

Section II: (20 marks 30 minutes)

Question 1: (5 marks)

Charlie Keen is a year first co-op student at the auditing firm, Aiy Win LLP and is currently working on his first audit engagement. The audit manager on the engagement asks Charlie to gather audit evidence for the year-end accounts payable balance by searching through all of the cash disbursements on the company's bank statements for the two months after the company's fiscal year end and randomly selecting 20 of them. He was also given instructions on how to finish this audit procedure, but Charlie cannot remember what he was told to do after selecting the 20 items. Charlie Keen has no idea of how his assigned tasks relates to the testing of the year-end balance of accounts payable.

Identify the type of audit evidence procedure that Charlie has been asked to perform and how the procedures tests accounts payable. Also, help Charlie remember the remaining steps in this audit procedure. **Note:** This question does not require you to explain how the sample of 20 was calculated.

- *Type of inspection: Tracing (1 mark)*
- *Assertion: Completeness (1 mark)*
- *Explanation: In tracing from cash disbursements in the bank statement to the G/L, the completeness assertion is being tested to ensure that any cash disbursements were properly included in accounts payable. Cannot go from accounts payable subledger to source because that would test for existence (1 marks)*
- *Final step: determine if the accounts payable was properly included in the accounts payable sub-ledger by tracing the cash disbursement to an invoice and ensuring that if it was not paid then look at the date of invoice. If the date of the invoice was before year end and it was not paid, it should be in the accounts payable subledger (or general ledger) (2 mark)*

Question 2: (5 marks)

A private gold mining company, Goldfinger Inc., would like to have an initial public offering (IPO) on the Vancouver Stock Exchange (VSE) in the next few months. The company desires an IPO as it has identified a potential deposit of gold in northern Sweden, but requires significant financing to explore the area. As a requirement to list on the VSE, a company must produce audited financial statements. Goldfinger Inc. asks your firm, Bond & James LLP, to audit the company's financial statements. The company has only been in operation for nine months and provides you with the trial balance for the nine month period ending September 30, 2011.

GoldFinger Inc. Trial Balance Nine Month Period ending Sept.30, 2011	
	<u>Sept.30/11</u>
Cash	\$ 50,000
Prepaid expenses	5,000
Investments	75,000
Mining Development costs	500,000
Bank Loan	(25,000)
Accrued Liabilities	(55,000)
Miscellaneous liabilities	(50,000)
Common Shares (issued privately)	(650,000)
Revenue	-
Operating Expense	150,000
	-
	Note: Balance dr/(cr)

- (a) Based on the above, what is the incentive(s) of Golderfinger Inc's management with regards to the financial statements? **(1 mark)**
- *Incentive to overstate revenues and understate expenses (or overstate assets and equity) to be looked upon as a favourable investment so that investors will purchase shares of Goldfinger*
 - *There can be other variations of this answer (as long as it makes sense within the context of the info above)*
- (b) Based on (a) and Goldfinger Inc's trial balance, identify an account(s) and the related management assertion(s) that directs your attention toward a possible significant risk(s) and fully explain why. **(4 marks)**
- *This question depends on the response in part (a). However, regardless one account that must be selected is the mining development costs **(1 mark)**. There is judgment/estimates (capital vs expense – **1 mark**) and the assertions that are most attention directing given the incentives of management would be existence **(1 mark)** and valuation **(1 mark)**.*
 - *1/2 mark maximum can be provided (if full marks are not received for identifying mining development costs) for identifying another account with a reasonable explanation*

Question 3: (5 marks)

For the following five scenarios identify whether the auditor's actions or conclusions are appropriate and explain why or why not. **(1 mark each, for total of 5 marks)**

- a) The auditor for the company Ravens Inc. decides to assess control risk at maximum as any test of controls would most likely fail due to the company's lack of documentation of internal controls. The auditor concludes that this decision will be more efficient as they can immediately begin test of details and avoid any documenting of internal controls.

Inappropriate - Maybe more efficient, however documenting of internal controls is necessary per GAAS (1 mark)

- b) The auditor for the company Pear Inc, where it has already been determined that management has an incentive to overstate income, concludes that audit risk for sales, accounts receivable, operating expenses and accounts payable is high.

Inappropriate - Audit risk needs to be assessed on the assertion level, not only on the overall account level. This is for risk efficiency (1 mark)

- c) The auditor for Summertime Inc. decides to perform substantive analytical procedures in testing the sales account. The auditor compares the prior year sales total (which was audited in the prior year) to the current year sales total. The difference between the prior year sales balance and current year sales balance is well below materiality and, therefore, the auditor concludes that no further work is necessary and the sales balance at year end is fairly presented.

Inappropriate - The auditor is attempting to perform substantive analytical procedures, however to perform this, an appropriate and detailed development of an expectation is necessary. It is unacceptable to use a prior year number unless it can be documented that there was no change in any of the circumstances from the prior year and thus using the prior year number is acceptable (1 mark)

- d) The auditor of Builder Bob Inc., a construction company, has inquired to the controller about an increase in salaries expense from the prior year. The controller tells the auditor that the increase is a result of the hiring of two additional full time employees. The auditor verifies the controller's explanation by discussing the hiring of the new employees with Builder Bob's Human Resources director and also by obtaining copies of their employment contracts.

Appropriate - Auditor is corroborating management inquiry and obtaining evidence (no conversational or CAT auditing) – 1 mark

- e) The auditor of Bamse Inc. documents that the control environment of the company is very strong as the company has many control activities such as bank reconciliations and authorizations requirements for all of their significant business transactions.

Inappropriate – the number of control activities have no relationship to the base level of the COSO framework – which is the control environment – or the tone of the top – how upper management feels about controls as evidenced by an employee handbook or mission statement – 1 mark

Question 4: 5 marks

Required:

Provide a description of how you might gather audit evidence to test each provided account and given assertion(s). (1 mark each, for a total of 5 marks)

An example:

Accounts receivable: Existence

Sending a sample of confirmations to customers with their year-end accounts receivable balances.

Comparing what the customers confirm as their year-end balance to what the client has.

1. Allowance for doubtful accounts – Valuation

Performing a retrospective review of allowance for doubtful accounts compared to actual bad debts written off. Also performing substantive analytics by comparing AFDA as a % of sales over a trend analysis (given auditor's understanding of business and industry trends)

2. Bond interest income - Existence

Assuming the bond asset has been audited (e.g. confirmation to validate existence and valuation of the bond itself), auditor can develop an expectation of bond interest by using external data for similar bond (e.g. from yahoo finance, Bloomberg) and multiplying the interest rate by the bond value and comparing to actual. Or a recalculation could be performed if the interest rate on the bond was also confirmed

3. Rent expense – Existence and completeness

Existence – inspecting rental agreement and agreeing rental expense amount to rental agreement. Completeness – tracing a sample of rental payments from bank statement to rental expense subledger.

4. Loan payable - Presentation and Disclosure

Loan payable will be divided in a current liability component and long term liability component. Auditor needs to ensure proper classification. Inspecting original and signed loan agreement for details of amortization of loan and comparing to disclosure and balance sheet presentation

5. Computer equipment – Existence and ownership

Reviewing original invoice and observing the computer (seeing the physical computer)

End of Section II

Section III: Case (20 marks 45 minutes)

Bank Street Credit Union (BSCU) is a small credit union that has operated in Ottawa since the year 2008. A credit union is a cooperative financial institution that is owned and controlled by its members for the purposes of providing financial services to its members such as taking deposits and providing loans. It is an alternative financial deposit taking institution to that of a large public bank such as CIBC and Royal Bank of Canada. Customers of BSCU are also its owners and this structure creates an environment in which the credit union is more likely to work for the best interests of its customers. BSCU, like most credit unions in Canada, are for profit making institutions (e.g. maximize net income).

The owners of the credit union elect a Board of Directors who is in charge of the governance of the credit union. The Board of Directors then determine who will be the executive management team that manages and operates the credit union. BSCU has an executive management team that consists of a CEO, vice president of operations and a treasurer. BSCU has been in operation as a fully registered credit union for two years. As an Ontario registered credit union, BSCU is regulated by the Ontario Superintendent of Financial Institutions (OSFI) as are all deposit taking institutions. The role of OSFI is to ensure that financial institutions work in the best interest of their customers and maintain a minimum capital requirement so that they are able to repay customers who demand their deposits back.

The current economic environment for small credit unions such as BSCU has been difficult. If members of BSCU do not deposit money with the credit union, then the credit union has fewer funds to lend and thereby earn investment income (e.g. such interest on car loans and mortgages or capital gains and dividends in stocks). With the current recession, many members of BSCU do not have disposable income to put into savings accounts. However, BSCU has still managed to do well in comparison to other similar sized credit unions (see trial balance information on pg. 8). The CEO of BSCU, Anne Cathaway, attributes the strong net income numbers (when other comparable credit unions show net losses) to high interest savings accounts (encouraging members to deposit savings) and an aggressive lending and investment strategy. Currently, BSCU has one credit union branch in the Glebe (a community in Ottawa), but Anne would like to open another branch in Old Ottawa south in the next two years. The big banks such as CIBC, Royal Bank and TD bank are increasingly competing against or taking over (hostilely) small credit unions to increase their market share. Anne does not worry about the increasing competition as she feels that the cooperative structure, customer service and financial products offered by BSCU are competitive advantages over banking larger financial institutions. Anne feels that 2011 will be a great year for BSCU as she believes that the economy is slowly moving out of the recession which will result in increased deposits from members.

As required by OSFI, BSCU has been audited for the two years since it has been in operations. BSCU decided to change auditors this year and has hired your firm, Dunn & Done LLP, to perform the May 31st, 2011 year-end audit. It is now March 17th, 2011, you are the audit senior on BSCU and you have accumulated the following information on BSCU through discussions with your partner and Anne Cathaway.

- OSFI's capital requirement for credit unions is calculated as a minimum ratio of equity to total assets of 1 to 5. If this ratio is not met, then OSFI can withdraw the credit union's license and the credit union would be dissolved immediately.
- BSCU is planning to create an employee handbook and mission statement before the end of the year 2011. This is the start of a major project to document all of the internal controls of the company within the next two years.
- BSCU has decided to install new accounting software specifically designed for small credit unions. The new accounting software will be installed and tested by April 15th, 2011
- CEO and vice president of operations have a 3% bonus based on net income that has been approved by the Board of Directors.
- BSCU does not have an audit committee.
- You are provided with the prior year trial balance information and the trial balance for the nine month period ending February 28, 2011.
- Allowance for impaired loans is calculated at 5% of the total balance.

Bank Street Credit Union Trial Balance Feb.28/11		
	Year end May.31/10	Nine month period ending Feb.28/11
	(audited)	(unaudited)
Cash	\$ 1,100,000	\$ 1,200,000
Loans receivable from members (net of allowance)		
Residential mortgage loans	9,500,000	10,750,000
Other loans (e.g. automotive, personal)	770,000	890,000
Accrued Interest on loans	575,000	975,000
Prepaid expenses	10,000	4,000
Property, plant and equipment (net of accumulated depreciation)	175,000	125,000
Other assets	1,500,000	1,750,000
Deposits (note 1)	(10,200,000)	(11,500,000)
Accrued Interest on deposits (note 1)	(625,000)	(700,000)
Accounts payable and accrued liabilities	(550,000)	(350,000)
Derivative financial instruments	(75,000)	(50,000)
Member's equity	(150,000)	(175,000)
Retained Earnings	(1,250,000)	(2,030,000)
Interest and Investment Income (on all loans)	(3,105,000)	(2,400,000)
Interest expense (on deposits)	450,000	400,000
Salaries expense	775,000	625,000
Administration expense	850,000	411,000
Other expenses	250,000	75,000
	-	-
Note 1: Deposits and accrued interest on deposits are liabilities for a credit union	Note: Balance dr/(cr)	

Required: Base your responses on the case information provided above

a) Identify one business risk of Bank Street Credit Union (BSCU) for each of the five categories in understanding a business and its environment (**5 marks**).

- *Nature of business: credit union, financial institution, recession (1 mark)*
- *Regulatory environment: OFSI – capital requirement (1 mark)*
- *Internal controls: No documentation of internal controls and/or new computer system (1 mark)*
- *Measurement of financial performance – very close to violating the OSFI capital requirement (currently ratio is at 1:5.04) – calculation can be here or in part (f) (1 mark)*
- *Strategy: Expanding credit union to another location (1 mark)*

b) Evaluate and conclude on the fraud risk(s) of Bank Street Credit Union (3 marks)

Use of fraud risk triangle to evaluate

- *Incentive – bonus plan related to net income and desire to expand and close to violating regulatory ratio (1 mark)*
- *Opportunity – no documented internal controls. Poor control environment – no mission statement or code of ethics (0.5 mark)*
- *Rationalization – the credit union produces strong products, is in good financial condition and no long term harm will result from short term fraudulent financial report. If action is not taken then the credit union may also be going concern as a result of being close to violating minimum capital ratio (0.5 mark)*
- *Conclusion: Fraud risk high (1 mark)*

c) Identify the incentive(s) of management (0.5 mark)

- *Overstate revenue and understate expenses for bonus and to meet OSFI capital requirements (0.5)*
- *Or for purposes of expanding*

d) Calculate a preliminary performance materiality and explain your calculation (1 mark)

- *Any calc as long as it makes sense given the identified primary uses (0.5 mark for identified users, 0.5 mark for calc)*
- *Suggestion would be either total assets and/or total equity as a primary F/S user is OSFI (for purposes of the minimum capital ratio)*

e) Identify one overall financial statement risk for BSCU (0.5 mark)

- *Installation of the new accounting computer software (0.5 mark)*

- f) Based on your responses (a) through (d), use your professional judgment to identify and assess the highest risk account(s) and their relevant assertion(s) for the Bank Street Credit Union. Explain your answer fully (e.g. use preliminary analytics, case info etc. to support your answer). **(10 marks)**

Explain answer fully - Set up (4 marks)

Calculates ratio of equity to assets and shows calculation (with reasonable assumptions) – 3 marks

My calc of minimum capital ratio as of Feb.28/11

Total assets (Cash + loan receivable + accrued interest on loan + prepaid expenses + PPE + Other assets) = \$15,694,000

Total equity (Member's Equity + Beginning R/E + Investment Income – Interest expense – Salaries expense – Admin expense – Other expense) = \$3,094,000

Need to show how your calc was arrived at and what assumption were made

Ratio 1:5.07 – very close to violation – major incentive

Conclusion: *ratio is close to being violated, key incentives would be overstatement assets and understate equity (1 mark). If violated, company could be a going concern (1 mark)*

Account and assertion analysis (max 6 marks)

The analysis that flows from here depends on the response above and from (a) to (e). Including the above (the setup was necessary so that your selected accounts had some context)

0.5 mark for each account identified and relevant assertion. 0.5 mark for explanation for why account was chosen (in line with incentives). 1 mark if supported by preliminary analytics (2 marks).

Explanation must make sense given your responses (a) through (e) and case facts

End of Exam

Bonus Question:

Which picture won the Oscar for best documentary this year?

Inside Job (1 mark)