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ÉCOLE DE GESTION
SCHOOL OF MANAGEMENT

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Midterm Examination
ADM 3349
Auditing Theory
Fall 2012

Time: **2.0 hours**

SECTION: ____________________________________
(A - Wednesdays 4pm to 7pm; B – Wednesdays 7pm to 10pm)

Student Name: ________________________________

Student #: ____________________________________

Make sure that you read the instructions on page 2 of this exam.

Q1	**/20**
Q2	**/20**
Q3	**/10**
Q4 – MULTIPLE CHOICE	**/30**
Bonus Mark	**/2**
TOTAL	**/80**

Instructions:

- Answer all questions in this booklet. Booklet is **not** to be removed from the examination room. You may separate the pages but ensure that you put them back together and staple before handing in. **Ensure that you show all supporting calculations in order to receive full marks.**
- Limit your answer to the space provided. Indicate if you use the back of a page.
- Budget about 1.5 minutes per mark.
- Language dictionaries are allowed. Use only non-programmable calculators.
- The use of electronic communication devices such as cell phones is strictly prohibited during the exam. Sharing of calculators is also strictly prohibited.
- **You must sign the Statement of Academic Integrity below.**

Statement of Academic Integrity:

The School of Management does not condone academic fraud, an act by a student that may result in a false academic evaluation of that student or of another student. Without limiting the generality of this definition, academic fraud occurs when a student commits any of the following offences: plagiarism or cheating of any kind, use of books, notes, mathematical tables, dictionaries or other study aid unless an explicit written note to the contrary appears on the exam, to have in his/her possession cameras, radios (radios with head sets), tape recorders, pagers, cell phones, or any other communication device which has not been previously authorized in writing.

Statement to be signed by the student:
I have read the text on academic integrity and I pledge not to have committed or attempted to commit academic fraud in this examination.

Signed: ____

Note:

An examination without this signed statement will not be graded and will receive an exam grade of zero.

Question #1 Audit Reports (20 marks - 20 minutes)

For each of the independent situations presented below, state what type of audit report should be issued. Briefly explain your rationale. Finally, if your report would be other than the standard unqualified report, state which paragraphs, if any, of the standard audit report would be changed.

A) Grinner and Greeter, CAs, were engaged to perform an audit of the financial statements of Happy, Inc. The management of Happy would not allow Grinner and Greeter to attend the year end physical inventory count. All other audit procedures were performed as considered necessary by Grinner and Greeter and no other problems were discovered. However, Grinner and Greeter were unable to satisfy themselves as to the balance in inventory. **(5 marks)**

The client has imposed a scope limitation on Grinner and Greeter. The type of report issued depends upon the materiality of inventory and the likelihood that a potential error would be material or significantly material.
If the inventory balance were insignificant and immaterial, then an unqualified report could be issued. If the likelihood that a potential error would be material or significantly material, then an opinion qualified as to scope or a denial of opinion, respectively, would be appropriate.
For a qualified audit report, both the scope paragraph and the opinion paragraph would be modified using words such as "except for" or "except that" and referring to the reservation paragraph. A reservation paragraph that explains the scope limitation should be inserted between the scope and opinion paragraphs.
For a denial of opinion, both the scope paragraph and the opinion paragraph would be modified and referenced to the reservation paragraph. A reservation paragraph that explains the scope limitation would be inserted between the scope and opinion paragraphs. The opinion paragraph would be modified to state that the auditor is "unable to express an opinion".

B) Tick and Tie, CAs, were performing their annual audit of Johnson Manufacturing Company. Johnson is currently being sued for $2,000,000 related to an alleged defective product sold to a customer. Johnson's lawyer told Tick and Tie that it is likely that Johnson will lose the suit and have to pay the entire $2,000,000. The management of Johnson has included information about the lawsuit in the footnotes. However, they have not recorded any loss in the income statement or liability in the balance sheet. **(5 marks)**

Because Johnson Manufacturing has not properly recorded a loss and a liability, the financial statements are not in accordance with GAAP. Therefore, depending on the materiality level, Tick and Tie should issue either a qualified opinion or an adverse opinion. In either case, a reservation paragraph that explains the GAAP departure should be inserted between the scope and opinion paragraphs. In the case of a qualified opinion, the opinion paragraph should be modified by using words such as "except for" or "except as" and by referring to the reservation paragraph. In the case of an adverse opinion, the opinion paragraph should be modified by using the words "these financial statements do not present fairly" and by referring to the reservation paragraph.

C) Telfer Desmarais LLP is performing the financial statement audit of Tucker Limited, a manufacturer of high end windows. This is the first time Tucker Limited has ever undergone a financial statement audit, so the opening balances of the balance sheet have not been audited. For the tests of details of accounts receivable and capital assets, Tucker staff were unable to provide appropriate supporting documentation with respect to sample items totaling $1 million for accounts receivable, and $2 million for capital assets. Assume Telfer Desmarais LLP was not able to obtain other audit evidence related to these items. **(5 marks)**

ANS - Depending upon the materiality and pervasiveness of the $3 million amount to the financial statements, Telfer Desmarais would issue either an unqualified opinion, a qualified opinion with scope restriction, or a denial of opinion. The $3 million that Telfer Desmarais was unable to obtain evidence to support represents the TOTAL POSSIBLE ERROR in Tucker's financial statements. The auditor does not know if the financial statements are actually misstated or not.

If the $3 million possible error is not material – a clean, or unqualified opinion should be issued

If the $3 million possible error is material, but the potential impact on the financial statements not pervasive – qualified opinion due to scope restriction.

If the $3 million possible error is material, and the potential impact on the financial statements pervasive – a denial of opinion should be issued.

D) Fred Flintstone LLP is the auditor of the consolidated financial statements of a parent company called Barney Rubble Inc. Fred Flinstone's audit of Barney Rubble proceeded without any exceptions or errors. The only issue was with respect to the Barney Rubble subsidiary Betty Rubble. The financial statement auditor of Betty Rubble, Wilma LLP, was determined by Fred Flinstone to have not completed sufficient testing of revenues. Betty Rubble's total revenues amounted to $10 million, compared to Barney Rubble's consolidated revenues of $100 million. Assume materiality for the consolidated financial statements of Barney Rubble Inc is $5 million. What type of opinion should be issued by Fred Flintstone on the financial statements of Barney Rubble Inc? **(5 marks)**

ANS – Fred Flintstone would need to issue a qualified opinion due to a scope restriction on Barney Rubble Inc. The qualified opinion due to the scope restriction arises from a lack of information on Fred Flintstone's part about a material component of the revenues line item for Barney Rubble on a consolidated basis. Since this uncertainty is limited to revenues, and not more pervasive, a denial of opinion would likely not be appropriate. The qualification due to scope arises due to a lack of information on Fred Flintstone's part about $10 million of the revenues recorded by Barney. The limitations of the audit work performed by Wilma LLP would be cited in the audit report of Fred Flintstone.

Question #2 – Audit Risk Model (20 marks – 25 minutes)

The chartered accounting firm of IB Hungry, CA is considering risk in planning the audit of the financial statements of the hot restaurant business, Yo Mo Food! (Yo Mo) for the year ended December 31, 2012. IB Hungry has gathered the following information concerning Yo Mo's environment:

Company Profile

Yo Mo Food! is a publicly listed corporation (TSX: YO!) which controls 5% of the restaurant market in Canada. Yo Mo has been consistently more profitable than the industry average due to free poutine weekends, which have attracted much of the younger demographic of restaurant goers. Yo Mo has boosted recent profits by introducing innovative dining features, such as flower bouquets which guests can buy in-restaurant to be delivered at the table to their special dining companion.

Yo Mo's majority owner is Big Bellie, the owner of 80% of the company's publicly traded shares. Big Bellie sits on both the Board and the Audit Committee. Big Bellie has appointed Lowfat Yogurt as the chief executive officer. Big Bellie assesses Lowfat's performance through a stringent and demanding annual performance evaluation process. Management at Yo Mo have been delegated full authority for directing and controlling restaurant operations and are compensated based on the chain's profitability. The company has an internal audit department, which is managed by a former Yo Mo waiter with no audit or accounting background.

The accounting department has experienced high turnover in personnel during the five years IB Hungry has audited Yo Mo, and the controller claims they are chronically understaffed. Yo Mo consistently fails to record revenues from New Year's Eve dining in the correct fiscal period, but its controller has always been receptive to the IB's proposed adjustments to account for the revenue recognition cut-off errors during each engagement.

Recent Developments

During 2012, Yo Mo launched an affiliated company dedicated to the wholesale distribution of restaurant supplies in Europe. This is a significantly new and much more competitive market for Yo Mo, and the affiliate's launch was apparently delayed due to difficulties in gaining customers in the new European marketplace. Although this affiliate is not yet profitable due to severe competition from better established wholesalers, management believes that it will be profitable by 2015. This affiliate comprises approximately 25% of consolidated revenues for Yo Mo. Due to time constraints, however, IB will be unable to do any detailed testing related to this affiliate as part of the current year audit.

Required:

Based only on the information given, identify and explain the factors that most likely would affect IB Hungry's assessment of Audit Risk (AR), Inherent Risk (IR), and Control Risk (CR). Indicate whether each factor increases or decreases the risk. Using the following format, complete the table on the next page:

Factor (1/2 mark)	**Explanation (1 mark)**	**Risk Affected (AR, IR, CR) (1/2 mark)**	**Increase or /Decrease (1/2 mark)**
<u>Example:</u> Yo Mo management has full authority for directing and controlling operations	Management may have an opportunity to circumvent existing internal controls	**CR**	**Increase**

Factor (1/2 mark)	Explanation (1 mark)	Risk Affected (AR, IR, CR) (1/2 mark)	Increase or Decrease (1/2 mark)
The majority owner has appointed a separate individual as CEO, and holds that individual accountable through rigorous performance reviews.	The appointment of a separate CEO from the majority owner provides for further independence of management, and should strengthen the governance function performed by the Board of Directors and the Audit Committee. The rigorous performance evaluation holds the CEO accountable, and further strenghens the control environment.	CR	Decrease
Management integrity could be an issue, as the Board is dominated by one person with a "do anything to win attitude".	The majority owner may exert his influence to override controls, or misstate the financial statements.	IR	Increases
Management is compensated based upon profitability of the enterprise.	This may provide management with additional incentive to manipulate financial results to show a greater profit.	IR	Increase
The internal audit function is not staffed with qualified personnel.	The overall control environment is weakened by the lack of a strong, trained and qualified internal audit function.	CR	Increase
There has been high turnover in recent years in the accounting department.	The high turnover rate implies that the staff are much less familiar with the nature of Yo Mo's business, and its accounting and financial reporting process. The risk of employee error is hence higher.	IR/ CR	Increase
			Decrease

The controller has been very receptive to past adjustments proposed by IB.	The client's willingness to record proposed adjustments shows a very positive attitude towards accurate financial reporting.	IR	
A new affiliate has been opened in a significantly more competitive market. The business is losing money, and no profits are forecast until 2012.	This significant diversification increases the risk of a future business failure for IB, and may lead the auditor to question the validity of using the going concern assumption.	IR	Increase
IB will not be auditing the new affiliate this year, despite the fact that it comprises a significant portion of total revenues.	This increases the risk that the auditor may not detect a material misstatement in revenues.	AR	Tolerable audit risk decreases.
Repeat audit engagement means auditor has greater familiarity with the client's operations.	IB Hungry has being doing the Yo Mo audit for several years, which implies a greater degree of client knowledge and familiarity with their accounting. As a result, auditor will be willing to assume more audit risk, all things being equal.	AR	Tolerable audit risk increases
External users heavy reliance on FS, as it is a publicly listed company	There could be broader "social" harm if the statements are materially misstated.	AR	Tolerable AR decreases

Question #3 – 10 marks – 15 minutes

A highly reputed graduate of the University of Ottawa, you have seized your love of auditing and embarked upon a career with an auditing firm. Now a senior in charge of your first audit file, you are asked by the Engagement Partner to do a review of the working paper file to make sure all of the necessary documentation regarding fraud risk has been included.

Required:

In our lecture on fraud risk, we identified six elements that the financial statement auditor must document in the audit file regarding fraud. Describe five elements of required documentation.

Students could discuss any 5 of the following:

- **Decision reached re: susceptibility of entity F/S's to fraud.**
- **Assessed risk of material misstmt due to fraud.**
- **Impact of assessed risk on nature, timing & extent of audit procedures.**
- **Risk of mgmt override of controls.**
- **Nature of fraud communications to mgmt & audit committee.**
- **Rationale for any conclusion *other than* significant risk of material improper revenue recognition.**

<u>QUESTION 4</u> - MULTIPLE CHOICE (30 marks - 30 minutes) Write the letter corresponding to the best response in the table below.

1. B	2. A	3. D	4. B	5. B
6. C	7. C	8. B	9. C	10. C
11. B	12. B	13. D	14. D	15. C
16. A	17. A	18. C	19. B	20 D
21. B	22. B	23. A	24. A	25 B
26 A	27 C	28 A	29 C	30 B

1. The risk of insufficient evidence being gathered on the facts concerning the client's economic circumstances is referred to as

a) Business risk
b) Audit risk (X)
c) Accounting risk
d) Control risk

2. A material misstatement is

a) one that would affect user decision making (X)
b) one that would not affect user decision making
c) Anything that is in excess of 5% of net income before taxes
d) The same for every company

3. What are the auditor's responsibilities as it relates to fraud?

a) Auditors are responsible to detect all fraud in an organization.
b) Fraud audits are conducted as part of the normal audit engagement
c) Auditors are not responsible to detect fraud at any level. This is done with a separate fraud audit.
d) Auditors are responsible to detect material financial reporting fraud. (x)

4. Professional ethics requires auditors having an objective state of mind. This is best described as:

a) Having adequate technical training and ability
b) Intellectual honesty and impartiality (X)
c) Observance of the rules of GAAS
d) A Prudent Auditor

5. The rules of professional ethics require competence—adequate technical training and proficiency—in auditors, this competence begins with?

a) Competence begins with the observance of the rules of GAAS.
b) Competence begins with an education in accounting, since auditors hold themselves out as experts in accounting standards and financial reporting. (X)
c) Competence begins with intellect, honesty, and impartiality.
d) Competence begins with on-the-job training and practice in applying professional judgment in real-world audit situations.

6. Poor internal control produces greater control risk. In this situation,

a) The extent of subsequent audit procedures should be decreased.
b) There should be no change in the extent of subsequent audit procedures.
c) The extent of subsequent audit procedures should be increased. (X)
d) Subsequent audit procedures will be eliminated.

7. Auditor Jones is studying a company's accounting treatment of a series of complicated transactions in exotic financial instruments. She should look for the highest level of authoritative support for the proper accounting in

a) Provincial securities commissions' staff position statements
b) CICA industry audit and accounting guides
c) CICA recommendations in the Handbook (X)
d) Emerging Issues Committee consensus statements

8. A good definition of an assurance engagement is:

a) an engagement where an accountability relationship exists between two or more parties concerning a subject matter for which the accountable party is responsible.
b) An engagement where a practitioner is engaged to issue a written communication expressing a conclusion concerning a subject matter for which an accountable party is responsible to a third-party. (X)
c) An engagement where, pursuant to an accountability relationship between two or more parties, a practitioner is engaged to verify a subject matter for which the accountable party is responsible.
d) An engagement where a practitioner issues a written communication expressing a conclusion concerning a subject matter.

9. Quality control can be defined as:

a) actions taken by a public accounting firm to evaluate compliance with internal standards.
b) actions taken by a public accounting firm to determine if the company is making a quality product.
c) actions taken by a public accounting firm to evaluate compliance with professional standards. (X)
d) actions taken by a public accounting firm to evaluate internal controls.

10. Professional accountants have a code of ethical conduct. Which one of the following statements is not accurate?

a) The code serves as a useful reference or benchmark and specifies criteria for the professional's conduct.
b) The code allows individuals to know what the profession expects.
c) To ensure accountants act the same in all situations. (X)
d) The code publicly declares the profession's principles of conduct so standards can be enforced.

11. When referring to PAs, what does "breach of contract" mean?

a) A client is involved in a lawsuit with the auditor.
b) Accounting services were not performed as agreed. (X)
c) The auditor has billed the client for extra services.
d) There is no engagement letter signed by the client.

12. DEF Co. is being sold by GHI Co. JKL Co. is interested in purchasing DEF Co., but requires audited financial statements before doing so. DEF Co. has substantial bank loans and the bank would like audited statements as well. DEF Co. appoints you as its auditor. Which of the following is considered to be the client?

a) The bank
b) DEF Co, (X)
c) GHI Co.
d) JKL Co.

13. Association with financial information issued by an organization can occur when

a) Through some action, the PA associates himself or herself with the information issued by the organization.
b) Without the PA's knowledge or consent, the enterprise indicates that the PA was involved with the information issued by them.
c) A third party assumes the PA was involved with the information issued by the enterprise.
d) All available answers are correct. (X)

14. A PA finds that the client has not recorded a material amount of sales leases in the financial statements. When considering the materiality of this departure from GAAP, the PA's reporting options are

a) Unqualified opinion or disclaimer of opinion.
b) Unqualified opinion or qualified opinion.
c) Qualified opinion or disclaimer of opinion.
d) Qualified opinion or adverse opinion. (X)

15. Pre-engagement activities are part of the risk assessment process. These activities include

a) Developing an audit plan.
b) Determining the nature and timing of substantive procedures.
c) Obtain an understanding of the entity and the engagement. (X)
d) Perform audit procedures on revenues and expenses.

16. The scope and nature of the auditor's contractual obligation to a client ordinarily is set forth in the

a) engagement letter. (X)
b) management letter.
c) introductory paragraph of the auditor's report.
d) scope paragraph of the auditor's report.

17. If the ABC company reports a $55,000 balance of accounts receivable, the completeness assertion means

a) All accounts receivable from XYZ have been included in the balance. (X)

b) All the amounts making up the $335,000 balance will be collected in full
c) All the amounts included in the $355,000 balance represent valid sales on account that are still outstanding and due to the company
d) The receivables have not been sold to another company

18. The number of customer accounts receivable to confirm is related to the _______ of the audit procedures relating to accounts receivable.
a) nature
b) timing
c) extent (X)
d) accuracy

19. The risk that material misstatements have occurred in transactions within the accounting system used to develop financial statements is
a) Control Risk
b) Inherent Risk (X)
c) Detection Risk
d) Audit Risk

20. Auditors are responsible for the quality of the work related to management and control of:
a) Inherent risk
b) Relative risk
c) Control risk
d) Detection risk (X)

21. Preventive controls
a) Are designed to detect misstatements after they have entered the system.
b) Are more effective than corrective controls. (X)
c) Are designed by the auditors.
d) Are never communicated to employees.

22. The primary purpose for obtaining an understanding of an auditee's internal control structure is to
a) Provide a basis for making constructive suggestions in a management letter.
b) Determine the nature, timing and extent of tests to be performed in the audit. (X)
c) Obtain sufficient appropriate evidential matter to afford a reasonable basis for an opinion on the financial statements.
d) Provide information for a communication of internal control structure-related matters to management.

23. Which of the following is considered by auditors to be the number one fraud warning sign?

a) Managers have lied to the auditors or have been overly evasive in response to audit inquiries. (X)
b) Key managers are considered highly unreasonable.
c) The client has engaged in opinion shopping.
d) The client has a weak control environment.

24. A succinct, but comprehensive definition of independence is that an auditor:

a) Must be independent in fact and in appearance. (X)
b) Must not have a direct financial interest in a client.
c) Must have a license to practice as a public accountant.
d) Must not take on as an audit client a company owned by a member of his/her immediate family.

25. Which of the following statements represents an audit failure?

a) A client goes bankrupt or has serious financial difficulty.
b) Because an auditor failed to conduct an audit in accordance with GAAS the auditor issued misleading financial statements. (X)
c) An auditor cannot collect the audit fees from the client.
d) An auditor is sued by a third party.

26. While conducting an audit, Larson Associates CAs failed to detect a material misstatement in its client's financial statements. Larson's unqualified opinion was included with the financial statements in a registration statement and prospectus for a public offering of securities made by the client. Larson knew that its opinion and the financial statements would be used for this purpose. In a suit by a purchaser against Larson for common law negligence, Larson's best defence would be that the:

a) Audit was conducted in accordance with generally accepted auditing standards. (X)
b) Client was aware of the misstatements.
c) Purchaser was not in privity of contract with Larson.
d) Identity of the purchaser was not known to Larson at the time of the audit.

27. Theoretically, when assessing the inherent risk related to an account balance, an auditor does not explicitly consider the:

a. Liquidity of the account.
b. Degree of management estimation involved in determining the proper account balance.
c. Related internal control policies and procedures. (X)
d. Complexity of calculations involved.

28. Key controls are those:

a) Over significant risks. (X)
b) Over physical access.
c) On which the auditor intends to rely.
d) Designed by the audit committee to prevent management fraud.

29. Control tests should be applied to samples of transactions and control procedures:
a) Which occurred during the interim audit so that they provide direct auditor's knowledge.
b) Selected by management as being representative of all transactions processed.
c) Throughout the period being audited. (X)
d) Which occur primarily close to reporting period ends such as year end or quarter end.

30. Which of the following best describes the main reason that independent auditors report on a company's financial statements?
a) Management fraud may exist within the company and it is likely that the independent auditors will detect it.
b) Managers who prepare the statements and the external users of those statements may have conflicting interests. (X)
c) Misstated account balances may be corrected as the result of the independent audit work.
d) The accounting system from which the financial statements are derived may have a poorly designed system of internal control.

END OF EXAM