August Exam 2017 - Answers

I - MULTIPLE CHOICE QUESTIONS (50%)

1	B	26	C
2	D	27	B
3	C	28	C
4	B	29	C
5	A	30	B
6	B	31	C
7	A	32	C
8	C	33	A
9	B	34	B
10	B	35	A
11	C	36	B
12	D	37	C
13	B	38	C
14	B	39	B
15	D	40	B
16	C	41	B
17	C	42	A
18	A	43	C
19	B	44	C
20	B	45	C
21	C	46	A
22	D	47	C
23	C	48	C
24	A	49	C
25	A	50	C

TRUE & FALSE (14%)

1	True
2	False
3	False
4	True
5	True
6	False
7	False

8	True
9	True
10	False
11	False
12	False
13	True
14	False

MATCHING (6%)

1	D
2	F
3	B

III) SHORT QUESTIONS (Please answer in bullet points) (30%)

Question I (10%)

The following elements should be included within an auditor's report along with why:

1. **Title:** The auditor's report shall have a title which clearly indicates that it is the report of an independent auditor; this distinguishes this report from any other.
2. **Addressee:** The auditor's report shall be addressed as required by the circumstances of the engagement; this is determined by law or regulation but is usually to the shareholders. This clarifies who may rely on the opinion and who may not, such as third parties.
3. **Introductory paragraph:** The introductory paragraph in the auditor's report shall identify the entity whose financial statements have been audited, state that the financial statements have been audited, identify the title of each statement which comprises the financial statements, refer to the summary of significant accounting policies and other explanatory information and specify the date or period covered by each financial statement. This paragraph aims to clarify what time period the audit covers and which pages of the financial statement have been audited, as not every page is audited.
4. **Management's responsibility for the financial statements:** This section of the auditor's report describes the responsibilities of those in the organization who are responsible for the

preparation of the financial statements. This paragraph along with that of the auditor's responsibilities looks to make clear what the role of management is, as well as what the role of the auditor is. It seeks to reduce the expectation gap.

5. **Auditor's responsibility:** The auditor's report shall state that the responsibility of the auditor is to express an opinion on the financial statements based on the audit and that the audit was conducted in accordance with International Standards on Auditing and ethical requirements and that the auditor plans and performs the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement. Along with the management's responsibility paragraph, it seeks to make clear the role of the auditor and also what management's role is. Also this paragraph seeks to explain what an audit involves and that only material misstatements are considered, as opposed to all errors.
6. **Opinion paragraph:** When expressing an unmodified opinion, the auditor's opinion shall either state that the financial statements 'present fairly' or 'give a true and fair view' in accordance with the applicable financial reporting framework. This paragraph details whether the financial statements are true and fair or not.
7. **Other reporting responsibilities:** If the auditor addresses other reporting responsibilities in the auditor's report, these shall be addressed in a separate section in the auditor's report titled 'Report on Other Legal and Regulatory Requirements'. This is important where there is local legislation which requires reporting on; this needs to be clearly identified in the report as this is in addition to the requirement of the ISAs.
8. **Signature of the auditor:** The auditor's report must be signed, this can be either the personal name of the auditor or, the signature is on behalf of the firm, depending on the jurisdiction in which the auditor is operating. This clarifies which firm or auditor has performed the audit engagement.
9. **Date of the auditor's report:** The auditor's report shall be dated no earlier than the date on which the auditor has obtained sufficient appropriate audit evidence on which to base the auditor's opinion on the financial statements. The date of the audit report is important in the case of subsequent events which impact the financial statements; the auditor's role is different depending on whether the audit report was signed or not when the subsequent event came to light.
10. **Auditor's address:** The auditor's report shall name the location where the auditor practices. This is useful in case shareholders need to contact the auditors.

QUESTION II (10 %)

Explain FIVE audit risks, and the auditor's response to each risk, in planning the audit of Eagle Heating Co.

Audit risk	Auditors response
Eagle Heating Co (Eagle) has decreased the selling price of products significantly since September 2014 and there are increased levels of inventory expected at the year end. It is possible that the selling price may have fallen so that the net realizable value (NRV) of inventory is below cost. IAS 2 Inventory requires inventory to be stated at the lower of cost and NRV. Hence it is possible that inventory is overvalued.	The auditor should undertake detailed cost and NRV testing to assess whether inventory is overvalued and requires write down.
A key customer of Eagle has been experiencing financial difficulties and Eagle has agreed a six-month payment break; however, the finance director does not believe an allowance is required.	If the six-months payment break has now ended, review after date cash receipts for this customer to assess whether any payments have been made.
If the customer is experiencing difficulties, there is an increased risk that the receivable is not recoverable and hence is overvalued.	Discuss with the finance director why he feels an allowance is not required. Review whether any general allowance for uncollectable accounts is sufficient to cover the amount of this receivable.
In light of the increased competition, reduction in selling price and financial difficulties of a key customer, there is an increased risk that Eagle is facing going concern difficulties.	The auditor should undertake detailed going concern testing. They should review the cash flow forecast for the foreseeable future to assess whether the going concern basis is appropriate or whether additional going concern disclosures are required in the financial statements.
The financial controller of Eagle was dismissed in October and is threatening to sue the company for unfair dismissal.	The audit team should write to the company's lawyers to enquire of the existence and likelihood of success of any claim from the former financial controller.
If it is probable that Eagle will make payment to the financial controller, a provision for unfair dismissal is required. If the payment is possible rather than probable, a contingent liability disclosure would be necessary. If Eagle has not done this, there is a risk over the completeness of any provisions or contingent liabilities.	
The financial controller has been dismissed and his tasks have been allocated between the finance department team, this has increased their workload.	The team should remain alert throughout the audit for additional errors within the finance department.

Audit risk	Auditors response
This increases the inherent and control risk within Eagle as errors may have been made within the accounting records by the overworked finance team members and there is no one working in a supervisory capacity.	In addition, discuss with the finance director whether he will be able to provide the team with assistance for any audit issues as there is no financial controller available.
The purchase ledger supervisor left in August and no reconciliations of supplier statements and purchase ledger control account have been performed. There is an increased risk of errors within trade payables and the year-end payable may be under or overstated.	The audit team should increase their testing on trade payables at the year end, with a particular focus on completeness of payables. A detailed review of the year-end purchase ledger control account reconciliation should be performed with a focus on any unusual reconciling items
Preliminary analytical review of the draft statement of profit or loss has identified a significant fall in administration expenses.	Update the analytical review with the full year results and if significant fluctuations on prior year remain, discuss these with management. Obtain supporting evidence to verify management explanations.
Administration expenses tend to be fixed costs and hence would be unlikely to fluctuate significantly with changes in sales volumes. Hence there is a risk that administration expenses are understated	

QUESTION III (10 %)

(i) Explain whether or not the 2014 financial statements require amendment; (4 %)

A key customer of Bullfinch.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. Note: The total marks will be split equally between each part. (6 %)

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.