



uOttawa

École de gestion
School of Management

Mid-Term Examination #1

ADM 3349 M
AUDITING THEORY

February 9, 2009

Professor: B. Church

INSTRUCTIONS

1. Books and notes **are not** permitted.
2. Calculators **are** permitted.
3. Complete all questions.
4. Write in pen.
5. Answer all questions directly on the examination paper.
6. Follow the suggested time frames for each question.

Question	Marks	Suggested Time	Grade
1	10	10 minutes	
2	15	20 minutes	
3	15	20 minutes	
4	30	30 minutes	
5	10	10 minutes	
Total	80	90 minutes	

NAME: _____

STUDENT #: _____

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 copy or booklet without that signed statement will not be graded and will receive a final exam grade of zero.

QUESTION 1 (10 marks - 15 minutes)

Discuss the conflict between the need for an audit firm to perform quality services and its desire to make a profit in the context of the investor's need for reliable information.

A perfect answer might consider:

An audit firm needs to be able to pay its staff in line with their abilities. Otherwise, more qualified staff will seek opportunities elsewhere. If they leave, only less qualified people will remain which will reduce the quality of audit possible. With less qualified people, the audit firm may be unable to express the correct opinion on the fairness of the financial statements. This would tend to increase investor's information risk.

One way to have more money to pay staff appropriately is to reduce the amount of time spent on each assignment. More assignments each with less time spent would permit more profit on each assignment. However, reducing the amount of time spent on each audit engagement would also increase the risk that a material error was missed in the audit. This increases the information risk to investors which decreases the value of the audit to them and increases the likelihood that they will sue the auditors to recover any investment losses.

A constant demand by investors for reduction in information risk means that except in the short term, an auditor cannot reduce the quality of its services. By the same token, there is an equilibrium level of profit for audit firms, and compensation for its staff and partners which investors are willing to provide in exchange for their desired reduction in information risk.

QUESTION 2 (15 marks - 20 minutes)

The second examination standard requires that auditors obtain "a sufficient understanding of internal control ...to plan the audit." This requirement encompasses obtaining an understanding of the control environment, the accounting system, and the control policies and procedures.

Required:

A) What are some of the reasons for obtaining an understanding of an audit client's internal control? (5 marks)

- i. To assist the auditor in determining the nature, timing, and extent of substantive procedures.
- ii. To obtain information about control weaknesses that should be reported to management, and the board of directors.
- iii. To identify areas at risk of material misstatement.

B) What audit work is required for an auditor to be able to assess control risk below maximum? (5 marks)

- i. Tests of controls to evaluate the actual effectiveness of control policies and procedures.
- ii. Documentation of the results of tests of controls.
- iii. Documentation of control risk assessment.

C) Should an auditor always try to obtain enough evidence to be able to assess control risk below maximum? Explain. (5 marks)

- i. Not necessarily – assessing control risk at maximum is acceptable and, in fact, may be the only option.
- ii. The cost of performing the work should always be considered in light of the benefits to be obtained. It may be more efficient to assess control risk at maximum and perform expanded substantive procedures only.

QUESTION 3 (16 marks - 20 minutes)

Murray & Co., CAs, completed the audit of Classic, Inc. on March 1, 2001 for a January 31, 2001 fiscal year end. The audit team had no significant problems and found no material misstatements. Murray has audited Classic, Inc. for several years and has experienced no problems with the audit. The audit partner determined that a standard unqualified audit report was appropriate. The audit report, drafted by I.M. Nu, a staff assistant, is provided below.

“We have audited the consolidated balance sheet of Classic, Inc. and subsidiaries as of January 31, 2001 and the related consolidated statements of cash flows and retained earnings for the year then ended. These financial statements are the responsibility of the company's management. We conducted our audit in accordance with the standards in the CICA (Canadian Institute of Chartered Accountants') Handbook. Those standards require that we plan and perform an audit to obtain absolute assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the internal controls, the accounting principles used, and significant estimates made by management, as well as evaluating the overall financial statement presentation. We believe that our audits provide an unconditional basis for our opinion.

In our opinion, these financial statements correctly show the financial position of Classic, Inc. and consolidated subsidiaries at January 31, 2001 and the results of its operations for the years then ended.”

Required: Identify the deficiencies and errors in the draft report. Do not rewrite the report, but utilize the following table format and be specific as to what is wrong or missing.

Deficiency/Omission and Explanation
Introductory paragraph - The statement of consolidated earnings is not included
Introductory paragraph - The paragraph does not include a statement describing the responsibility of the auditors.
Scope paragraph - The first sentence should indicate that "the audit was conducted in accordance with generally accepted auditing standards." The specific standards should not be spelled out.
Scope paragraph - The second sentence should not include the term "absolute." The term that should be used is "reasonable."
Scope paragraph - The paragraph should not refer to "internal controls."
Scope paragraph - The final sentence should be deleted - it is not part of the standard audit report.
Opinion paragraph - The term "correctly" does not belong. It should be replaced by the phrase "present fairly, in all material respects."
Opinion paragraph - The sentence include "and its cash flows" and the sentence should finish with the phrase "in accordance with generally accepted accounting principles."

QUESTION 4 (30 marks - 30 minutes) Circle the letter corresponding to the best response.

1. 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.**
 - 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.
2. The auditor's judgment as to the overall fairness of financial position, results of operations, and cash flows is applied within the framework of
- A. Quality control.
 - B. Generally accepted auditing standards that include the concept of materiality.
 - C. The auditor's evaluation of the internal control of the audited company.
 - D. Generally accepted accounting principles.**
3. Self regulation as applied to the auditing profession means:
- A. The profession advises the government on the laws which should be applied to the profession.
 - B. The profession is solely responsible for disciplining any member found to be engaged in wrong doing.
 - C. The profession establishes the rules that govern audit practice and monitors compliance with these rules.**
 - D. The profession exists to protect the best interests of its members and not the best interests of the public.
4. On which of the following reasons do many people blame for the profession's problems in the post-Enron world?
- A. Inadequate training of professional accountants.
 - B. The lack of focus on fraud investigation by external auditors.
 - C. A lack of independence between audit services and non-audit services provided to the same client.**
 - D. New stock trading technology causing major swings in the capital markets.
5. 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.**

6. Which of the following statements best explains an unqualified report opinion?
- A. The financial statements contain a departure from GAAP.
 - B. The auditor was unable to complete the work necessary to form a complete opinion.
 - C. The auditor was not aware of any reasons not to believe the statements are correct.
 - D. Based on the evidence obtained the auditor believes the statements are free of material error.
7. According to the fourth reporting standard in the generally accepted auditing standards (GAAS), when the opinion contains a reservation the auditor must
- A. withdraw from the engagement.
 - B. state the reason.
 - C. give an adverse opinion.
 - D. qualify the report.
8. The audit program prepared by the independent auditors prior to the start of field work is considered appropriate documentation of
- A. Planning.
 - B. Supervision.
 - C. Information evaluation.
 - D. Quality assurance.
9. Which of the following best explains practical materiality?
- A. Materiality can be calculated precisely based on percentages applicable to each industry.
 - B. Materiality has both qualitative and quantitative aspects.
 - C. Materiality is calculated after risk is assessed.
 - D. Materiality should be carried forward from year to year to ensure consistency.
10. Because of the risk of material misstatement, an audit of financial statements in accordance with generally accepted auditing standards should be planned and performed with an attitude of
- A. Objective judgment.
 - B. Independent integrity.
 - C. Professional skepticism.
 - D. Impartial conservatism.
11. Which of the following is not included in the scope paragraph of the standard audit report?
- A. Our responsibility is to express an opinion.
 - B. Standards require that we plan and perform the audit to obtain reasonable assurance.
 - C. An audit also includes assessing the accounting principles used.
 - D. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures.

12. 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. denial of opinion.

13. When an auditor denies an opinion on audited financial statements the report would

- A. modify the introductory paragraph
- B. include an extra paragraph explaining the alternative procedures carried out
- C. modify the standard scope paragraph.
- D. include an extra paragraph explaining the departure from GAAP.

14. An auditor most likely would issue a denial of opinion because of

- A. inadequate disclosure of material information.
- B. the omission of the statement of cash flows.
- C. a material departure from generally accepted accounting principles.
- D. management's refusal to furnish written representations.

15. CA has been engaged to audit the financial statements of Marchano Ltd., a manufacturer of toys. Several individuals are suing the company because of a toy that injured children. The company has not disclosed the lawsuit in its financial statements. The type of audit report issued should be:

- A. Adverse.
- B. A GAAP qualification.
- C. A scope qualification.
- D. Denial.

16. Which of the following is not an impediment to a CA's independence in appearance?

- A. The CA received a set of professional quality, graphite golf clubs from a client as an expression of appreciation for the quality of the work performed.
- B. The CA is suing the client for non-payment of fees.
- C. The fees from one audit client comprise sixty-five percent of the CA's total billings for the year.
- D. When the CA serves in an honorary and non-participating role as a director for a nonprofit organization.

17. Under common law, which of the following statements most accurately reflects the liability of a CA who gives a fraudulent opinion on an audit of a client's financial statements?

- A. The CA is liable only to third parties who are in privity of contract with the CA.
- B. The CA is liable only to known users of the financial statements.
- C. The CA probably is liable to any person who suffered a loss as a result of the fraud.
- D. The CA probably is liable to the client even if the client was aware of the fraud and did not rely on the opinion.

18. A CA may be liable to any purchaser of a security if the CA issued a clean opinion on materially misstated financial statements. CA usually will not be liable to the purchaser

- A. If the purchaser is guilty of contributory negligence.
- B. If the CA can prove due care in the audit.
- C. Unless the purchaser can prove privity with the CA.
- D. Unless the purchaser can prove scienter on the part of the CA.

19. 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.
- 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.

20. You have just acquired a new client and have discussed various services that you will perform for the client including the annual audit and preparation of corporate tax returns. What documentation should you obtain from the client in order to reduce any misunderstandings over the type of services being performed?

- A. Management letter.
- B. Auditor's report
- C. Legal letter
- D. Engagement letter.

21. The valuation assertion includes:

- A. The measurement assumption used.
- B. Ensuring all inventory is counted.
- C. Making sure that all receivables relate to sales during the year.
- D. The method of presenting short term and long term liabilities.

22. Factors that an auditor might take into account in determining the level of inherent risk are:

- A. Management philosophy and operating style.
- B. Classes of transactions and systems employed.
- C. The reliability of evidence which can be obtained.
- D. Extent of management judgement over nonroutine transactions.

23. According to COSO, internal control includes the following components:

- A. Control activities and inherent risks.
- B. Information systems and external influences.
- C. The control environment and risk assessment processes.
- D. Financial reporting and control activities.

24. The probability that an auditor will give an inappropriate opinion on the financial statements best describes

- A. Audit risk.
- B. Inherent risk.
- C. Control risk.
- D. Detection risk.

25. In the planning stage, analytical procedures are used to

- A. Assess overall reasonableness of the financial statements.
- B. Identify potential problem areas.
- C. Determine the mathematical correctness of the financial statements.
- D. Provide direct evidence about the balances in accounts.

26. 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.

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. One of the auditor's primary concerns with regard to internal controls is:

- A. The degree to which the internal controls are working as designed.
- B. The possibility of an inherent risk which has to be controlled.
- C. The impact the controls have on the accuracy of the accounting records.
- D. The amount of substantive work to be saved by testing controls instead.

29. Key controls are those:

- A. Over significant risks.
- B. Over physical access.
- C. On which the auditor intends to rely.
- D. Designed by the audit committee to prevent management fraud.

30. 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.
- D. Which occur primarily close to reporting period ends such as year end or quarter end.

QUESTION 5 (10 marks, 2 marks each)

For each of the following independent situations:

1. Identify whether it is an accounting (GAAP) problem or auditing (scope) problem
2. Describe the specific type of problem and
3. Indicate the appropriate form of reservation in the auditor's report.

Assume each situation is material.

- a. The auditor was appointed on January 25, 2009 for the 2008 fiscal year audit (year-end December 31st). As a result, the auditor has missed the client's year-end inventory count, and was unable to physically verify the inventory on hand. Assume no other appropriate audit evidence is available to substantiate the balance. The recorded cost for inventory on hand at year end is material to the client's financial statements.
- b. The client has stated that although the fair market value of its stock market long-term investments has been falling steadily for the past two years, they are not going to write down the value of their investment (currently recorded at original cost), despite the evidence of permanent impairment.
- c. As a result of communicating with the client's lawyer, the auditor has become aware of a pending product liability lawsuit against the client. The client claims the suit has no foundation and has not disclosed it in their financial statements.
- d. The client has material inventories held at fifty different geographical locations. Because the audit fees will increase, the client has decided that the auditors are not to count inventories nor conduct alternative procedures for year end inventory balances.
- e. During the year end audit, you read in the newspaper that a major customer of your client has declared bankruptcy. You notice that there is no allowance established on the amount receivable. You discuss this with the comptroller who informs you that it is not possible to take an allowance because the net income figure has already been used to calculate bonuses.

Situation	GAAP or Scope Problem (1/½ mark)	Type of Problem (1/½ mark)	Appropriate Reservation (1 mark)
a	SCOPE	Since the auditor was appointed after year-end, there is a scope restriction with respect to inventory, which is beyond the control of both the auditor and the client.	Qualification of scope and opinion.
b	GAAP	Long-term investment is permanently impaired, and therefore must be written down to the lower of cost and market in accordance with GAAP.	Qualification due to GAAP departure.

c	GAAP	The client should disclose the product liability lawsuit in the notes to its financial statements, with an indication of the likelihood of a loss resulting from the suit, and the probable amount of loss (if estimable).	Depends. Qualification due to GAAP departure (if probability of loss to client is likely). OR No reservation (if it is argued that there is a very low probability of loss)
d	SCOPE	The client is restricting the auditor from audit and gathering evidence regarding existence of inventory. Restriction is within client's control	Qualification re: scope and opinion Denial if material & persuasive
e	GAAP	Allowance needs to be booked as the receivable is likely not collectible	Qualification due to GAAP departure.