

Part 1: Multiple Choice (20 marks, 38 minutes)

- 1 C
- 2 A
- 3 D
- 4 B
- 5 D
- 6 B
- 7 A
- 8 D
- 9 C
- 10 A
- 11 C
- 12 B
- 13 D
- 14 A
- 15 C
- 16 A
- 17 B
- 18 C
- 19 D
- 20 C

Part 2: Technical & Theoretical

Question 1 (8 marks, 12 minutes)

	Book Value	Audit Value	Difference
Customer A	\$23,789	\$20,089	\$3,700
Customer D	\$65,785	\$60,236	\$5,549
Customer H	\$99,765	\$96,467	<u>\$3,298</u>
		Actual Errors	<u>\$12,547</u>
		Total Sample Size	\$1,575,276
		Percentage of Error	0.7965%
		Total Population	\$4,500,789
		Projected Error	<u>\$35,849</u>

- The projected error of \$35,849 is less than the total materiality of \$80,000. Therefore, the error would be taken to the summary of unadjusted errors. It is not possible to adjust for these errors since it is only a projection.
- The actual error of \$12,547 is below materiality, and it is unlikely that these accounts would need to be adjusted.
- All three of the identified errors had a book value greater than the audit value, which creates a concern that management is trying to overstate sales and accounts receivable.

- Follow up should occur on the receipt of payments (i.e. you should question the AR clerk regarding whether cheques were received that were not posted on a timely basis.)
- Follow up should occur on the amounts making up the difference (i.e. was the difference based on an invoice for goods that was not shipped at year end but recorded as sales, in order to overstate the sales?)

Question 2 (10 marks, 16 minutes)

Situation 1

- A sample of three purchase orders is not a sufficient sample
- Samples should be at least ten items in size and can vary based on the materiality of the items, expectation of errors, and controls in place
- The internal control questionnaire should have been completed before the test of controls was completed
- An understanding of the internal controls was not sufficiently obtained
- The auditor was unable to form expectations nor identify what would be considered an error without first understanding the internal controls
- Other valid points

Situation 2

- While it is appropriate to select some of the largest quantities items, selecting a sample made up of only these items is not a representative sample. Therefore, it will not be possible to extrapolate the results of the sample onto the entire population.
- While 8% of the 200 items was incorrect, it is not possible to state that 8% of the 1,000 items will be incorrect
- It may still be necessary for the foreman to recount the inventory if the sixteen incorrect counts were material or would impact the audit report
- It is very difficult to re-do the inventory count after year end, and it is better to be safe than sorry
- It is necessary to select some small dollar amounts (made up of the other 800 items) to have a representative sample
- Instead of automatically requiring the foreman to redo the count, Rudolph should complete test counts of the other 800 items to determine the actual rate of error within the sample
- Other valid points

Question 3 (13 marks, 16 minutes)

Part a)

The use of analytical procedures in an audit provides two general advantages to a public accountant:

- (1) a broad view is obtained of the data under audit
 - It is possible to draw conclusions about the data as a whole which cannot be obtained by looking at transactions

- Able to assess the reasonableness, validity, and consistency of the data in light of the surrounding circumstances
- (2) attention is focused on exceptions or variations in the data
- By focusing on exceptions or variations, the audit is more efficient and economical as detailed testing can be reduced
 - Manipulation of accounts can be revealed as the manipulation of one account will impact another account
 - Managerial problems and trouble spots will be highlighted and lead to the opportunity of the auditor to provide additional services to the client

[4 marks]

Part b)

The ratios that a public accountant may compute during an audit as overall checks on balance sheet accounts and related income accounts may include the following:

- accruals of individual expenses to related total expenses
- accounts payable to purchases (days of purchases outstanding)
- long-term debt and interest expense thereon
- return on equity (relationship of net income to ownership equity)
- return on investments (relationship of investment income to investments)
- Other valid example

[5 marks]

Part c)

The possible reasons for a decrease in the rate of inventory turnover include:

- decline in sales
- increase in inventory quantities, intentional or unintentional
- incorrect computation of inventory because of errors in pricing, extensions, or taking of physical inventory
- Inclusion in inventory of slow-moving or obsolete items
- erroneous cut-off of purchases
- erroneous cut-off of sales under the perpetual inventory
- unrecorded purchases
- change in inventory valuation method

[2 marks]

The possible reasons for an increase in the number of days' sales in receivables include:

- change in credit terms
- decreasing sales
- change in the sales mix of products with different sales terms
- change in mix of customers
- improper sales cut-off
- unrecorded sales
- lapping
- slower collections caused by tighter economic conditions or lowering of the quality of the receivables

[2 marks]

Question 4 (9 marks, 12 minutes)

For situation 1:

- The payroll cheques should not be returned to the supervisor, but should be distributed by persons independent of those having a part in making up the payroll data. This could lead to padding of payroll with fictitious names and extracting the cheques made out to such names when they are returned after they have been signed. Have the cheques handed out by an independent person and not returned to the computer programmer.
- There is a lack of internal verification of the hours, rates, and extensions of employees. There may be errors in hours, rates, extensions, and the existence of non-working employees. Internal verification of information needs to be performed by the treasurer or someone else.

For situation 2:

- The bank statement and cancelled cheques should not be reconciled by the manager but should be sent by the bank directly to the home office, where the reconciliations should be made against the manager's report of reimbursements. The manager may draw cheques to herself or others for personal purposes and omit them from her list of disbursements, or inflate other reported disbursement amounts. Have all bank statements sent directly to the home office, and have Mary report directly to the home office by use of a list of expenditures and all supporting documentation.

Question 5 (9 marks, 12 minutes)

Situation	Error/Fraud	Preventative Control	Audit Procedure
1.	Error	Use of pre-numbered bills of lading that are periodically accounted for.	Trace a sequence of pre-numbered bills of lading to recorded sales transactions. Confirm accounts receivable at year end.
2.	Error	Internal review and verification by an independent person.	Test accuracy of invoice classification.
3.	Fraud	The listing of cash received should be compared to the postings in the accounts receivable master file and to the validated bank deposit slip.	Trace cash received from prelisting to cash receipts journal. Confirm accounts receivable.

Question 6 (9 marks, 12 minutes)

Part a)

The junior accountant's approach to determining why this year's employee benefits expense was so high suffers from two serious deficiencies:

- It lacks relevance
 - She is testing payroll withholding which is not the same as employee benefits expense
 - Only some employee benefits are related to withholdings
 - Income taxes withheld does not create an expense, while worker's compensation is not withheld
- It is too narrowly focused
 - The analytical procedure results could have resulted from a misstatement of the payroll itself

[6 marks]

Part b)

A more suitable approach for determining whether employee benefits expense was properly stated in the current year would be to evaluate the reasonableness of the total payroll, reconcile the payroll to amounts shown on employee benefits remittance returns, and check computations as shown on those returns for reasonableness.

[3 marks]

Question 7 (6 marks, 10 minutes)

- It is not possible for auditors to look at every single transaction within a company
- If auditors looked at every transaction, the audit report would take too long to complete and would therefore not be valuable to the user (as the information is outdated)
- Even if an auditor looks at every single transaction, the auditor would not be able to verify unrecorded transactions like cut-off errors
- Auditors are not expected to identify fraud within a company; however, the auditor should investigate further if they identify fraud
- Management is actually in a better position to identify fraud than the auditor
- Auditors should only be sued if the auditor was not independent or did not follow GAAS with respect to the audit (i.e. if the auditor failed to properly plan the audit, supervise the juniors, or lacked the understanding needed to plan the engagement)
- If the auditor did everything that another competent auditor would do, then the auditor should not be sued
- The audit report clearly identifies the fact that the financial statements represent fairly the results of the operations, and therefore the auditor does not provide an opinion on whether the financial statements are completely accurate
- Other valid points

Question 8 (6 marks, 10 minutes)

- The auditor completes test accounts during the audit

- These test counts help to verify the completeness and existence of the inventory
- The auditor observes the count procedures to ensure that all procedures have been properly completed
- The auditor also has the ability to assess whether the inventory is obsolete (i.e. is dusty or broken) which would impact the inventory's valuation
- While onsite, the auditor will record their counts, which are compared to the client's records during the audit
- The auditor can verify that the client did not change the inventory quantities by reviewing the count sheets during the audit (i.e. by looking for changes in the quantity of the original count sheets)
- The auditor should also request a complete listing of inventory at the count date
- It can be difficult to determine whether all quantities have been changed
- Any differences between the auditor's count and the client's count would be identified as an audit difference and taken to the summary of unadjusted misstatements
- If the client changed the inventory by a material amount, then the auditor could request that a re-count occur and the inventory count would be rolled back to year end
- Other valid points

Part 3: Case (30 marks, 42 minutes)

Inherent risk was incorrectly set at low, based on the assumption that few issues would impact the risk assessment. However, inherent risk should be assessed as high for some of the following reasons:

- The company is issuing shares this year, implying that management will want to show strong profits and could have an incentive to overstate the financial statement
- The pre-tax profit is slightly over the requirement for the CFO's bonus. It is possible that the CFO overstated the company's profits in order to ensure he obtained his bonus
- The company has been experiencing increasing profits for the past seven years and therefore there would be motivation to continue to show increasing profits

[4 marks]

Control risk was incorrectly assessed as low, meaning that controls could be relied upon for the audit. However, through discussions with the CFO, it was noted that there were minor control issues during the year and one employee was suspected of taking money. This indicates that controls may not have been effective for all or part of the year.

- Further discussions with the CFO are warranted to understand the control risks, and to assess whether or not controls can be relied upon for the audit.

- If it is determined that there were control weaknesses then it may not be possible to complete tests of controls, in which case the audit approach would need to change from a combined approach to a substantive approach.

[4 marks]

Fraud risk

- There is a possibility that an employee was stealing cash. Further procedures will need to be completed surrounding the possible fraud. For example, if the employee was stealing cash and not recording the sales, then the revenue would be understated for the year. This would be very difficult to identify. However, if the employee was stealing payments on accounts, it would be possible to identify the fraud.

[3 marks]

Computer System

- The computer system crashed during the year and at least five days worth of data needed to be entered by hand
- A discussion with the CFO noted that everything went fine and no further work was needed
- Further investigation should be completed on the computer crash
- It is possible that not all transactions were re-entered into the system, or that the workers were tired and made mistakes while entering information into the system. To test this, we should trace the transactions from the source document to the general ledger, verifying the accuracy of amounts, the classification of the accounts, and the completeness.
- It is possible that transactions were entered more than once into the system. We should run tests to determine whether there are duplicate invoice numbers, PO numbers, or receiving report numbers. Entering transactions more than once would be in line with a possible bias to improve the financial statement results.
- We should select a sample of transactions from the “re-entered time period” from the general ledger, and agree the details to the source documents to verify occurrence

[4 marks]

Capital Asset

- TTL purchased two special pieces of equipment each costing \$3,575,000, including installation
- TTL has decided to amortize the machines over 20 years, which is the expected useful life of the equipment; however, the BreadMaker Plus is only going to be sold for 8 years, and at the end of 8 years the machines will need to be replaced. Therefore, the amortization period should be a maximum of 8 years.
- Using 20 years results in a lower amount of amortization, which would be in line with the CFO's bias to improve net income to obtain his bonus

- It is possible to use the units-of-production method to amortize the machines instead of straight-line amortization, as this would be a better match against revenues (i.e. base amortization on the 650,000 units)
- Additionally, amortization was not taken during the first year. Not taking any amortization is in line with the CFO's bias to obtain his bonus.
- Amortization should be taken once the machines have been placed into operation
- The comment that the amortization was recorded correctly is incorrect. Assuming the machines were placed into operation at the start of the year, the annual amortization would have been \$893,750, which is a material error.
- We will require this amount to be adjusted, or if it is not material, which depends on when the machines were put into use, the amount can be recorded on the statement of unadjusted errors.

[6 marks]

Inventory

- The candy cane division has had difficulty due to an increased consumer dislike for candy canes
- Candy cane inventory is 50% above the previous year and accounts for 30% of inventory
- The accountant noted that the candy cane inventory was reasonably stated; however, there is a concern that the inventory will be obsolete due to the change in customer preferences
- The higher inventory is likely attributed to the fact that candy canes cannot be sold due to changing customer tastes
- Inventory needs to be valued at the lower of cost and net realizable value. It is likely that write downs will be needed
- Tests will need to be completed by comparing the aging of the inventory to its best before date. The unit cost of the candy canes will also need to be compared to the selling costs after year end to determine if the candy canes need to be written down. The selling season for candy canes is normally completed by January, and therefore, any candy canes that were not sold in the subsequent events period will not be written off.

[4 marks]

Customer Complaints

- Unhappy customers that complain about the non-stick coating of the bread pans are being provided with a new bread pan and several coupons for free bread supplies
- The total cost will range from \$25,000 to \$37,500
- The fact that this liability has not been recorded is consistent with the CFO's bias to show improved profits
- Since the original sale occurred in the current year, the company should accrue the liability related to bread pans (matching principle)

- This accrual is not material and could be taken to the summary of unadjusted misstatements

[4 marks]

Lawsuit

- TTL has sued the manufacturer for \$600,000 and recorded the amount as an extraordinary item
- This is in line with the CFO's bias to improve net income to obtain his bonus
- Contingent gains are only recorded when the gain has been realized. In this case, the matter has not gone to the court and the lawyers are unsure of the outcome. It is therefore not appropriate to accrue the \$600,000 since the amount has not been realized. This is a GAAP departure.
- The audit senior noted that the lawsuit was not material to the financial statements. However, based on net income before taxes of \$3,010,000 and materiality being set at 5%, materiality would be set at \$150,050. Therefore, the lawsuit of \$600,000 is material

[4 marks]

Communication

The audit team determined that there were no matters to communicate with the audit committee or the board of directors (BOD). The following matters should be discussed with the audit committee and board of directors:

- The computer system crash caused the company to lose five days worth of data. Data should be backed up on a daily basis to prevent the loss of critical information and to reduce the burden on the staff of re-entering information
- We must enquire of the board and the audit committee regarding any knowledge they have of fraud, including the employee theft
- We will need to discuss with the audit committee the errors that were identified (capital assets, inventory, lawsuit) even if the errors are corrected
- Assuming that the errors will be corrected, the BOD will need to approve the journal entries
- We should discuss our independence with the board
- We should discuss the fees for the engagement
- During the audit, the audit team should have discussed with the BOD the planning, including the approach, high risk areas, materiality, timing, and reliance on internal staff. It does not appear that this was communicated
- We should also discuss with the BOD judgments and estimates, including the 20-year useful life of the new capital assets, and the fact that an estimated accrual for the replacement pans was not made

[5 marks]

Financial Statements

- The audit team determined that the financial statements were fairly stated. However, based on the GAAP departures, the financial statements are not fairly stated as there are material misstatements

- Adjustments will be necessary; however, adjustments would eliminate the CFO's bonus
- Unless the material adjustments are made, a qualification will be needed for the financial statement.
- Due to the material nature and the variety of errors (i.e. many accounts are impacted), an adverse opinion would be necessary (i.e. cannot rely on the financial statements due to the many GAAP departures)

[4 marks]

[Maximum marks for the solution 30]