A. MULTIPLE CHOICE QUESTIONS (30%)

1	A
2	D
3	D
4	B
5	C
6	C
7	D
8	B
9	C
10	A

11	A
12	C
13	B
14	C
15	D
16	C
17	D
18	A
19	B
20	A

B. Cases

Case # 1 (25%)

EHC

Required:

a) Calculate FOUR ratios, for BOTH years, which would assist in planning the audit of EHC:

- **Quick Ratio**
- **Payables Payment Period**
- **Receivables Collection Period**
- **Operating Profit Margin**

	20X5	**20X4**
Quick Ratio	1.5 (35+0.1)/(19+5)	1.4 (25+3.4)/(16+5)
Payables Payment Period	40 days (19/172x365)	32 days (16/184x365)
Receivables Collection Period	52 days (35/246x365)	32 days (25/283x365)
Operating Profit Margin	13.8% (34/246x100)	17.3% (49/283x100)

b) Using the information provided and the ratios calculated, identify and describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of EHC.

Audit Risks	The Auditor's Response
Eagle Heating Co (EHC) has decreased the selling price of products significantly and increased levels of inventory are expected at the year-end. This can be seen in the inventory holding period which has increased from 56 days to 108 days. It is possible that the net realisable value (NRV) of inventory is now below cost and inventory is overvalued.	The auditor should undertake detailed cost and NRV testing to assess whether inventory is overvalued and requires write down.
The finance director does not believe an allowance for receivables is required despite a key customer experiencing financial difficulties.	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.
The receivables collection period shows that the time taken for customers to pay has increased from 32 days to 52 days which may indicate other irrecoverable debts. There is an increased risk that the receivables are overstated.	Discuss with the finance director why he feels an allowance is not required. Review whether any general allowance for uncollectable accounts is sufficient.
In light of the increased competition, reduction in selling price and financial difficulties of a key customer, EHC may be facing going concern difficulties. The ratios show that the operating cycle is extending. Whilst the current and quick ratios appear to be improving, this is due to increasing receivables and inventory balances rather than cash. EHC may be facing going concern problems. There is a risk of inadequate disclosure of going concern uncertainties in the financial statements.	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 EHC was dismissed in June and is threatening to sue the company for unfair dismissal. If it is probable that EHC 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 EHC has not done this, there is a risk over	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.

Audit Risks	The Auditor's Response
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. This increases the inherent and control risk within EHC 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.	The team should remain alert throughout the audit for additional errors within the finance department. 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 April 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.
Analytical review of the draft statement of profit or loss has identified a significant fall in operating expenses. Operating expenses would be unlikely to fluctuate significantly with changes in sales volumes. Hence there is a risk that operating expenses are understated.	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.

c) Describe the substantive procedures that should be performed to obtain sufficient and appropriate evidence in relation to the receivable balance outstanding from EHC's key customer.

Audit procedures: Receivable balance

- Inspect after date cash receipts from the customer to identify if any payments have been received from the customer.
- Inspect correspondence from the customer indicating any further financial problems which would indicate payment will not be made.
- Perform a search for the company to identify whether it is still registered or whether it has become insolvent and ceased to trade.
- Discuss with management the need for an allowance for the doubtful receivable.

d) Explain the audit senior's responsibilities in relation to supervising the work of the audit team during the audit of EHC.

Supervisor's responsibilities

During the audit, the supervisor should keep track of the progress of the audit engagement to ensure that the audit timetable is met, and should ensure that the audit manager and partner are kept updated of progress.

The competence and capabilities of individual members of the engagement team should be considered, including whether they have sufficient time to carry out their work, whether they understand their instructions and whether the work is being carried out in accordance with the planned approach to the audit.

In addition, part of the supervision process should involve addressing any significant matters arising during the audit, considering their significance and modifying the planned approach appropriately.

The supervisor would also be responsible for identifying matters for consultation or consideration by the audit manager or engagement partner.

Case # 2 (25%)

DEAN MANUFACTURING
Required:

For each internal control deficiency in the purchasing system:

a) **Identify the deficiency and briefly explain its audit significance (if any), in terms of the type of errors that could result from it.**

Deficiency	Significance
Ordering of goods	
No authorisation is required in order for employees to order goods.	It will be difficult to check that all goods ordered are for the purpose of the business.
The order forms are not pre-numbered.	It will be difficult to check that all commitments have been recorded and, as a result, that liabilities are not understated.
Employees place orders as they wish.	There is no central control over re-order levels and therefore efficiency of the business may be lost. Also, employees may place orders for personal items, causing loss for the company.
There is no central buying department. No evidence of an authorised supplier list being used.	The best prices may not be achieved without a central buying policy.
Receipt of goods	
No physical check of goods received to purchase order or	The quality of goods received may not be satisfactory with the consequence that inventory and liabilities may

Deficiency	Significance
advice note or for quality control.	be overstated.
No check of supplier's delivery note to purchase order.	Goods which have not been ordered could be accepted incurring additional cost for the company.
A sequentially numbered goods received note is not completed.	Completeness of goods received cannot be verified as the supplier dispatch note will use the suppliers referencing system. As multiple suppliers will be used, goods received notes with Dean Manufacturing's referencing system should be prepared.
Goods inward clerk has receipt of both delivery note and the retained copy of the order form giving her the capacity to misappropriate inventory by altering the delivery note and order form.	The effect on year-end inventories of under supply of goods or misappropriation will depend upon how the year-end inventory is calculated. As it will most likely be based upon a year-end count the statement of financial position value will be unaffected. However purchases will be overstated with a consequential reduction in profit.
Receipt of invoice	
No checks exist to agree quantities invoiced to quantities ordered or received.	Purchases and liabilities may be misstated if the company is over or under invoiced.
Invoice is recorded before authorisation.	Inventory value, based upon amount invoiced, may be misstated due to inclusion of sub-standard goods. Purchases and liabilities could be overstated by recording invoices not authorised.
Authorisation	
No reliable evidence exists to ensure all invoices are authorised by management (i.e. invoices not initialed).	Possible overstatement of purchases and liabilities by invoices not being passed for authorisation by person ordering the goods.

b) Describe the effect it would have on your normal audit procedures in terms of any additional or extended procedures required.

Additional or extended procedures

Given the deficiencies identified above, no reliance can be placed on the purchases system and, as a result, full substantive testing must be performed.

The emphasis of the substantive tests would be to detect the possible errors identified above, i.e.

- Understatement or overstatement of purchases and liabilities.
- Misstatement of inventory.

The areas in which normal audit work would be extended or further tests introduced would be as follows:

Cut-off testing

- Agreeing delivery notes to invoices and into the purchase day book and payables ledger. Tests of inventory received both sides of the year-end should be done.
- Post year-end cash book review agreeing post year-end payments to relevant invoice and delivery note and ensuring inclusion in the correct period.
- Post year-end invoice review for further liabilities regarding inventory received before the year-end.

Misstatement of inventory

- Extended quantity checks at year-end inventory count with particular emphasis on overstatement.
- Review of goods for faulty items, and ensure adjustments are made accordingly.
- Extended testing of post year-end sales in order to detect possible write downs to net realisable value.

Overstatement of purchases and liabilities

- Analytical review of costs per area in order to identify over expenditure.
- Extended testing in the high risk areas identified above.
- Careful scrutiny of invoice details to orders and delivery notes.
- Scrutiny of orders and delivery notes for evidence of alteration.
- Inspection of purchase orders and delivery notes for recognised suppliers.
- Agreement of cash payments per cash book to the payables ledger and invoice/supplier statements/remittance advice.
- Review and agreement of month-end payables ledger control account reconciliations and supplier statement reconciliations.
- Perform accounts payable circularisation in order to agree year-end balances with a sample of suppliers.

<u>Case # 3 (20%)</u>

Required:

Discuss each of the cases outlined above, referring to materiality considerations and, where appropriate, relevant accounting principles and appropriate accounting standards. Explain the audit reporting implications in each case.

Answers:

(a) Jones (Profit before tax $150,000)

Materiality:

The receivable of $30,000 represents 20% of profit and more than 4% of receivables therefore is material.

Relevant accounting principles:

The bankruptcy of the customer provides evidence of a condition existing at the statement of financial position date. It should therefore be treated as an adjusting event in accordance with

IAS 10 Events after the Reporting Period. The receivable should be written off in full in the financial statements at 30 September 20X2.
The company has overstated receivables and profit by $30,000.
Impact on the auditor's report:

- The financial statements are materially misstated.
- The matter is material but not pervasive.
- A qualified opinion should be issued with the "except for" wording.
- The "Basis for Opinion" section will be amended to a "Basis for Qualified Opinion" to explain the reason for the qualified opinion.

(b) Roberts (Profit before tax $500,000)
Materiality:
The amount of $10,000 represents only 2% of the stated profit before tax and therefore is not material.
The potential losses may be more significant than the figure of $10,000 since other claims are now pending. The auditor may conclude that the whole legal matter is potentially material.
Relevant accounting principles:
There is uncertainty with regard to the outcome of the pending claims and the potential liability which may arise as a result of the product defect. The appropriate accounting treatment will depend on whether the chance of loss is probable, possible or remote. If it is probable a provision should be recognized. If it is possible a contingent liability should be disclosed. If it is remote the financial statements will not be affected. (IAS 37 Provisions, Contingent Liabilities and Contingent Assets).
Liabilities may be understated or contingent liabilities may not be adequately disclosed.
Impact on the auditor's report:

- Management has chosen to ignore both the actual loss (which is not individually material) and the potential loss (which may be material). If the auditor does not believe that the management's view is acceptable, or does not think that the disclosure is adequate, the financial statements will be materially misstated.
- If the potential claims are considered material, a qualified opinion with the "except for" wording should be issued.
- If the auditor believes that the claims are likely to be successful and are likely to be substantial then an adverse opinion should be issued stating that the financial statements do not show a true and fair view.
- The "Basis for Opinion" section will be amended to a "Basis for Qualified Opinion" or "Basis for Adverse Opinion" to explain the reason for the modified opinion.

(c) Griffiths (Profit before tax $250,000)
Materiality:
The fall in value is material and pervasive as the adjustment would have the effect of turning a profit before tax of $250,000 into a loss of $50,000.
Relevant accounting principles:

Investments should be written down if they are impaired. A fall in the value of one asset must not be offset against an increase of value of another asset. Each asset has to be considered separately.
As the company admits that a permanent fall in value has taken place it should write the value of the assets down otherwise assets will be overstated.
Impact on the auditor's report:

- The financial statements are materially misstated.
- The matter is material and pervasive.
- An adverse opinion should be issued stating that the financial statements do not show a true and fair view.
- The "Basis for Opinion" section will be amended to a "Basis for Adverse Opinion" to explain the reason for the adverse opinion.

(a) Evans (Profit before tax $100,000)
Materiality:
The $10,000 represents 10% of profit before tax, and so would appear to be material.
Since the accounting records were only destroyed for the early part of the year, the auditor would still be able to confirm the calculations for the later part of the year. in these particular circumstances the auditor may consider that the amount of any error (which is likely to be considerably less than $10,000) is not material.
Relevant accounting principles:
The company must include the cost of its own labor and materials in the construction of the warehouse, since these have been used to create a capital asset.
Impact on the auditor's report:

- There is a lack of sufficient appropriate evidence to support the treatment of the $10,000 labour costs therefore the auditor does not know whether the costs are materially misstated.
- Assuming that the extent of any potential misstament is considered not material, an unmodified opinion will be issued stating that the financial statements give a true and fair view.
- If the possible misstament is considered material, a qualified opinion with the "except for" wording will be required.
- If modified, the "Basis for Opinion" section will be amended to a "Basis for Qualified Opinion" to explain the reason for the qualified Opinion.