uOttawa
L'Université canadienne
Canada's university

ÉCOLE DE GESTION
SCHOOL OF MANAGEMENT

LIÉE au LINKED with LEADERSHIP

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)
Required: Answer the following questions in the table provided

You are the Supervisor in charge of the audit of Harringays – a high end ladies clothing store based in Brockville, Ontario with a year end of December 31st. You have taken over the Supevisor role from another staff in your office, who had to depart the job suddenly due to a family emergency.

Before leaving the audit on January 15th, the other Supervisor had drafted the following audit report to be issued for Harringays. The audit has gone fine with the exception of the year-end inventory count for Harringays. Since the count happened in between the first Supervisor's departure, and your arrival on the job, no one from the auditing firm attended the inventory count. Harringays inventory records were subsequently destroyed in a fire, and you were unable to obtain any verification of the inventory balance recorded on the balance sheet. Inventory is Harringays most material asset.

The Partner will be reviewing the audit file tomorrow, January 31st. She has asked you to review the draft audit report, and to correct it for any errors or omissions before she arrives.

REQUIRED: Identify each error or omission in the draft audit report for Harringays, In the second column, correct the error or omission so the Auditor's Report will be revised for the Partner's review.

INDEPENDENT AUDITOR'S REPORT
To the Director of Finance, Harringays

Report on the Financial Statements

We have audited the accompanying financial statements of Harringays, for the year ended December 31, 2011, and a summary of significant accounting policies and other explanatory information.

<u>Management's Responsibility for the Financial Statements</u>

Management is responsible for the preparation and fair presentation of these financial statements in accordance with Canadian generally accepted accounting principles.

<u>Auditor's Responsibility</u>

Our responsibility is to express an opinion on these financial statements based on our audit. We conducted our audit in accordance with Canadian generally accepted auditing standards. Those standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from misstatement.

<u>Basis for Qualified Opinion</u>

Due to factors beyond the client's control, we were not able to obtain sufficient appropriate audit evidence with respect to a material amount on the balance sheet. Had we been able to obtain evidence related to this amount, it may have indicated the presence of a material misstatement.

<u>Qualified Opinion</u>

In our opinion, the financial statements present fairly, in all material respects, the financial position of Harrringays as at December 31, 2011, and its financial performance and its cash flows for the year then ended in accordance with International Financial Reporting Standards.

January 15, 2012

Public Accountants LLP

	ERROR/ OMISSION (1 mark each)	CORRECTION (1 mark each)
1	The auditors report is addressed to the Director of Finance. This is likely not the appropriate addressee for the audit report.	It should be addressed to the party or parties who have retained your firm to carry out an audit – often the Board of Directors or any shareholders.
2	The introductory paragraph does to reference each of the financial statements audited – it just refers to the financial statements generically.	Each financial statement audited needs to be referenced. The balance sheet, statement of operations, statement of cash flows, etc.
3.	The section on management responsibility only refers to management responsibilities with respect to financial statement presentation, and not regarding internal controls.	The report should indicate management responsibility for internal control determined as necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error
4	The auditors responsibility section notes the firm's responsibility to obtain reasonable assurance about whether the financial statements are free from ANY misstatement. Auditor responsibility only extends to material misstatements	Our responsibility to obtain reasonable assurance about whether the financial statements are free from MATERIAL misstatement should be referenced..
5	A description of the audit is not provided. As a result, it does not contain key references to Canadian Auditing Standards.	A description of what an audit is should be provided….such as "An audit involves performing procedures to obtain audit evidence about the amounts and disclosures in the financial statements. The procedures selected depend on the auditor's judgment, including the assessment of the risks of material misstatement of the financial statements, whether due to fraud or error. In making those risk assessments, the auditor considers internal control relevant to the entity's preparation and fair presentation of the financial statements in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of accounting estimates made by management, as well as evaluating the overall presentation of the financial statements."
6	The basis for qualification does not provide any details about the nature of the qualification. It should provide more details to enable users to	The qualification should specifically reference the inventory balance, and state the amount of inventory recorded on the

	understand the impact of the scope restriction.	balance sheet. This is essential to indicate the possible misstatement which could exist, had the auditor been able to obtain evidence related to this balance.
7	The wording of the opinion given is for an unqualified opinion, not a qualified one. As a result, the opinion does not correspond with the basis for qualification presented above.	The opinion paragraph should commence with, “In our opinion, except for the effects of the matter described in the Basis for Qualified Opinion paragraph…” to be consistent with the qualification.
8	The opinion paragraph references IFRS, whereas the management responsibility section indicates the statements are prepared in accordance with Canadian generally accepted accounting principles. Inconsistent.	The opinion paragraph and the section on management responsibility should be consistent in the reference to the basis of accounting – IFRS or Canadian GAAP.
9	The auditor’s address is not given, just the name of the firm.	The auditor’s address/place of issue of the financial statements should be referenced in the signature line.
10	The auditors report is dated when the previous supervisor left the audit, not the date of completion of the audit.	The auditors report should be dated when the firm has identified and sought all audit evidence required to support the opinion, and have obtained and examined substantially all such evidence. Likely should be dated January 31, not January 15th.

Question #2 – Generally Accepted Auditing Standards (20 marks – 25 minutes)

You work for a large public accounting firm with many offices across the country. As part of your new job in the national office, you have been assigned a quality control review of the Famous Movie Company, an audit conducted by one of your offices in north west Manitoba.

Your firm has been auditing Famous for the last four years, ever since Famous went public. There may be a problem with the file, as the bank did not renew the bank loan last month, and Famous is struggling to meet payroll costs. They are having trouble getting additional financing, and are wondering whether adjustments could be made to the financial statements so that they can be presented in a more favourable light to the bank.

Following are your notes from the review of the Famous March 31, 2012 year end audit file:

- Files appear to be well organized. Working papers were reviewed by a junior audit partner, although not the partner who signed the financial statements.
- This is one of three public company audits conducted by this office.
- Only the current year audit file was reviewed. The prior year file was not considered to be appropriate for review, as it still contained many review note references that had not been cleared by the audit team.
- A recently qualified Public Accountant conducted the audit with the help of two assistants. The Public Accountant had no previous experience in the movie industry, but was helped by the senior assistant (whose mother in law worked at Famous). The senior assistant had extensive knowledge of the movie industry.
- Substantive audit procedures were specifically designed and conducted for this audit engagement. This was done by following the prior year's audit approach. Due to an initial discussion with respect to poor segregation of duties, control procedures were not documented in detail.
- Materiality of $150,000 was used (based upon a percentage of expenditures), as the company was currently unprofitable. Notes indicated that accounts payable was understated by over $200,000. No adjustments were made, as there was an offsetting error of almost $40,000 in the accounts receivable section of the file.

Required:

Evaluate the quality of the audit engagement using each of the generally accepted auditing standards. Briefly discuss each standard, and then assess the audit engagement using specific examples. Use the following format:

GAAS Standard (2 marks each)	How Met/Failed to Meet (3 marks each)
<u>**General Standard**</u> **technical training and proficiency**	**The PA assigned to the engagement had no experience in the movie industry, it is**

objective state of mind and due care	possible that there was inadequate competence. One of the juniors had a mother in law working at the client. This person would not be objective during the audit engagement. Students could also point to the sloppy documentation in last years file as evidence of a lack of due care.
Examination Standard reducing audit risk using planning	There is limited evidence of planning in the file. Staff simply followed the prior year's audit approach.
Examination Standard understanding of entity, environment and internal control. Assess risks of material misstatement	There is no indication that this area was documented in the audit file. There seems to have been inadequate work done in documenting internal controls. Given the need to refinance, management was motivated to misstate the financial statements. There seems to be a material error in the financial statements that was left uncorrected.
Examination Standard sufficient appropriate audit evidence	There is no indication that audit work completed was linked to risks. Previous comments indicate inadequate work completed.

Question #3 – 10 marks – 15 minutes

After months of flirting with that hottie in your ADM3349 class, you have embarked on a romantic journey rooted in your mutual love of GAAS and audit risk. Your sweety has now texted you that their parents are coming into town, and would like to meet you over dinner. Worse, they are already at the restaurant and you need to rush. Stress!

After arriving at the restaurant, your sweety's father pulls you aside and says he has some questions for you, "to get to know you better". He explains that he is a business journalist, and is writing an article due tomorrow on how financial statement auditors should address suspected risk of fraud through their audit. He has heard of your superior audit acumen, and is keen for your opinion!

<u>Required:</u>

For the sake of your budding romantic relationship, explain to your potential future father-in-law how an auditor can respond to a risk of fraud through the audit process.

Students could discuss any of the following. 1 mark for identifying the factor, and 1 mark for discussing it.

- **Change the conduct of the audit**: More experienced staff; greater focus on accounting principles used by mgmt. Gather more evidence, and be unpredictable (*required*)!
- **Design & perform appropriate audit procedures**: Will depend upon risk identified, and accounts involved.
- **Address mgmt override of controls**: The following are required in *every audit*:
    - **Examine journal entries & other adjustments**. Enquire about unusual or inappropriate entries. Extent of testing depends upon the controls present, and results of enquiries.
    - **Review accounting estimates.** Consider potential for mgmt bias when reviewing estimates. Compare to prior years, and look at trends. Earning smoothing?
    - **Business rationale for unusual transactions.** Is accounting treatment appropriate based upon substance of the transaction?
- **Update risk assessment process**
    - Beware of discrepancies in accounting records, contradictory or missing evidence, or relationship problems/ unusual relationship between auditor/ management.

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

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

1. Professional judgment is a widely used concept in accounting and auditing. How is it defined in the audit standards?
A) There is no definition of professional judgment in the auditing standards.
B) Professional judgment includes consideration of key principles and concepts of disciplines underlying the professional standards, such as economics, psychology, law, finance, statistics and philosophy.
C) Professional judgement means reaching a complex decision by incorporating auditing standards, accounting standards, and rules of professional ethics in a coherent manner.
D) Professional judgement involves specialized concepts and language integrating several disciplines in order to provide appropriate justification for audit decisions.

2. According to GAAS, the overall objective of a financial statement audit is:
A) To enable the auditor to express an opinion as to whether the financial statements are prepared in accordance with generally accepted accounting principles.
B) To reduce audit risk to an acceptably low level.
C) To determine whether the financial principles adopted by management in preparing the financial statements are acceptable.
D) To obtain reasonable assurance that the financial statements taken as a whole are free from misstatement, whether due to fraud or error.

3. Subsequent to the introduction of the Sarbanes Oxley Act in the United States, it is mandatory that at least one member of the audit committee be:
A) A member of management.
B) A director who is not part of company management.
C) A non-director and non-manager.
D) Financially literate.

4. For the audit of a for profit company, materiality should be set:
A) To 5% of profit or 1% of sales
B) By the field auditor once they begin to gather evidence.
C) By the client's board of directors who represent the shareholders.
D) Based on both quantitative and qualitative criteria.

5. The mix between controls testing and substantive testing:
A) Will affect the effectiveness of the audit.
B) Will affect the efficiency of the audit.
C) Will affect the results of the audit.
D) Will affect the profitability of the audit.

6. Which of the following statements is not a reporting standard for an assurance engagement?
A) A conclusion whether the assertion is presented in conformity with established or stated criteria.
B) A statement of whether the practitioner has significant reservations about the engagement.
C) Identification of the assertion(s) being reported on.
D) An indication by the accountant of responsibility to update the report.

7. Under which of the following circumstances does an accountant become associated with a financial report?
A) The accountant works for the enterprise which issues the report.
B) The accountant sits on the board of directors of the enterprise which issues the report.

C) The enterprise indicates that the accountant audited or reviewed the information included in the report.
D) The report is does not mention that the accountant prepared or performed other services with respect to the information.

8. Levels of assurance refer to
A) The nature of the work performed and the conclusions auditors can render about financial statements.
B) Generally accepted auditing standards.
C) Qualifications, modifications, expansions.
D) Changes in the language of the audit report.

9. An audit report included an additional paragraph disclosing a difference of opinion between the auditor and the client. The auditor believed that an adjustment should be made to the financial statements. The opinion paragraph of the audit report should express
A) An unqualified opinion.
B) An "except for" opinion citing a departure from generally accepted accounting principles.
C) An "except for" opinion citing a scope limitation.
D) A disclaimer of opinion.

10. In which of the following situations would an auditor ordinarily choose between expressing an "except for" qualified opinion or an adverse opinion?
A) The auditor did not observe the entity's physical inventory and is unable to become satisfied as to its balance by other auditing procedures.
B) The financial statements fail to disclose information that is required by generally accepted accounting principles.
C) The auditor is asked to report only on the entity's balance sheet and not on the other basic financial statements.
D) Events disclosed in the financial statements cause the auditor to have substantial doubt about the entity's ability to continue as a going concern.
11. If financial statements contain a very material departure from GAAP such that the financial statements are virtually useless, the auditor can render a (an)
A) Qualified "except for" opinion with reference to the departure.
B) Adverse opinion with scope limitation reference.
C) Adverse opinion with reference to the departure.
D) Disclaimer of opinion.

12. Under which of the following circumstances would a disclaimer of opinion be appropriate?
A) The client refuses to allow the auditor to review the minutes of the Board of Director's meetings.
B) The financial statements fail to contain adequate disclosure of related party transactions.
C) The auditor is engaged during the year and is unable to observe opening physical inventories which are material.
D) The auditor has identified illegal payments to foreign officials made by the client's management.

13. A succinct, but comprehensive definition of independence is that an auditor
A) Must be independent in fact and in appearance in order to maintain credibility.
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

14, The familiarity threat refers to:
A) Becoming too sympathetic to a client’s interests.
B) Providing assurance on one's own work.
C) Promoting a client’s position or opinion.

D) Benefiting from a financial interest in a client.

15. According to the profession's rules of conduct, an auditor would be considered independent in which of the following instances?
A) The auditor is the officially appointed stock transfer agent of a client.
B) The auditor has a personal chequing account in a branch of a client bank.
C) The client has not paid its audit fees for the past three years.
D) The client is the only tenant in a commercial building owned by the auditor.

16. The interpretations related to the rules governing objectivity or independence allow
A) A member to hold a material indirect interest in a client.
B) A member to finance a home mortgage with a client if the mortgage is made under the client's normal lending procedures and terms.
C) A member's spouse to hold a position as a director of a client of a member.
D) A member to serve as a trustee of the pension fund of a client.

17. Assume that application of analytical procedures revealed significant unexplained differences between recorded amounts and the auditor's expectations. If management is unable to provide an acceptable explanation, the auditor should
A) Consider the matter a scope limitation.
B) Perform additional audit procedures to investigate the matter further.
C) Intensify the audit with the expectation of detecting management fraud.
D) Withdraw from the engagement.

18. The concept of materiality refers to:
A) Any misstatement in the financial statements.
B) The overall degree of risk in an organization.
C) An amount of misstatement that could lead someone to make a poor decision and suffer a loss.
D) An amount of risk in an organization sufficient to offset the expected returns of any investment in the company.

19. The audit objective specifying that “all recorded assets, liabilities, and transactions represent real assets, liabilities, revenues, and expenses” is related most closely to which assertion(s)?
A) Existence or occurrence
B) Rights and obligations
C) Completeness
D) Presentation and disclosure

20. Three key management assertions about items on the balance sheet are:
A) Occurrence, completeness and accuracy.
B) Classification, existence and cut-off.
C) Confirmation, presentation and disclosure.
D) Existence, completeness and presentation.

21. The risk that an auditor's procedures will lead to the conclusion that a material misstatement does not exist in an account balance when, in fact, such misstatement actually does exist is
A) Audit risk
B) Inherent risk.
C) Control risk.

D) Detection risk.

22. The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor

A) Obtains reasonable assurance about whether the financial statements are free of material misstatement.
B) Assesses the accounting principles used and also evaluates the overall financial statement presentation.
C) Realizes some matters, either individually or in the aggregate, are important while other matters are not important.
D) Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.

23. If control risk increases and all other risks in the audit risk model stay constant (except the one referred to below) which of the following is correct?
A) Detection risk must increase.
B) Inherent risk will increase.
C) Audit risk will decrease.
D) Detection risk must decrease.

24. After obtaining an understanding of the internal control system and assessing control risk, an auditor decided not to perform additional tests of controls. The auditor most likely concluded that the

A) Additional evidence to support a further reduction in control risk was not cost-beneficial.
B) Assessed level of inherent risk exceeded the assessed level of control risk.
C) Internal control system was properly designed and justifiably may be relied on.
D) Evidence obtainable through tests of controls would not support an increased level of control risk.
25. An auditor can broadly define controls as:
A) Those elements of an organization that taken together support people in achieving an organization's objectives.
B) Those systems, processes and procedures which prevent fraud.
C) Key performance indicators employed by management to measure an organization's success.
D) The structure and culture of an organization which helps to eliminate risk.

26. One example of a formal authoritative document is a:
A) Purchase order.
B) Bank statement.
C) Vendor invoice.
D) Loan application.

27. The strongest form of audit evidence:

A) Auditor's direct personal knowledge.
B) Evidence gathered directly from independent third parties.
C) Evidence produced by independent third parties.
D) Comprehensive analysis performed by the auditor.

28. The overall audit strategy is documented in the:
A) Engagement letter.
B) Management letter.
C) Audit program.
D) Planning memorandum.

29. An advantage of statistical sampling over non-statistical sampling is that statistical sampling helps an auditor to
A) Minimize the failure to detect errors and irregularities.
B) Eliminate the risk of non-sampling errors.
C) Reduce the level of audit risk and materiality to a relatively low amount.
D) Make a preliminary estimate of the appropriate sample size.

30. Non-statistical sampling may be better to use than statistical sampling when:
A) The auditor has insufficient knowledge about the population to take a statistical sample.
B) The inherent risk of error in the population is low.
C) The population is known to be diverse, with a high inherent risk of error.
D) Auditors are not technically proficient in sampling.

END OF EXAM