A. MULTIPLE CHOICE QUESTIONS (30%)

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

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

B. Exercises

Exercise # 1 (20%)

Required:

a) Explain why analytical procedures are used during THREE stages of an audit.

Analytical procedures can be used at all stages of an audit, however, ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* and ISA 520 *Analytical Procedures* identify three particular stages.

During the planning stage, analytical procedures must be used as risk assessment procedures in order to help the auditor to obtain an understanding of the entity and assess the risk of material misstatement.

During the final audit, analytical procedures can be used to obtain sufficient appropriate evidence. Substantive procedures can either be tests of detail or substantive analytical procedures.

At the final review stage, the auditor must design and perform analytical procedures which assist them when forming an overall conclusion as to whether the financial statements are consistent with the auditor's understanding of the entity.

b) Calculate THREE ratios, for BOTH years, which would assist you in planning the audit of Darjeeling Co.

Ratios to assist the audit supervisor in planning the audit:

	20X8	20X7
Gross margin	7,410/19,850 = 37.3%	6,190/16,990 = 36.4%
Inventory holding period	1,850/12,440 * 365 = 54 days	1,330/10,800 * 365 = 45 days

OR		
Inventory turnover	12,440/1,850 = 6.7	10,800/1,330 = 8.1
Receivables collection period	2,750/19,850 * 365 = 51 days	1,780/16,990 * 365 = 38 days
Payables payment period	1,970/12,440 * 365 = 58 days	1,190/10,800 * 365 = 40 days
Current ratio	4,600/(1,970 + 810) = 1.65	3,670/1,190 = 3.08
Quick ratio	2,750/(1,970 + 810) = 0.99	(3,670 – 1,330)/1,190 = 1.97

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.

Audit risk	**Auditor's response**
During the year, Darjeeling Co has spent $0·9m on developing new product lines, some of which are in the early stages of their development cycle. This expenditure is classed as research and development under IAS® 38 *Intangible Assets*. The standard requires research costs to be expensed to profit or loss and only development costs to be capitalised as an intangible asset.	Obtain a breakdown of the expenditure and verify that it relates to the development of the new products. Review expenditure documentation to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with IAS 38.
The company has included all of this expenditure as an intangible asset. If research costs have been incorrectly classified as development expenditure, there is a risk that intangible assets could be overstated and expenses understated.	
Darjeeling Co purchased and installed a new manufacturing line. The costs include purchase price ($2·2m), installation costs ($0·4m) and a five-year servicing and maintenance plan ($0·5m).	Review the purchase documentation for the new manufacturing line to confirm the exact cost of the servicing and that it does relate to a five-year period.
As per IAS 16 *Property, Plant and Equipment*, the cost of an asset includes its purchase price and directly attributable costs only. IAS 16 does not allow servicing and maintenance costs to be capitalised as part of the cost of a non-current asset, as they are not directly related to the cost of bringing the asset to its working condition.	Discuss the accounting treatment with the finance director and the level of any necessary adjustment to ensure treatment is in accordance with IAS 16.
The servicing costs relate to a five-year period and so should be charged to profit or loss over this time. The upfront payment represents a prepayment for five years; as the services are received, the relevant proportion of the cost should be charged to profit or	

Audit risk	Auditor's response
loss. If the service for 20X8 has been carried out, then \$0·1m (\$0·5m/5) should be charged to profit or loss. Therefore property, plant and equipment (PPE) and profits are overstated and prepayments are understated.	
The company has borrowed \$4m from the bank via an eight-year loan. This loan needs to be correctly split between current and non-current liabilities in order to ensure correct disclosure.	During the audit, the team would need to confirm that the \$4 million loan finance was received. In addition, the split between current and non-current liabilities and the disclosures for this loan should be reviewed in detail to ensure compliance with relevant accounting standards and local legislation. Details of security should be agreed to the bank confirmation letter.
As the level of debt has increased, there should be additional finance costs as the loan has an interest rate of 5%. There is a risk that this has been omitted from the statement of profit or loss leading to understated finance costs and overstated profit.	The finance costs should be recalculated and any increase agreed to the loan documentation for confirmation of the 5% interest rate. Interest payments should be agreed to the cash book and bank statements to confirm the amount was paid and is not therefore a year-end payable.
Darjeeling Co intends to undertake a stock exchange listing in the next 12 months. In order to maximise the success of the potential listing, Darjeeling Co will need to present financial statements which show the best possible position and performance. The directors therefore have an incentive to manipulate the financial statements, by overstating revenue, profits and assets.	Earl & Co should ensure that there is a suitably experienced audit team. Also, adequate time should be allocated for team members to obtain an understanding of the company and the significant risks of overstatement of revenue, profits and assets, including attendance at an audit team briefing. The team needs to maintain professional scepticism and be alert to the increased risk of manipulation. Significant estimates and judgements should be carefully reviewed in light of the misstatement risk.
The receivables collection period has increased from 38 to 51 days and management has extended the credit terms given to customers on the condition that sales order quantities were increased. The increase in receivable days could be solely due to these increased credit terms. However, it could also be due to an increased risk over recoverability of receivables as they may be	Review and test the controls surrounding how Darjeeling Co identifies receivables balances which may not be recoverable and procedures around credit control to ensure that they are operating effectively. Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation. Also consider the

Audit risk	Auditor’s response
overvalued and expenses understated.	adequacy of any allowance for receivables.
This year the company made a ‘price promise’ to match the price of its competitors for similar products. Customers are able to claim the difference from the company for one month after the date of purchase of goods. The company should account for the price promise in accordance with IFRS® 15 *Revenue from Contracts with Customers*. As the company may be required to provide a refund, the anticipated refund amount should not be initially recognised as revenue but instead as a refund liability until the one-month price promise period has ended. This is a highly subjective area, with many judgements required with regards to the level of likely refund due. As this is a new liability, the directors may not have correctly accounted for this sum resulting in overstated revenue, under/overstated profits and liabilities.	Discuss with management the basis of the refund liability of $0·25m and obtain supporting documentation to confirm the reasonableness of the assumptions and calculations.
Darjeeling Co has stopped further sales of one of its paint products and a product recall has been initiated for any goods sold since June. This product recall will result in Darjeeling Co paying refunds to customers. The sales will need to be removed from the 20X8 financial statements and a refund liability recognised. Also inventory will need to be reinstated, albeit at a possibly written down value. Failing to account for this correctly could result in overstated revenue, understated liabilities and misstated inventory.	Review the list of sales of the paint product made between June and the date of the recall, agree that the sales have been removed from revenue and the inventory included. If the refunds have not been paid before the year end, review the draft financial statements to confirm that it is included within current liabilities.
The company is holding a number of damaged paint products in inventory and overall the inventory holding period has increased from 45 days to 54 days.	Discuss with the finance director whether any write downs will be made to this product, and what, if any, modifications will be required to rectify the quality of the product.

Audit risk	Auditor’s response
Due to the issue with the paint consistency, the quality of these products is questionable and management is investigating whether these products can be rectified. There is a risk that this inventory may be overvalued as its net realisable value may be below cost.	Testing should be undertaken to confirm cost and NRV of the affected paint products held in inventory and that on a line by line basis the goods are valued correctly.
Revenue has increased by 16·8% in the year; and the gross margin has increased slightly from 36·4% to 37·3%. This is a significant increase in revenue and, along with the increase in gross margin, may be related to the increased credit period and price promise promotion or could be due to an overstatement of revenue.	During the audit a detailed breakdown of sales will be obtained, discussed with management and tested in order to understand the sales increase. Also increased cut-off testing should be undertaken to verify that revenue is recorded in the right period and is not overstated.
The payables payment period has increased from 40 to 58 days. The current ratio has decreased from 3.08 to 1.65. The quick ratio has also decreased from 1.97 to 0.99. In addition, the bank balance has moved from $0·56m to an overdraft of $0·81m. These are all indicators that the company could be experiencing a reduction in its cash flow which could result in going concern difficulties or uncertainties. These uncertainties may not be adequately disclosed in the financial statements.	Detailed going concern testing to be performed during the audit, including the review of cash flow forecasts and the underlying assumptions. These should be discussed with management to ensure that the going concern basis is reasonable.

d) Describe substantive procedures the auditor should perform in relation to the faulty paint products held in inventory at the year end.

- Obtain a breakdown of the damaged goods held in inventory and returned from customers and cast to confirm its accuracy.
- From the breakdown, agree the damaged goods quantities manufactured since June to production records; and agree to sales records the quantities sold.
- Agree on a sample basis the returns from customers as per the breakdown back to sales returns documentation to confirm the existence of the returns quantities.
- Discuss with management the current status of their plans for this product line and whether they are able to rectify the damage and then sell the goods on. If so, agree the costs of rectification to supporting documentation.
- If the damaged inventory has been rectified and sold post year end, agree to the sales invoice to assess NRV in line with the new cost of the product.

- Agree the cost of damaged goods to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.
- Discuss with management if the goods have been written down; if so, follow through the write down to the inventory valuation to confirm.
- Inspect monthly board meeting minutes from June 20X8 onwards to obtain further information regarding the faulty paint and its possible resale value.

e) Describe substantive procedures the auditor should perform to obtain sufficient and appropriate evidence in relation to Darjeeling Co's revenue.

- Compare the overall level of revenue against prior years and budget for the year and investigate any significant fluctuations.
- Perform a proof in total calculation for revenue, creating an expectation of the average price for the main paint products multiplied by the increased sales volumes for this year. This expectation should be compared to actual revenue and any significant fluctuations should be investigated.
- Obtain a schedule of sales for the year broken down into the main product categories and compare this to the prior year breakdown and for any unusual movements, discuss with management.
- Calculate the final gross profit margin for Darjeeling Co and compare this to the prior year and investigate any significant fluctuations.
- Select a sample of sales invoices for customers and agree the sales prices back to the price list or customer master data information to ensure the accuracy of invoices.
- For a sample of invoices, recalculate invoice totals including discounts and sales tax.
- Select a sample of credit notes raised, trace through to the original invoice and ensure the invoice has been correctly removed from sales.
- Select a sample of customer orders and agree these to the despatch notes and sales invoices through to inclusion in the sales ledger and revenue general ledger accounts to ensure completeness of revenue.
- Select a sample of despatch notes both pre and post year end and follow these through to sales invoices in the correct accounting period to ensure that cut-off has been correctly applied. For sales made under the price promise, compare the level of claims made to date with the refund liability recognised and assess whether it is reasonable. For a sample of sales invoices issued between June and the product recall, trace to subsequent credit notes to confirm that the sale has been removed from revenue.

Exercise # 2 (20%)

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.

- **Substantive procedures for research and development**
- Obtain and cast a schedule of intangible assets, detailing opening balances, amounts capitalised in the current year, amortisation and closing balances.
- Agree the closing balances to the general ledger, trial balance and draft financial statements.

- Discuss with the finance director the rationale for the three-year useful life and consider its reasonableness.
- Recalculate the amortisation charge for a sample of intangible assets which have commenced production and confirm it is in line with the amortisation policy of straight line over three years and that amortisation only commenced from the point of production.
- For the nine new projects, discuss with management the details of each project along with the stage of development and whether it has been capitalised or expensed.
- For those expensed as research, agree the costs incurred to invoices and supporting documentation and to inclusion in profit or loss.
- For those capitalised as development, agree costs incurred to invoices and confirm technically feasible by discussion with development managers or review of feasibility reports.
- Review market research reports to confirm Gooseberry Co has the ability to sell the product once complete and probable future economic benefits will arise.
- Review the disclosures for intangible assets in the draft financial statements to verify that they are in accordance with IAS 38 *Intangible Assets*.

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.

Substantive procedures for depreciation

- Discuss with management the rationale for the changes to property, plant and equipment (PPE) depreciation rates, useful lives, residual values and depreciation methods and ascertain how these changes were arrived at.
- Confirm the reasonableness of these changes, by comparing the revised depreciation rates, useful lives and methods applied to PPE to industry averages and knowledge of the business.
- Review the capital expenditure budgets for the next few years to assess whether the revised asset lives correspond with the planned period until replacement of the relevant asset categories.
- Review the non-current asset register to assess if the revised depreciation rates have been applied.
- Review and recalculate profits and losses on disposal of assets sold/scrapped in the year, to assess the reasonableness of the revised depreciation rates.
- Select a sample of PPE and recalculate the depreciation charge to ensure that the non-current assets register is correct and ensure that new depreciation rates have been appropriately applied.
- Obtain a breakdown of depreciation by asset categories, compare to prior year; where significant changes have occurred, discuss with management and assess whether this change is reasonable.
- For asset categories where there have been a minimal number of additions and disposals, perform a proof in total calculation for the depreciation charged on PPE, discuss with management if significant fluctuations arise.
- Review the disclosure of the depreciation charges and policies in the draft financial statements and ensure it is in line with IAS 16 *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.

Substantive procedures for directors' bonuses

- Obtain a schedule of the directors' bonus paid in February 20X8 and cast the schedule to ensure accuracy and agree amount disclosed in the financial statements.
- Review the schedule of current liabilities and confirm the bonus accrual is included as a year-end liability.
- Agree the individual bonus payments to the payroll records.
- Recalculate the bonus payments and agree the criteria, including the exclusion of intangible assets, to supporting documentation and the percentage rates to be paid to the directors' service contracts.
- Confirm the amount of each bonus paid post year end by agreeing to the cash book and bank statements.
- Agree the amounts paid per director to board minutes to ensure the sums included in the current year financial statements are fully accrued and disclosed.
- Review the board minutes to identify whether any additional payments relating to this year have been agreed for any directors.
- Obtain a written representation from management confirming the completeness of directors' remuneration including the bonus.
- Review the disclosures made regarding the bonus paid to directors and assess whether these are in compliance with local legislation.

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

Impact on auditor's report

One of the new health and beauty products Gooseberry Co has developed in the year does not meet the recognition criteria under IAS 38 *Intangible Assets* for capitalisation but has been included within intangible assets. This is contrary to IAS 38, as if the criteria are not met, then this project is research expenditure and should be expensed to the statement of profit or loss rather than capitalised.

The error is material as it represents 6·9% of profit before tax (0·44m/6·4m) and 1·2% of net assets (0·44m/37·2m) and hence management should adjust the financial statements by removing this amount from intangible assets and charging it to the statement of profit or loss instead. IAS 38 requires costs to date to be expensed; if the project meets the recognition criteria in 20X9, then only from that point can any new costs incurred be capitalised. Any costs already expensed cannot be written back to assets.

If management refuses to amend this error, then the auditor's opinion will need to be modified. As management has not complied with IAS 38 and the error is material but not pervasive, then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would be needed after the opinion paragraph and would explain the material misstatement in relation to the incorrect treatment of research and development and the effect on the financial statements. The opinion paragraph would be qualified 'except for'.

Exercise # 3 (20%)

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.

Only the management responsibilities section will follow the standard wording. Those elements that differ from the standard unmodified auditor's report are given as the answer.

Disclaimer of Opinion

Because of the significance of the matters in the basis for Disclaimer of opinion section of our report, we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

Basis for disclaimer of opinion (extract)

The evidence available to us limited because a significant number of the company's key accounting records were destroyed by fire in November 2017. The financial statements therefore include significant amounts based on our estimates. In these circumstances there were no satisfactory audit procedures that we could adopt to obtain all the information and explanations we consider necessary to enable us to express an opinion.

Auditor's responsibilities for the audit of financial statements

Our responsibility is to conduct an audit of the company's financial statements in accordance with International Standards on Auditing and to issue an auditor's report. However, because of the matter described in the Basis for Disclaimer of opinion section of our report, we were not able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion on these financial statements.

We are independent of the company in accordance with the ethical requirements that are relevant to our audit of these financial statements in [jurisdiction], and we have filled our other ethical responsibilities in accordance with these requirements.

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

(i) Emphasis of matter;

- An Emphasis of Matter is clearly distinguishable from other modifications (e.g. qualified opinions) in that it does not affect the auditor's opinion.
- An Emphasis of Matter paragraph highlights a matter affecting the financial statements which is discussed in the notes to the financial statements, for example going concern.

(ii) Qualified opinion;

A qualified ‘except for’ opinion is expressed when the auditor cannot express an unmodified opinion but the effect of the matter is not so material and pervasive as to require an adverse opinion or disclaimer of opinion.

(iii) Disclaimer of opinion;

An auditor is unable to express (i.e. disclaims) an opinion when the effect of the lack of available evidence is so material and pervasive that the auditor has been unable to obtain sufficient appropriate audit evidence (which may be reasonably expected to be available)

(iv) Adverse opinion.

The effect of the material misstatement is so pervasive that the auditor concludes that an ‘except for’ qualification is not adequate to disclose the misleading or incomplete nature of the financial statements.
Distinctions

There are three issues which distinguish the form of modified reports

EITHER the matter does not affect the auditor’s opinion (i.e. (i)) or it does (i.e. (ii), (iii) and (iv)).
If the audit opinion is affected, then:
EITHER there is sufficient appropriate evidence on a matter for the auditor to disagree with the amount, treatment or disclosure in the financial statements (as in (iv));
OR there is sufficient evidence (in (iii).
EITHER the misstatement is ‘so material and pervasive’ (as in (iii) & (iv) resulting in ‘because of the significant of…’.
OR not so material and pervasive (as in (ii) resulting in a qualified ‘except for’ opinion).

Exercise # 4 (10%)

1	**D**
2	**A**
3	**H**
4	**F**
5	**G**

6	**B**
7	**E**
8	**I**
9	**C**