

**A. MULTIPLE CHOICE QUESTIONS (30%)**

1	AVA (Accuracy, valuation, Allocation)	9	D	17	C	25	A
2	CO (Completeness)	10	A	18	E	26	C
3	AVA (Accuracy, valuation, Allocation)	11	AUDITORS	19	MODERATE	27	D
4	EX (Existence)	12	DIRECTORS	20	NEGATIVE	28	D
5	B	13	DIRECTORS	21	A	29	A
6	D	14	AUDITORS	22	B	30	D
7	D	15	A	23	D	31	C
8	B	16	B	24	B	32	B

**Exercise # 1 (30%)**

**(a) For the inventory count arrangements of Lily Window Glass Co:**

**(i) Identify and explain SIX deficiencies; and**

**(ii) Provide a recommendation to address each deficiency.**

Deficiencies	Recommendations
The warehouse manager is planning to supervise the inventory count. Whilst he is familiar with the inventory, he has overall responsibility for the inventory and so is not independent. He may want to hide inefficiencies and any issues that arise so that his department is not criticized.	An alternative supervisor who is not normally involved with the inventory, such as an internal audit manager, should supervise the inventory count. The warehouse manager and his team should not be involved in the count at all.
There are ten teams of counters, each team having two members of staff. However, there is no clear division of responsibilities within the team. Therefore, both members of staff could count together rather than checking each other's count. Errors in their count may not be identified.	Each team should be informed that both members are required to count their assigned inventory separately. Therefore, one counts and the second member checks that the inventory has been counted correctly.
The internal audit teams are undertaking inventory counts. Internal audit should review the controls and perform sample test counts to confirm the count is being performed accurately and effectively. Issues with the count may not be identified resulting in an ineffective count.	The internal audit counters should sample check the counting undertaken by the ten teams to provide an extra control over the completeness and accuracy of the count.
Once areas are counted, the teams are not flagging the aisles as completed. Some areas of the warehouse could be double	All aisles should be flagged once the inventory has been counted. In addition, internal audit or the count supervisor should check at the end of the count that

Deficiencies	Recommendations
<p>counted or missed out. This will increase the risk of the inventory quantities being either under or overstated.</p>	<p>all 20 aisles have been flagged as completed.</p>
<p>Inventory not listed on the sheets is to be entered onto separate sheets, which are not sequentially numbered. The supervisor will be unable to ensure the completeness of all inventory sheets. This could result in understatement of the inventory.</p>	<p>Each team should be given a blank sheet for entering any inventory count which is not on their sheets. This blank sheet should be sequentially numbered, any unused sheets should be returned at the end of the count, and the supervisor should check sequence of all sheets at the end of the count.</p>
<p>There is no indication that the completed count sheets are signed by the counting team. If any issues arise with the counting in an aisle, it will be difficult to follow up as the identity of the counting team will not be known.</p>	<p>All inventory sheets should be signed by the relevant team upon completion of an aisle. When the sheets are returned, the supervisor should check that they have been signed.</p>
<p>Damaged goods are not being stored in a central area, and instead the counter is just noting on the inventory sheets the level of damage. It will be difficult for the finance team to decide on an appropriate level of write down if they are not able to see the damaged goods. The inventory value for the damaged items may not be appropriate. In addition, if these goods are left in the aisles, they could be inadvertently sold to customers or moved to another aisle.</p>	<p>Damaged goods should be clearly flagged by the counting teams and at the end of the count appropriate machinery should be used to move all damaged windows to a central location. This will avoid the risk of selling these goods. A senior member of the finance team should then inspect these goods to assess the level of any write down or allowance.</p>
<p>Lily Window Glass Co undertakes continuous production and so there will be movements of goods during the count. Goods may be missed or double counted due to movements in the warehouse. Inventory records could be under or overstated as a result.</p>	<p>It is not practical to stop all inventory movements as the production needs to continue. However, any raw materials required for 31 December should be estimated and put to one side. These will not be included as raw materials and instead will be work-in-progress. The goods which are manufactured on 31 December should be stored to one side, and at the end of the count should be counted once and included within finished goods. Any goods received from suppliers should be stored in one location and counted once at the end and included as part of raw materials. Goods to be dispatched to customers should be kept to a minimum for the day of the count.</p>
<p>The warehouse manager is to assess the level of work-in-progress and raw materials. In the past, a</p>	<p>A specialist should be utilized to assess both work-in-progress and the quantities of raw materials.</p>

Deficiencies	Recommendations
specialist has undertaken this role. It is unlikely that the warehouse manager has the experience to assess the level of work-in-progress as this is something that the factory manager would be more familiar with. Work-in-progress may be under or overvalued.	
The warehouse manager will also estimate the quantity of raw materials. He may make a mistake when assessing the quantities. Inventory could be materially misstated.	With regards to the warehouse manager, he could estimate the raw materials and the specialist could check it. This would give an indication as to whether he is able to accurately assess the quantities for subsequent inventory counts.

**(b) Describe the procedures to be undertaken by the auditor DURING the inventory count of Lily Window Glass Co in order to gain sufficient appropriate audit evidence.**

1. Observe the counting teams of Lily Window Glass to confirm whether the inventory count instructions are being followed correctly.
2. Select a sample and perform test counts from inventory sheets to warehouse aisle and from warehouse aisle to inventory sheets.
3. Confirm the procedures for identifying and segregating damaged goods are operating correctly.
4. Select a sample of damaged items as noted on the inventory sheets and inspect these windows to confirm whether the level of damage is correctly noted.
5. Observe the procedures for movements of inventory during the count, to confirm that no raw materials or finished goods have been omitted or counted twice.
6. Obtain a photocopy of the completed sequentially numbered inventory sheets for follow up testing on the final audit.
7. Identify and make a note of the last goods received notes (GRNs) and goods dispatched notes (GDNs) for 31 December in order to perform cut-off procedures.
8. Observe the procedures carried out by the warehouse manager in assessing the level of work-in-progress and consider the reasonableness of any assumptions used.
9. Discuss with the warehouse manager how he has estimated the raw materials quantities. To the extent that it is possible, re-perform the procedures adopted by the warehouse manager.
10. Identify and record any inventory held for third parties (if any) and confirm that it is excluded from the count.

**(c) For the audit of the inventory cycle and year-end inventory balance of Lily Window Glass Co:**

**(i) Describe FOUR audit procedures that could be carried out using computer assisted audit techniques (CAATS)**

1. The audit team can use audit software to calculate inventory days for the year-to-date to compare against the prior year to identify whether inventory is turning over slower, as this may be an indication that it is overvalued.
2. Audit software can be utilized to produce an aged inventory analysis to identify any slow-moving goods, which may require write down or an allowance.
3. Cast the inventory listing to confirm the completeness and accuracy of inventory.

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4. Audit software can be used to select a representative sample of items for testing to confirm net realisable value and/or cost.
5. Audit software can be utilized to recalculate cost and net realisable value for a sample of inventory.
6. CAATs can be used to verify cut-off by testing whether the dates of the last GRNs and GDNs recorded relate to pre year-end; and that any with a date of 1 January 20X3 onwards have been excluded from the inventory records.
7. CAATs can be used to confirm whether any inventory adjustments noted during the count have been correctly updated into final inventory records.

**(ii) Explain the potential advantages of using CAATs, including data analytics.**

1. CAATs and DA enables the audit team to test a large volume of inventory data accurately and quickly.
2. If CAATs such as audit software are utilized on the audit of Lily, then as long as they do not change their inventory systems, they can be cost effective after setup.
3. CAATs such as test data can test program controls within the inventory system as well as general IT controls, such as passwords.
4. CAATs and DA allows the team to obtain information directly from the system and test the actual inventory system and records rather than printouts from the system which could be incorrect.
5. CAATs and DA reduce the level of human error in testing and hence provide a better quality of audit evidence.
6. CAATs results can be compared with traditional audit testing; if these two sources agree, then overall audit confidence will increase.
7. The use of CAATs and DA frees up audit team members to focus on judgmental and high risk areas, rather than number crunching.
8. Enables the auditor to perform audit procedures throughout the year rather than just at the year end.

**(iii) Explain the potential disadvantages of using CAATs**

1. The cost of using CAATs in this first year will be high as there will be significant set up costs, it will also be a time-consuming process which increases costs.
2. As this is the first time that CAATs will be used on Lily's audit, then the team may require training on the specific CAATs to be utilized.
3. If Lily's inventory system is likely to change in the foreseeable future, then costly revisions may be required to the designed CAATs.
4. The inventory system may not be compatible with the audit firm's CAATs, in which case bespoke CAATs may be required, which will increase the audit costs.
5. If testing is performed over the live inventory system, then there is a risk that the data could be corrupted or lost.
6. If testing is performed using copy files rather than live data, then there is the risk that these files are not genuine copies of the actual files.
7. In order to perform CAATs, there must be adequate systems documentation available. If this is not the case for Lily, then it will be more difficult to devise appropriate CAATs due to a lack of understanding of the inventory system.

**(iii) Explain the potential disadvantages of using data analytics.**

1. The data obtained may not be complete which will limit the assurance that can be obtained.

2. The inventory balance is still influenced by subjective estimates and management judgement, e.g. work-in-progress and allowance for slow moving inventory. Therefore, audit staff with appropriate experience and skepticism will still be required to audit these areas.

**Exercise # 2 (20%)**

**(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;
- (ii) qualified opinion;
- (iii) disclaimer of opinion;
- (iv) adverse opinion.

**(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 # 3 (20%)**

- 1. Using the information above, comment on the matters to be considered when planning for the audit and explain the audit procedures you are likely to perform to audit the cash and cash equivalents.**
- 2. Discuss the effects of the matters described above on the audit report and draft, if any, the additional paragraphs to be added to the report in accordance with International Standards on Auditing.**

The appropriate answer for this question should address:

1. The going concern
2. The procedures to be followed to test the cash and the cash equivalent
3. The difference in exchange rates and how to deal with those changes
4. The hyperinflation factor could be addressed as well.