A. MULTIPLE CHOICE QUESTIONS (30%)

The following scenario relates to questions 1–5

Chester Co manufactures and sells pet toys to the wholesale market. It has prepared its financial statements to 31 July 20X8. You are an audit assistant with Durham & Co and you have been assigned the current liabilities balances in the audit work plan.

You have calculated the payables payment period to be 66 days in 20X8 (45 days in 20X7) and have asked the directors of Chester Co to provide an explanation as to the increase in days.

Chester Co receives monthly statements from its main suppliers and performs regular supplier statement reconciliations.

There were inconsistencies noted in respect of the following at 31 July 20X8:

Supplier	**Balance per purchase ledger**	**Balance per supplier statement**
	$	**$**
Oxford Co	151,480	296,120
Poole Co	(72,168)	84,235
Bath Co	82,348	92,340

Oxford Co

Chester Co has a credit agreement with Oxford Co under which it receives goods 14 days before the supplier raises the invoice. Chester Co received goods worth $144,640 on 18 July 20X8 for which the invoice was received shortly after the year end in accordance with the agreement. Chester Co entered the transaction into its accounting records at the date of invoice.

Poole Co

The difference on this balance has still to be investigated.

Bath Co

Chester Co's finance director has informed you that there was an error in closing the purchase ledger and it was closed three days early. Invoices received 29, 30 and 31 July 20X8 were posted to the 20X9 ledger. The directors of Chester Co have confirmed that following the discovery of this error, a manual adjustment was made using the journal book.

1. Which of the following supplier balances would indicate a high risk in relation to the COMPLETENESS of the liability recorded at the year end?

a. A supplier with a high balance at the year end and with a low volume of transactions during the year
b. A supplier with a low balance at the year end and with a high volume of transactions during the year
c. A supplier with a low balance at the year end and with a low volume of transactions during the year
d. A supplier with a high balance at the year end and with a high volume of transactions during the year

2. **Which of the following would correctly explain why the payables payment period has increased from 45 days in 20X7 to 66 days in 20X8?**
   a. Chester Co received a prompt payment discount from one of its suppliers for the first time in 20X8
   b. Chester Co obtained a trade discount from one of its biggest suppliers which has reduced the amount owed to that supplier by 10% in the year
   c. Chester Co purchased an unusually high level of goods in July 20X8 to satisfy a large order and had not paid for those goods by the year end
   d. Chester Co took advantage of extended credit terms offered by a new supplier in respect of a large order which it had fully settled by the year end

3. **Which of the following is an appropriate action in respect of the inconsistency in the balance with Oxford Co?**
   a. The auditor should take no further action as this is a timing difference which was resolved upon receipt and posting of the invoice
   b. The auditor should request that the purchase ledger balance is amended at the reporting date to reflect the recent invoice
   c. The auditor should contact the supplier and request a supplier statement as at the current date
   d. The auditor should request that an accrual is created in respect of the goods received but not yet invoiced

4. **Which of the following would be a valid explanation for the difference in respect of Poole Co?**
   (1) An invoice for $156,403 has been paid twice
   (2) An invoice for $156,403 has been posted as a debit note
   (3) An invoice for $156,403 has been received and processed prior to receipt of the goods
   a. 1 only
   b. 1 and 2 only
   c. 2 and 3 only
   d. 1, 2 and 3

5. **Which of the following would NOT provide sufficient and appropriate audit evidence over the COMPLETENESS of the purchase ledger balance in respect of Bath Co?**
   a. Obtain the journal book and confirm that all invoices recorded as received from Bath Co dated 29–31 July have been manually adjusted for
   b. Review the accruals listing to ensure goods received from Bath Co post year end for which an invoice has not been received have been recorded in the correct period
   c. For post year-end cash book payments to Bath Co, confirm date of matching invoice and if pre year end agree to liability

d. Review a sample of invoices received from Bath Co recorded post year end and match to GRN to determine if they should have been recorded at the year end

Read the below scenario and answer questions 6 - 10

You are planning the audit of Wyndham Co. The company sells diamonds and other precious stones. You have decided to use the work of an auditor's expert to provide sufficient appropriate evidence over the valuation of inventory.

6. Before appointing an auditor's expert, what factors must the auditor consider?

(i) Competence
(ii) Capability
(iii) Objectivity
(iv) Reliability of the source data

a. (i), (ii) and (iii)
b. (ii), (iii) and (iv)
c. (i) (iii) and (iv) only
d. (i), (ii), (iii) and (iv)

7. How can the auditor assess the competence of an auditor's expert?

(i) Obtain copies of professional certificates and make enquiries of the expert's experience.
(ii) Ask for confirmation from the expert of their independence .
(iii) Inspect the register of members of the relevant professional body for the name of the expert.

a. (i) and (ii) only
b. (ii) and (iii) only
c. (i) and (iii) only
d. (i), (ii) and (iii)

8. What must be agreed with the auditor's expert in writing before the work is performed?

(i) Responsibilities of each party
(ii) Inherent limitations of the audit
(iii) Deadline for the work
(iv) Scope and objectives

a. All of them
b. (i), (iii) and (iv) only
c. (iii) and (ii) only
d. (i), (ii) and (iv) only

9. Which of the following statements is true in respect of the expert's work?

a. The auditor can rely on expert's work and does not need to review it
b. The auditor may choose not to review the expert's work if it is an area in which the auditor lacks knowledge or experience
c. The auditor must review the assumptions and source data used by the expert to ensure they were reasonable and reliable
d. The auditor will engage a second expert to review the work of the first to ensure sufficient appropriate evidence has been obtained

10. Which of the following statements best describes a management's expert?

a. A management's expert is an employee of the company
b. A management's expert is someone appointed by the company to provide evidence for the auditor
c. A management's expert is someone recommended by the auditor which management appoints to provide evidence for the audit
d. A management's expert is someone appointed by the company to provide evidence for management which may be relied upon by the auditor

11. The most favorable type of audit report opinion for the client to receive is:

a. Qualified.
b. Unqualified.
c. Full assurance.
d. Exceptional.

12. Which of the following is generally not considered one of the five business processes or cycles?

a. Information technology
b. Revenue [or sales]
c. Financing
d. Inventory management

13. Which of the following management assertions is generally of greatest importance in the audit of inventory?

a. Existence
b. Completeness
c. Rights and Obligations
d. Presentation and Disclosure

14. 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

15. 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

16. In its annual report to shareholders, Omega included a letter to shareholders that contained financial summaries of the past two years. Omega's auditor is expressing an unmodified opinion on Omega's financial statements but has not been engaged to examine and report on this additional information. What is the auditor's responsibility concerning the financial summaries?

a. The auditor should express a qualified or adverse opinion because all financial statement information should be audited.
b. The auditor should include an emphasis-of-matter paragraph that includes a disclaimer of opinion on this information.
c. The auditor should inquire of management regarding the purpose of the supplementary information and the criteria used to prepare the information.
d. The auditor should read the letter to the shareholders and verify the information is materially consistent with the information presented in the audited financial statements.

17. Which would most likely determine the appropriate form of audit report when financial statements are prepared in accordance with a financial reporting framework generally accepted in another country?

a. The other country's auditing standards.
b. The geographic location of the company.
c. The expected distribution of the financial statements.
d. The country's economic conditions.

18. An auditor most likely would apply analytical procedures in the overall review stage of an audit to:

a. Identify unusual or unexpected balances that were not previously identified.
b. Obtain an understanding of high risk areas.
c. Evaluate the design and implementation of internal control.
d. Identify related party transactions that may not have been previously identified.

19. Which of the following identified misstatements would most likely result in the auditor still concluding that the financial statements are free of material misstatement?

a. A material overstatement in revenue that is offset by an equivalent overstatement of expenses.

b. A misclassification amount, which is below the materiality of the financial statements as a whole, between balance sheet line items that results in the company meeting its debt covenant.

c. A misstatement in cash that is clearly trivial.

d. A factual misstatement of an accounts receivable sample that is below the materiality of the financial statements, but where the projected misstatement is above the materiality level of the financial statements as a whole.

20. An advantage of using statistical over nonstatistical sampling methods in tests of controls is that the statistical methods:

a. Can more easily convert the sample into a dual-purpose test useful for substantive testing.

b. Eliminate the need to use judgment in determining appropriate sample sizes.

c. Afford greater assurance than a nonstatistical sample of equal size.

d. Provide an objective basis for quantitatively evaluating sample risk.

B. <u>Exercises</u>

<u>Exercise # 1 (20%)</u>

You are an audit supervisor of Earl & Co and are planning the audit of Darjeeling Co for the year ending 30 September 20X8. The company develops and manufactures specialist paint products and has been a client of your firm for several years. The audit manager has attended a planning meeting with the finance director and has provided you with the following notes of the meeting and financial statement extracts. You have been asked by the audit manager to undertake preliminary analytical procedures using the financial statement extracts.

Planning meeting notes

During the year Darjeeling Co has spent $0·9m, which is included within intangible assets, on the development of new product lines, some of which are in the early stages of their development cycle. Additionally, as the company is looking to expand production, during the year it purchased and installed a new manufacturing line. All costs, incurred in the purchase and installation of that asset, have been included within property, plant and equipment. These capitalised costs include the purchase price of $2·2m, installation costs of $0·4m and a five-year servicing and maintenance plan costing $0·5m. In order to finance the development projects and the new manufacturing line, the company borrowed $4m from the bank which is to be repaid in instalments over eight years and has an interest rate of 5%. Developing new products and expanding production is important as the company intends to undertake a stock exchange listing in the next 12 months.

The company started a number of initiatives during the year in order to boost revenue. It offered extended credit terms to its customers on the condition that their sales order quantities were increased. In addition, Darjeeling Co made an announcement in October 20X7 of its ‘price promise’: that it would match the prices of any competitor for similar products purchased. Customers who are able to prove that they could purchase the products cheaper elsewhere are asked to claim the difference from Darjeeling Co, within one month of the date of purchase of goods, via its website. The company intends to include a refund liability of $0·25m, which is based on the monthly level of claims to date, in the draft financial statements.

The finance director informed the audit manager that a problem arose in June 20X8 in relation to the mixing of materials within the production process for one particular product line. A number of these faulty paint products had already been sold and the issue was identified following a number of complaints from customers about the paint consistency being incorrect. As a precaution, further sales have been stopped and a product recall has been initiated for any of these specific paint products sold since June. Management is investigating whether the paint consistency of the faulty products can be rectified and subsequently sold.

Financial statement extracts for year ending 30 September

	Forecast 20X8	**Actual 20X7**
	$’000	**$’000**
Revenue	19,850	16,990
Cost of sales	(12,440)	(10,800)
Gross profit	7,410	6,190
Inventory	1,850	1,330
Trade receivables	2,750	1,780
Bank	(810)	560
Trade payables	1,970	1,190

Required:

a) **Explain why analytical procedures are used during THREE stages of an audit.**
b) **Calculate THREE ratios, for BOTH years, which would assist you in planning the audit of Darjeeling Co.**
c) **Using the information provided and the ratios calculated, describe EIGHT audit risks and explain the auditor’s response to each risk in planning the audit of Darjeeling Co.**
   Note: Prepare your answer using two columns headed Audit risk and Auditor’s response respectively.
d) **Describe substantive procedures the auditor should perform in relation to the faulty paint products held in inventory at the year end.**
e) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Darjeeling Co’s revenue.**

Exercise # 2 (20%)

You are an audit manager of Cranberry & Co and you are currently responsible for the audit of Gooseberry Co, a company which develops and manufactures health and beauty products and distributes these to wholesale customers.

Its draft profit before tax is $6·4m and total assets are $37·2m for the financial year ended 31 January 20X8. The final audit is due to commence shortly and the following matters have been brought to your attention:

Research and development

Gooseberry Co spent $1·9m in the current year developing nine new health and beauty products, all of which are at different stages of development. Once they meet the recognition criteria under IAS® 38 *Intangible Assets* for development expenditure, Gooseberry Co includes the costs incurred within intangible assets. Once production commences, the intangible assets are amortised on a straight line basis over three years. Management believes that this amortisation policy is a reasonable approximation of the assets' useful lives, as in this industry there is constant demand for innovative new products.

Depreciation

Gooseberry Co has a large portfolio of property, plant and equipment (PPE). In March 20X7, the company carried out a full review of all its PPE and updated the useful lives, residual values, depreciation rates and methods for many categories of asset. The finance director felt the changes were necessary to better reflect the use of the assets. This resulted in the depreciation charge of some assets changing significantly for this year.

Bonus

The company's board is comprised of seven directors. They are each entitled to a bonus based on the draft year-end net assets, excluding intangible assets. Details of the bonus entitlement are included in the directors' service contracts. The bonus, which related to the 20X8 year end, was paid to each director in February 20X8 and the costs were accrued and recognised within wages and salaries for the year ended 31 January 20X8. Separate disclosure of the bonus, by director, is required by local legislation.

Required:

a) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to Gooseberry Co's research and development expenditure.**

b) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the matters identified regarding depreciation of property, plant and equipment.**

c) **Describe substantive procedures the auditor should perform to obtain sufficient and appropriate audit evidence in relation to the directors' bonuses.**

During the audit, the team discovers that the intangible assets balance includes $440,000 related to one of the nine new health and beauty products development projects, which does not meet the criteria for capitalisation. As this project is ongoing, the finance director has suggested that no adjustment is made in the 20X8 financial statements. She is confident that the project will meet the criteria for capitalisation in 20X9.

Required:

d) Discuss the issue and describe the impact on the auditor's report, if any, should this issue remain unresolved.

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

In November 2017, the head office of XYZ was damaged by a fire. Many of the company's accounting records were destroyed before the audit for the year ended on December 31, 2017 took place. The company's financial accountant has prepared financial statements for the year ended 31 December 2017 on the basis of estimates and the information he has been able to recover. You have completed the audit of these financial statements but have not been able to obtain sufficient audit evidence in all areas.

Required:

(a) Draft, for inclusion in the auditor's report, wording appropriate to XYZ.

Note: You are not required to reproduce the auditor's report in full. Only the differences for an unmodified report were required.

(b) Explain and distinguish between the following forms of modified report.

(i) Emphasis of matter;
(ii) qualified opinion;
(iii) disclaimer of opinion;
(iv) adverse opinion.

<u>Exercise # 4 (10%)</u>

Match nine of the terms (a-i) with the definitions provided below (1-9):

a. Business risk
b. Preliminary judgment about materiality
c. Inherent risk
d. Planned detection risk
e. Audit assurance
f. Acceptable audit risk
g. Tolerable misstatement
h. Control risk
i. Materiality

________ 1. A measure of the risk that audit evidence for a segment will fail to detect misstatements exceeding a tolerable amount, should such misstatements exist.

________ 2. The risk that the auditor or audit firm will suffer harm because of a client relationship, even though the audit report rendered for the client was correct.

________ 3. A measure of the auditor's assessment of the likelihood that misstatements exceeding a tolerable amount in a segment will not be prevented or detected by the client's internal controls.

________ 4. A measure of how much risk the auditor is willing to take that the financial statements may be materially misstated after the audit is completed and an unqualified audit opinion has been issued.

________ 5. The materiality allocated to any given account balance.

________ 6. The maximum amount by which the auditor believes that the statements could be misstated and still not affect the decisions of reasonable users.

________ 7. This term is synonymous with acceptable audit risk.

________ 8. The magnitude of an omission or misstatement of accounting information that makes it probable that the judgment of a reasonable person would have been changed.

________ 9. A measure of the auditor's assessment of the likelihood that there are material misstatements before considering the effectiveness of internal control.

Good Work!!