2013, and the related statements of income and cash flows for the years then ended. These financial statements are the responsibility of the Company's management.

We conducted our audits in accordance with international auditing standards. Those standards require that we plan and perform the audit to obtain reasonable assurance about whether the financial statements are fairly presented. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide a basis for determining whether any material modifications should be made to the accompanying financial statements.

As discussed in Note X to the financial statements, the company changed its method of computing depreciation in fiscal year 2014.

In our opinion, except for the accounting change, with which we concur, the financial statements referred to above present fairly, in all material respects, the financial position of the Company as of December 31, 2014, and the results of its operations and its cash flows for the year then ended in conformity with IFRS.
As discussed in Note Y to the financial statements, the company is a defendant in a lawsuit alleging infringement of certain copyrights. The company has filed a counteraction, and preliminary hearings on both actions are in progress. Accordingly, any provision for liability is subject to adjudication of this matter.

J&M auditors
July 27, 2015
Required:

Identify the deficiencies in the auditors' report as drafted by Sami. Group the deficiencies by paragraph and in the order in which the deficiencies appear. **Do not redraft the report.**

<u>Solution</u>
Deficiencies in the auditors' report are as follows:

First (introductory) paragraph:
- The statement of retained earnings is not identified.
- The auditors' responsibility to express an opinion is omitted.

Second (scope) paragraph:
- The auditor obtains reasonable assurance about whether the financial statements are "free of material misstatement," not "fairly presented."
- The auditors' assessment of the accounting principles used is omitted.

- An audit provides a "reasonable basis for an opinion," not a "basis for determining whether any material modifications should be made."

Third (first explanatory) paragraph:

- An explanatory paragraph added to the report to describe a change in accounting principle (lack of consistency) should follow the opinion paragraph, not precede it.

Fourth (opinion) paragraph:

- The phrase "except for" should not be used.
- The auditor's concurrence with the change in accounting principles is implicit and should not be mentioned.
- Reference to the prior year's (2013) financial statements is omitted.

Fifth (second explanatory) paragraph:

- The fact that the outcome of the lawsuit cannot presently be estimated is omitted.
- It is inappropriate to state that "provision for any liability is subject to adjudication" because the report is ambiguous as to whether a liability has been recorded.