



MONASH

University

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BUSINESS

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ACC/ACF 3600- S2, 2020

AUDITING & ASSURANCE

Lecture 11

Revision of Mock e-exam questions






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Question 1

Sola Drink Ltd. (Sola) manufactures fizzy drinks such as cola and lemonade and its year end is 31 December 2017. You are the audit manager of Steven & Partners and are currently planning the audit of Sola. You attended the planning meeting with the engagement partner and finance director last week. The minutes of the meeting are presented below. You are reviewing these as part of the process of preparing the audit strategy.

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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Question 1

Required:

(a) Explain the THREE (3) components of audit risk in general. **(6 marks)**

(b) Using the minutes provided, identify and describe FIVE (5) audit risks, and explain the auditor's response to each risk, in planning the audit of Sola Drink Ltd. **(15 marks)**

(c) Identify TWO (2) main areas, other than audit risks, that should be included in the audit strategy document for Sola Drink Ltd, and for each area provide an example relevant to the audit. **(6 marks)**

(d) Describe TWO (2) substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence relating to the following three matters:

(i) The treatment of the \$5 million expenditure incurred on improving the factory production process; **(6 marks)**

(ii) The release of the \$1.5 million allowances for receivables; and **(6 marks)**

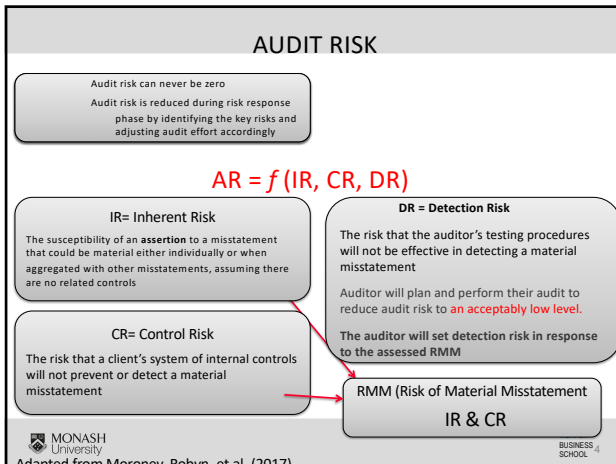
(iii) The damaged batch of cola inventory. **(6 marks)**

(Total = 6 + 15 + 6 + 6 + 6 = 45)

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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Solution – Question 1

(a)

Inherent risk is the susceptibility of an assertion about a class of transaction, account balance or disclosure to a misstatement that could be material, either individually or when aggregated with other misstatements, before consideration of any related controls. (2m)

Control risk is the risk that a misstatement which could occur in an assertion about a class of transaction, account balance or disclosure and which could be material, either individually or when aggregated with other misstatements, will not be prevented, or detected and corrected, on a timely basis by the entity's internal control. (2m)

Detection risk is the risk that the procedures performed by the auditor to reduce audit risk to an acceptably low level will not detect a misstatement which exists and which could be material, either individually or when aggregated with other misstatements. Detection risk is affected by sampling and non-sampling risk. (2m)

(6 marks)

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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Question 1

Minutes of the Planning Meeting for Sola

Sola's trading results have been strong this year and the company is forecasting revenue of \$85 million, which is an increase from the previous year. The company has invested significantly into the fizzy drinks production process at the factory. **This resulted in an expenditure of \$5 million on updating, repairing and replacing a significant amount of the machinery used in the production process.**

- If this expenditure is of a capital nature - capitalised as part of property, plant and equipment (PPE).
If it relates more to repairs - expensed to the statement of profit or loss (income statement).
If the expenditure is not correctly classified, profit and PPE could be under or overstated. (1 mark)

The auditor should **review a breakdown of these costs** to ascertain the **split of capital and revenue expenditure** (2 marks)

Adapted from Moroney, Robyn, et al. (2017). Auditing: A practical approach (3rd ed.). Wiley

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Question 1

Minutes of the Planning Meeting for Sola

As the level of production has increased, the company has expanded the number of warehouses it uses to store inventory. It now utilises 15 warehouses; Sola owns some of these while some are rented from third parties. There will be inventory counts taking place at all 15 of these sites at year end.

2. Inventory counts undertaken in all 15 warehouses – Auditor may not be able to attend all 15 inventory counts. Need to ensure that they obtain sufficient evidence over the inventory counting controls for any warehouses not visited.

The auditor should **assess which of the inventory sites they will attend the counts for** – Material inventory or which have a history of significant errors. For those not visited - will need to review the level of exceptions noted during the count and discuss with management any issues which arose during the count.

3. Inventory is stored within 15 warehouses; some are owned by Sola and some rented from third parties. **Only warehouses owned by Sola** should be included within PPE.

The auditor should **review supporting documentation for all warehouses included** within PPE to confirm ownership by Sola and to ensure non-current assets are not overstated.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

Minutes of the Planning Meeting for Sola

A new accounting general ledger has been introduced at the beginning of the year, with the old and new systems being run in parallel for two months.

4. A new accounting general ledger system has been introduced at the beginning of the year. **There is a risk of opening balances being misstated and loss of data if they have not been transferred from the old system correctly.** In addition, the **new general ledger system will require documenting**

The auditor should undertake **detailed testing to confirm that all opening balances** have been correctly recorded in the new general ledger system. **They should document and test the new system.** They should review any management reports run comparing the old and new system during the parallel run to identify any issues with the processing of accounting information.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

Minutes of the Planning Meeting for Sola

Because of the increase in revenue, Sola has recently recruited a new credit controller to chase outstanding receivables. The finance director thinks it is not necessary to continue to maintain an allowance for receivables and so has released the opening allowance of \$1.5 million.

5. The finance director of Sola has decided to release the opening provision of \$1.5 million for allowance for receivables as he feels it is unnecessary. There is a risk that receivables will be overvalued, as despite having a credit controller, some balances will be irrecoverable and so will be overstated if not provided against.

Extended post year-end cash receipts testing and a review of the aged receivables ledger to be performed to assess valuation and the need for an allowance for receivables.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

Sola also incurred an expenditure of \$4.5 million on developing a new brand of fizzy soft drinks. The company started this process in April 2017 and is close to launching their new product into the market place.

6. Sola has incurred expenditure of \$4.5 million on developing a new brand of fizzy drink. This expenditure is research and development. The standard requires research costs to be expensed and development costs to be capitalised as an intangible asset. If Sola has incorrectly classified research costs as development expenditure, there is a risk the intangible asset could be overstated and expenses understated.

Obtain a breakdown of the expenditure and undertake testing to determine whether the costs relate to the research or development stage. Discuss the accounting treatment with the finance director and ensure it is in accordance with accounting standard.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

The finance director stated that there was a problem in November in the mixing of raw materials within the production process which resulted in a large batch of cola products tasting different. A number of these products were sold; however, due to complaints by customers about the flavour, no further sales of these goods have been made. No adjustment has been made to the valuation of the damaged inventory, which will still be held at the cost of \$1 million at year end.

7. A large batch of cola products has been damaged in the production process and will be in inventory at the year end. No adjustment has been made by management. Inventories should be at the lower of cost and net realisable value. Hence it is likely that this inventory is overvalued.

Detailed cost and net realisable value testing to be performed to assess how much the inventory requires writing down by.

8. Due to the damaged cola products, a number of customers have complained. It is likely that for any of the damaged goods sold, Sola will need to refund these customers.

Review the breakdown of sales of damaged goods, and ensure that they have been accurately removed from revenue.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

As in previous years, the management of Sola is due to be paid a significant annual bonus based on the value of total year end assets.

9. Revenue is possibly overstated if the sales returns are not completely and accurately recorded. The management of Sola receives a significant annual bonus based on the value of year-end total assets. There is a risk that management might feel under pressure to overstate the value of assets through the judgements taken or through the use of releasing provisions.

Throughout the audit the team will need to be alert to this risk. They will need to maintain professional skepticism and carefully review judgmental decisions and compare treatment against prior years.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 1

Required:

(a) Explain the THREE (3) components of audit risk in general. **(6 marks)**

(b) Using the minutes provided, identify and describe FIVE (5) audit risks, and explain the auditor's response to each risk, in planning the audit of Sola Drink Ltd. **(15 marks)**

(c) Identify TWO (2) main areas, other than audit risks, that should be included in the audit strategy document for Sola Drink Ltd, and for each area provide an example relevant to the audit. **(6 marks)**

(d) Describe TWO (2) substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence relating to the following three matters:

(i) The treatment of the \$5 million expenditure incurred on improving the factory production process; **(6 marks)**

(ii) The release of the \$1.5 million allowances for receivables; and **(6 marks)**

(iii) The damaged batch of cola inventory. **(6 marks)**

(Total = 6 + 15 + 6 + 6 + 6 = 45)

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Solution – Question 1

(c) Identify TWO (2) main areas, other than audit risks, that should be included in the audit strategy document for Sola Drink Ltd, and for each area provide an example relevant to the audit. **(6 marks)**

The audit strategy sets out the **scope, timing and direction** of the audit and helps the development of the audit plan. It should consider the following main areas:

It should identify the main characteristics of the engagement which define its scope. For Sola it should consider the following:

- Whether the financial information to be audited has been prepared in accordance with IFRS.
- To what extent audit evidence obtained in previous audits for Sola will be utilised.
- Whether computer-assisted audit techniques will be used and the effect of IT on audit procedures.
- The availability of key personnel at Sola.

It should ascertain the reporting objectives of the engagement to **plan the timing of the audit and the nature of the communications required**, such as:

- The audit timetable for reporting and whether there will be an interim as well as final audit.
- Organisation of meetings with Sola's management to discuss any audit issues arising.
- Location of the 15 inventory counts.
- Any discussions with management regarding the reports to be issued.
- The timings of the audit team meetings and review of work performed.
- If there are any expected communications with third parties.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Solution – Question 1

The strategy should consider the factors that, **in the auditor's professional judgement, are significant in directing Sola's audit team's efforts**, such as:

- The determination of materiality for the audit.
- The need to maintain a questioning mind and to exercise professional skepticism in gathering and evaluating audit evidence.

It should consider **the results of preliminary audit planning activities** and, where applicable, whether knowledge gained on other engagements for Sola is relevant, such as:

- Results of previous audits and the results of any tests over the effectiveness of internal controls.
- Evidence of management's commitment to the design, implementation and maintenance of sound internal control.
- Volume of transactions, which may determine whether it is more efficient for the audit team to rely on internal control.
- Significant business developments affecting Sola, such as the change in the accounting system and the significant expenditure on an overhaul of the factory.

The audit strategy should **ascertain the nature, timing and extent of resources necessary** to perform the audit, such as:

- The selection of the audit team with experience of this type of industry.
- Assignment of audit work to the team members
- Setting the audit budget.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Solution – Question 1

(d) Describe TWO (2) substantive procedures the audit team should perform to obtain sufficient and appropriate audit evidence relating to the following three matters:

(i) The treatment of the \$5 million expenditure incurred on improving the factory production process; **(6 marks)**

(ii) The release of the \$1.5 million allowances for receivables; and **(6 marks)**

(iii) The damaged batch of cola inventory. **(6 marks)**

(i) \$5 million expenditure incurred on improving the factory production process (6 marks - 2 marks for each point)

- Obtain a schedule of the \$5 million expenditure and cast to ensure accuracy.
- For those items treated as capital and included with property, plant and equipment, agree to purchase invoices and ascertain whether they are in fact of a capital nature.
- For capital items, agree to the non-current assets register to ensure that they are correctly included.
- For capital items, recalculate the depreciation charged to ensure it has been appropriately time apportioned.
- For items treated as repairs, agree to invoices to ensure they are not of a capital nature and that they have been correctly expensed to the statement of profit or loss (income statement).

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Solution – Question 1

(ii) Release of \$1.5 million allowances for receivables (6 marks)

- Discuss with the finance director his rationale for not providing against any receivables.
- Review the aged receivable ledger to identify any slow moving or old receivable balances, discuss the status of these balances with the credit controller to assess whether they are likely to pay.
- Review whether there are any after date cash receipts for slow moving/old receivable balances.
- Review customer correspondence to identify any balances which are in dispute or unlikely to be paid.
- Review board minutes to identify whether there are any significant concerns in relation to payments by customers. – Calculate the potential level of receivables which are not recoverable and assess whether this is material or not and discuss with management.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Solution – Question 1

(iii) Damaged inventory (6 marks)

- Obtain a schedule of the \$1 million damaged cola products and cast to ensure accuracy.
- During the inventory count identify the quantity of the damaged goods and agree to the schedule.
- Discuss with management their plans for disposing of these goods, whether they believe these goods have a net realisable value (NRV) at all or if they will need to be scrapped.
- If any of the goods have been sold post year end, agree to the sales invoice to assess NRV.
- Agree the cost of the inventory to supporting documentation to confirm the raw material cost, labour cost and any overheads attributed to the cost.
- Quantify the level of adjustment required to value inventory at the lower of cost and NRV and discuss with management.

Adapted from Moroney, Robyn, et al. (2017). *Auditing: A practical approach* (3rd ed.). Wiley

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Question 2

You are the audit manager of Edward & Partners and you are currently reviewing the audit files for several of your clients for which the audit fieldwork is complete. The audit seniors have raised the following issues for two clients described in Part A and B:

Part A

Max Designs Ltd. (Max)

Max's year end is 30 September, however, subsequent to the year end the company's sales ledger was corrupted by a computer virus. Max's finance director was able to produce the financial statements before this occurred; however, the audit team has been unable to access the sales ledger to undertake detailed testing of revenue or year-end receivables. All other accounting records are unaffected and there are no backups available for the sales ledger. Max's revenue is \$15.6 million, its receivables are \$3.4 million and profit before tax is \$2 million.

Required:

- (i) Discuss the issue described above, including an assessment of whether it is material in nature to completing your audit. **(4 marks)**
- (ii) Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue in (i). **(4 marks)**
- (iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Max Designs Ltd. **(4 marks)**

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (A)

(i) Max's sales ledger has been corrupted by a computer virus; hence no detailed testing has been performed on revenue and receivables. The audit team will need to see if they can confirm revenue and receivables in an alternative manner. If they are unable to do this, then two significant balances in the financial statements will not have been confirmed. Revenue and receivables are both higher than the total profit before tax (PBT) of \$2m; receivables are 170% of PBT and revenue is nearly eight times the PBT; hence this is a significant material issue.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (A)

(ii) Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue in (i). **(4 marks)**

Procedures to be adopted include:

- Discuss with management whether they have any alternative records which detail revenue and receivables for the year.
- Attempt to perform analytical procedures, such as proof in total or monthly comparison to last year, to gain comfort in total for revenue and for receivables.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (A)

(iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Max Designs Ltd. **(4 marks)**

Pervasive effects on the financial statements are those that, in the auditor's professional judgment:

- Are not confined to specific elements, accounts or items of the financial statements
- If confined, represent or could represent a substantial proportion of the financial statement
- With regard to disclosures, are fundamental to users' understanding of the financial statements.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (A)

(iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Max Designs Ltd. **(4 marks)**

The auditors will need to modify the audit report as they are unable to obtain sufficient appropriate evidence in relation to **two material and pervasive areas, being receivables and revenue**. Therefore a **disclaimer of opinion will be required**. A basis for disclaimer of opinion paragraph will be required to explain the limitation in relation to the lack of evidence over revenue and receivables. The opinion paragraph will be a disclaimer of opinion and will state that we are unable to form an opinion on the financial statements.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Question 2 (B)

Part B

Sky Enterprises Ltd. (Sky)

Sky has experienced difficult trading conditions and as a result it has lost significant market share. The cash flow forecast has been reviewed during the audit fieldwork and it shows a significant net cash outflow. The management of Sky are confident that further funding can be obtained, so they have prepared the financial statements on a going concern basis with no additional disclosures; the audit senior is highly sceptical about this. The prior year financial statements showed a profit before tax of \$1.2 million; however, the current year loss before tax is \$4.4 million and the forecast net cash outflow for the next 12 months is \$3.2 million.

Required:

- Discuss the issue described above, including an assessment of whether it is material. **(4 marks)**
- Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue. **(4 marks)**
- If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Sky Enterprises Ltd. **(4 marks)**

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (B)

- (i) The prior year financial statements showed a profit of \$1.2m and the current financial statements show a loss before tax of \$4.4m, the net cash outflow of \$3.2m represents 73% of this loss (3.2/4.4m) and hence is a material issue.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (B)

- (ii) Recommend TWO (2) procedures the audit team should undertake at the completion stage to try to resolve the issue. **(4 marks)**

Management are confident that further funding can be obtained; however, the team is skeptical and so the following procedures should be adopted:

- Discuss with management whether any finance has now been secured.
- Review the correspondence with the finance provider to confirm the level of funding that is to be provided and this should be compared to the net cash outflow of \$3.2m.
- Review the most recent board minutes to understand whether management's view on Sky's going concern has altered.
- Review the cash flow forecasts for the year and assess the reasonableness of the assumptions adopted.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (B)

- (iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Sky Enterprises Ltd. **(4 marks)**

Going concern

- If the use of the going concern basis of accounting is inappropriate •An adverse opinion
- When the use of the going concern basis of accounting is appropriate but a material uncertainty exists related to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern and disclosures in the financial statements are adequate. •An unmodified opinion – section with Material Uncertainty Related to Going Concern
- When the use of the going concern basis of accounting is appropriate but a material uncertainty exists related to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern and disclosures in the financial statements are inadequate or omitted •Qualified or adverse opinion
- When the use of the going concern basis of accounting is appropriate but a material uncertainty exists related to events or conditions that may cast significant doubt on an entity's ability to continue as a going concern but, based on the audit evidence obtained the auditor concludes that no material uncertainty exists • Report as KAM

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (B)

KAM

Matters that, in the auditor's professional judgement, were of most significance in the audit of the financial statements of the current period

EOM

- For auditors to include additional communication in the auditor's report through the use of EOM when the auditor considers it necessary **but did not require significant auditors attention**
- They are separate from KAM

Action

If a matter has been determined to be a KAM then auditor report under KAM and should not use EOM

If matter is not determined to be a KAM but the matter is fundamental to the users understanding of the financial statements, then report in EOM

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Solution - Question 2 (B)

(iii) If the issue remains unresolved, describe the impact on the audit report that your firm will issue to Sky Enterprises Ltd. **(4 marks)**

If management refuse to amend the going concern basis of the financial statements or at the very least make adequate going concern disclosures, then the audit report will need to be modified.

As the going concern basis is probably incorrect and the error is material and pervasive, then an adverse opinion would be necessary. A basis for adverse opinion paragraph will be required to explain the inappropriate use of the going concern assumption. The opinion paragraph will be an adverse opinion and will state that the financial statements do not give a true and fair view.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Question 3

(a) Identify and explain TWO (2) factors that influence the sample size for substantive tests. **(5 Marks)**

(b) The auditor needs to gather sufficient and appropriate audit evidence to form their audit opinion. Explain what you understand by the terms 'sufficient' and 'appropriate'. **(5 Marks)**

(c) What are the THREE (3) audit assertions that are important to ensuring that the auditor has gained sufficient and appropriate audit evidence for sales account? Explain. **(5 Marks)**

[Total = 5 + 5 + 5 = 15 marks]

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.), Wiley

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Question 3

(a) When determining size of sample for **substantive testing**, ISA 530; ISA 530 requires auditor to consider:

1. Larger sample size if auditor assesses *risk of material misstatement* as greater (higher IR, CR).
2. Smaller sample size if auditor also using *other substantive procedures* for same *assertion*.
3. Larger sample size if auditor requires *greater confidence* from results of tests (requires lower DR).
4. Smaller sample size if auditor is willing to accept greater total error (*higher tolerable misstatement*).
5. Greater sample size if auditor expects to find *greater misstatement in population*.
6. Smaller sample size if auditor using *stratification* of population.
7. Very little change to sample size if population has more sampling units.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.). Wiley

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Question 3 Solution

(b) The auditor needs to gather sufficient and appropriate audit evidence to form their audit opinion. Explain what you understand by the terms 'sufficient' and 'appropriate'.
(5 Marks)

Sufficient – sampling – is there enough evidence

Appropriate – is the evidence relevant and reliable?

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.). Wiley

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Question 3 Solution

(c) What are the THREE (3) audit assertions that are important to ensuring that the auditor has gained sufficient and appropriate audit evidence for sales account? Explain. (5 Marks)

Key assertion at risk for sales revenue is overstatement: *occurrence, accuracy, cut-off*.

Adapted from Moroney, Robyn, et al. (2014). *Auditing: A practical approach* (2nd ed.). Wiley

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