

Chapter 02

Student: _____

1. Which of the following statements best explains why the auditing profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?
 - A. Ethical standards that emphasise excellence in performance over material rewards establish a reputation for competence and character.
 - B. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.
 - C. A distinguishing mark of a profession is its acceptance of responsibility to the public.
 - D. A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.

2. Which of the following bodies is able to impose penalties on auditors who have failed to carry out their duties properly?
 - A. Financial Reporting Council.
 - B. Companies Auditors and Liquidators Disciplinary Board.
 - C. Auditing and Assurance Standards Board.
 - D. All of the options listed here are correct.

3. Which of the following bodies monitors the operation of the Auditing and Assurance Standards Board?
 - A. Financial Reporting Council.
 - B. Companies Auditors and Liquidators Disciplinary Board.
 - C. Australian Securities Exchange.
 - D. All of the given answers are correct.

4. The Australian auditing standards issued by the Australian Auditing and Assurance Standards Board (AUASB) are intended to be applied to:
 - A. all audit, review, assurance and related engagements conducted by external firms.
 - B. all audits of entities listed on the Australian Securities Exchange.
 - C. all audits of companies incorporated under the *Corporations Act 2001*.
 - D. all audit, review, assurance and related engagements where the entity has more than five shareholders.

5. Which of the following bodies monitors the operation of the Australian Accounting Standards Board?

- A. Australian Securities Exchange.
- B. Financial Reporting Council.
- C. Australian Securities and Investments Commission.
- D. Auditing and Assurance Standards Board.

6. Which of the following statements is correct?

- A. ASIC is a member of the International Forum of Independent Audit Regulators.
- B. International auditing standards are mandatory for all auditors.
- C. The FRC is a member of IFAC.
- D. Membership of the International Auditing and Assurance Standards Board is restricted to members of the Forum of Firms.

7. Which of the following types of companies can only be used by an audit firm with the consent of the National Council of the Institute of Chartered Accountants in Australia?

- A. Nominee company.
- B. Service company.
- C. Practice company.
- D. All of the given answers are correct.

8. Which of the following are elements of an audit firm's quality control that should be considered in establishing its quality control policies and procedures?

	Personnel management	Monitoring	Engagement performance
A. Yes		Yes	No
B. Yes		Yes	Yes
C. Yes		No	Yes
D. No		Yes	Yes

9. The objective of quality control dictates that a public accounting firm should establish policies and procedures for

professional development which provide reasonable assurance that all entry-level personnel:

- A. prepare working papers that are standardised in form and content.
- B. have the knowledge required to enable them to fulfil responsibilities assigned.
- C. advance within the organisation.
- D. develop specialties in specific areas of public accounting.

10. A firm of independent auditors must establish and follow explicit quality control policies and procedures because

these standards:

- A. are necessary to meet increasing requirements of auditors' liability insurers.
- B. give reasonable assurance that the firm as a whole will conform to the auditing standards.
- C. include formal filing of records of such policies and procedures.
- D. are required by ASIC for auditors of all entities.

11. In pursuing its quality control objectives with respect to acceptance of a client, an audit firm is not likely to:

- A. make inquiries of the proposed client's legal adviser.
- B. review financial reports of the proposed client.
- C. make inquiries of previous auditors.
- D. review the personnel practices of the proposed client.

12. The mandatory continuing professional education (CPE) requirement for members of The Institute of Chartered

Accountants in Australia is:

- A. 120 CPE hours every year.
- B. 120 CPE hours every three years.
- C. 60 CPE hours every three years.
- D. 60 CPE hours every year.

13. With respect to the quality control element concerning hiring, which policy will provide reasonable assurance that

those employed possess the appropriate characteristics to enable them to work competently?

- A. Establish qualifications and guidelines for evaluating potential hirees at each professional level.
- B. Establish guidelines and requirements for the firm's professional development program and communicate them to personnel.
- C. Establish qualifications deemed necessary for the various levels of responsibility.
- D. Assign responsibility for making advancement decisions.

14. An auditor who is approached by the ICAA, CPA Australia or IPA to undergo a quality control audit must:
- A. provide audit files to the investigators without delay.
 - B. obtain the client's permission to disclose information to the investigators prior to giving them any information.
 - C. co-operate in every way without delay.
 - D. disclose to the investigators any potential quality control problems that the member is aware of.

15. The primary purpose of establishing quality control policies and procedures for deciding whether to accept a new client is to:

- A. enable the audit firm to attest to the reliability of the client.
- B. satisfy the audit firm's duty to the public concerning the acceptance of new clients.
- C. minimise the likelihood of association with clients whose management lacks integrity.
- D. anticipate before performing any fieldwork whether an unmodified opinion can be expressed.

16.

In pursuing the audit firm's quality control objectives, the firm may maintain records indicating which partners or employees of the firm were previously employed by the firm's clients. Which quality control objective would this be most likely to satisfy?

- A. Professional relationship.
- B. Supervision.
- C. Independence.
- D. Advancement.

17. A basic objective of an audit firm is to provide professional services to conform with professional standards.

Reasonable assurance of achieving this basic objective is provided through:

- A. continuing professional education.
- B. a system of quality control.
- C. compliance with ASX listing requirements.
- D. a system of peer review.

18. Which of the following statements concerning auditing in the public sector is correct?

- A. The Auditor-General only conducts financial report audits in the public sector.
- B. Private sector auditors may conduct audits in the public sector as a delegate of the Auditor-General.
- C. The Auditor-General is appointed by the government.
- D. None of the options listed here are correct.

Chapter 02 Key

1. Which of the following statements best explains why the auditing profession has found it essential to promulgate ethical standards and to establish means for ensuring their observance?
- A. Ethical standards that emphasise excellence in performance over material rewards establish a reputation for competence and character.
 - B. Vigorous enforcement of an established code of ethics is the best way to prevent unscrupulous acts.
 - C. A distinguishing mark of a profession is its acceptance of responsibility to the public.
 - D.** A requirement for a profession is to establish ethical standards that stress primarily a responsibility to clients and colleagues.

Chapter - Chapter 02 #1

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.1 Identify the attributes of professional status and describe to what extent they exist in public accounting.

Section: Professional status of the auditor

2. Which of the following bodies is able to impose penalties on auditors who have failed to carry out their duties properly?
- A. Financial Reporting Council.
 - B.** Companies Auditors and Liquidators Disciplinary Board.
 - C. Auditing and Assurance Standards Board.
 - D. All of the options listed here are correct.

Chapter - Chapter 02 #2

Difficulty: Easy

Est Time: < 1 min

Learning Objective: 2.2 Describe the regulation of auditing and its subject matter.

Section: Regulation of auditing and of the subject matter of audits

3. Which of the following bodies monitors the operation of the Auditing and Assurance Standards Board?
- A.** Financial Reporting Council.
 - B. Companies Auditors and Liquidators Disciplinary Board.
 - C. Australian Securities Exchange.
 - D. All of the given answers are correct.

Chapter - Chapter 02 #3

Difficulty: Easy

Est Time: < 1 min

Learning Objective: 2.2 Describe the regulation of auditing and its subject matter.

Section: Regulation of auditing and of the subject matter of audits

4. The Australian auditing standards issued by the Australian Auditing and Assurance Standards Board (AUASB)

are intended to be applied to:

- A. all audit, review, assurance and related engagements conducted by external firms.
- B. all audits of entities listed on the Australian Securities Exchange.
- C.** all audits of companies incorporated under the *Corporations Act 2001*.
- D. all audit, review, assurance and related engagements where the entity has more than five shareholders.

Chapter - Chapter 02 #4

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.2 Describe the regulation of auditing and its subject matter.

Section: Regulation of auditing and of the subject matter of audits

5. Which of the following bodies monitors the operation of the Australian Accounting Standards Board?

- A. Australian Securities Exchange.
- B.** Financial Reporting Council.
- C. Australian Securities and Investments Commission.
- D. Auditing and Assurance Standards Board.

Chapter - Chapter 02 #5

Difficulty: Easy

Est Time: < 1 min

Learning Objective: 2.2 Describe the regulation of auditing and its subject matter.

Section: Regulation of auditing and of the subject matter of audits

6. Which of the following statements is correct?

- A.** ASIC is a member of the International Forum of Independent Audit Regulators.
- B. International auditing standards are mandatory for all auditors.
- C. The FRC is a member of IFAC.
- D. Membership of the International Auditing and Assurance Standards Board is restricted to members of the Forum of Firms.

Chapter - Chapter 02 #6

Difficulty: Easy

Est Time: < 1 min

Learning Objective: 2.3 Explain the impacts of internationalisation on auditing.

Section: Internationalisation of auditing

7. Which of the following types of companies can only be used by an audit firm with the consent of the National Council of the Institute of Chartered Accountants in Australia?
- A. Nominee company.
 - B. Service company.
 - C. Practice company.**
 - D. All of the given answers are correct.

Chapter - Chapter 02 #7

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.4 Outline the characteristics of the professional bodies and accounting firms engaged in the auditing profession, and describe the internal structure of an audit firm.

Section: Profile of the auditing profession and of audit firms

8. Which of the following are elements of an audit firm's quality control that should be considered in establishing its quality control policies and procedures?

	Personnel management	Monitoring	Engagement performance
A.			
Yes		Yes	No
B.			
Yes		Yes	Yes
C.			
Yes		No	Yes
D.			
No		Yes	Yes

Chapter - Chapter 02 #8

Difficulty: Medium

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

9. The objective of quality control dictates that a public accounting firm should establish policies and procedures for professional development which provide reasonable assurance that all entry-level personnel:
- A. prepare working papers that are standardised in form and content.
 - B.** have the knowledge required to enable them to fulfil responsibilities assigned.
 - C. advance within the organisation.
 - D. develop specialties in specific areas of public accounting.

Chapter - Chapter 02 #9

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

10. A firm of independent auditors must establish and follow explicit quality control policies and procedures because these standards:
- A. are necessary to meet increasing requirements of auditors' liability insurers.
 - B.** give reasonable assurance that the firm as a whole will conform to the auditing standards.
 - C. include formal filing of records of such policies and procedures.
 - D. are required by ASIC for auditors of all entities.

Chapter - Chapter 02 #10

Difficulty: Medium

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

11. In pursuing its quality control objectives with respect to acceptance of a client, an audit firm is not likely to:
- A. make inquiries of the proposed client's legal adviser.
 - B. review financial reports of the proposed client.
 - C. make inquiries of previous auditors.
 - D.** review the personnel practices of the proposed client.

Chapter - Chapter 02 #11

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

12. The mandatory continuing professional education (CPE) requirement for members of The Institute of Chartered

Accountants in Australia is:

- A. 120 CPE hours every year.
- B.** 120 CPE hours every three years.
- C. 60 CPE hours every three years.
- D. 60 CPE hours every year.

Chapter - Chapter 02 #12

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

13. With respect to the quality control element concerning hiring, which policy will provide reasonable assurance that

those employed possess the appropriate characteristics to enable them to work competently?

- A.** Establish qualifications and guidelines for evaluating potential hirees at each professional level.
- B. Establish guidelines and requirements for the firm's professional development program and communicate them to personnel.
- C. Establish qualifications deemed necessary for the various levels of responsibility.
- D. Assign responsibility for making advancement decisions.

Chapter - Chapter 02 #13

Difficulty: Medium

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

14. An auditor who is approached by the ICAA, CPA Australia or IPA to undergo a quality control audit must:

- A. provide audit files to the investigators without delay.
- B.** obtain the client's permission to disclose information to the investigators prior to giving them any information.
- C. co-operate in every way without delay.
- D. disclose to the investigators any potential quality control problems that the member is aware of.

Chapter - Chapter 02 #14

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

15. The primary purpose of establishing quality control policies and procedures for deciding whether to accept a new client is to:

- A. enable the audit firm to attest to the reliability of the client.
- B. satisfy the audit firm's duty to the public concerning the acceptance of new clients.
- C.** minimise the likelihood of association with clients whose management lacks integrity.
- D. anticipate before performing any fieldwork whether an unmodified opinion can be expressed.

Chapter - Chapter 02 #15

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

16.

In pursuing the audit firm's quality control objectives, the firm may maintain records indicating which partners or employees of the firm were previously employed by the firm's clients. Which quality control objective would this be most likely to satisfy?

- A. Professional relationship.
- B. Supervision.
- C.** Independence.
- D. Advancement.

Chapter - Chapter 02 #16

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

17. A basic objective of an audit firm is to provide professional services to conform with professional standards.

Reasonable assurance of achieving this basic objective is provided through:

- A. continuing professional education.
- B.** a system of quality control.
- C. compliance with ASX listing requirements.
- D. a system of peer review.

Chapter - Chapter 02 #17

Difficulty: Easy

Est Time: 1–3 mins

Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.

Section: Quality control

18. Which of the following statements concerning auditing in the public sector is correct?
- A. The Auditor-General only conducts financial report audits in the public sector.
 - B.** Private sector auditors may conduct audits in the public sector as a delegate of the Auditor-General.
 - C. The Auditor-General is appointed by the government.
 - D. None of the options listed here are correct.

Chapter - Chapter 02 #18

Difficulty: Medium

Est Time: 1–3 mins

Learning Objective: 2.6 Explain how auditing in the public sector fits into the Australian auditing and assurance environment.

Section: Auditing in the public sector

Chapter 02 Summary

<u>Category</u>	<u># of Questions</u>
Chapter - Chapter 02	18
Difficulty: Easy	14
Difficulty: Medium	4
Est Time: < 1 min	4
Est Time: 1–3 mins	14
Learning Objective: 2.1 Identify the attributes of professional status and describe to what extent they exist in public accounting.	1
Learning Objective: 2.2 Describe the regulation of auditing and its subject matter.	4
Learning Objective: 2.3 Explain the impacts of internationalisation on auditing.	1
Learning Objective: 2.4 Outline the characteristics of the professional bodies and accounting firms engaged in the auditing profession, and describe the internal structure of an audit firm.	1
Learning Objective: 2.5 Identify the elements of quality control within audit firms, and explain practice monitoring programs.	10
Learning Objective: 2.6 Explain how auditing in the public sector fits into the Australian auditing and assurance environment.	1
Section: Auditing in the public sector	1
Section: Internationalisation of auditing	1
Section: Professional status of the auditor	1
Section: Profile of the auditing profession and of audit firms	1
Section: Quality control	10
Section: Regulation of auditing and of the subject matter of audits	4

Gay and Simnett Mock Exam 2

Part A

Circle the *best* answer for each of the following ten (10) multiple-choice questions. Each multiple-choice question is worth one (1) mark.

1. An auditor's duty of due care to a client is most likely breached when the auditor:
 - a. gives a client an oral report instead of a written report
 - b. gives a client incorrect advice based on an honest error of judgment
 - c. fails to follow generally accepted auditing standards
 - d. fails to detect all of a client's fraudulent activities
2. Which of the following should an auditor obtain from his/her predecessor prior to accepting an audit engagement?
 - a. Analysis of financial report.
 - b. An indemnity for errors occurring prior to the change of auditor.
 - c. All correspondence with the company's legal counsel.
 - d. Facts that might bear on an assessment of the integrity of management.
3. When an auditor increases the assessed level of control risk because certain control procedures are determined to be ineffective, the auditor will most likely increase the:
 - a. extent of tests of controls
 - b. level of detection risk
 - c. extent of substantive tests
 - d. level of inherent risk
4. The risk in which an auditor will conclude, based on substantive tests, that a material error does *not* exist in an account balance when, in fact, such an error does exist is referred to as:
 - a. sampling risk
 - b. detection risk
 - c. nonsampling risk
 - d. inherent risk
5. Which of the following circumstances would most likely cause an auditor to consider whether material misstatements exist in an entity's financial report?
 - a. Management places little emphasis on meeting earnings projections.
 - b. The board of directors makes all major financing decisions.
 - c. Audit trails of computer-generated transactions exist for only a year.
 - d. Transactions selected for testing are *not* supported by proper documentation.
6. In examining cash disbursements, an auditor plans to choose a sample using systematic selection with a random start. The primary advantage of such a systematic selection is that population items:
 - a. that include fraud will *not* be overlooked
 - b. may occur in a systematic pattern, thus, making the sample more representative.

- c. may occur more than once in a sample
- d. do *not* have to be prenumbered in order for the auditor to use the technique

7. Which of the following courses of action would an auditor most likely follow in planning to test a sample of cash disbursements, if the auditor were aware of several unusually large cash disbursements that he/she wishes to test?
 - a. Set the tolerable rate of deviation at a lower level than originally planned.
 - b. Stratify the cash disbursements population so that the unusually large disbursements are selected.
 - c. Increase the sample size to reduce the effect of the unusually large disbursements.
 - d. Continue to draw new samples until all of the unusually large disbursements appear in the sample.

8. An auditor, John Jupp, failed to follow generally accepted auditing standards in auditing Ace Ltd's financial report. Ace's management had told Jupp that the audited report would be submitted to several banks to obtain financing. Relying on the report, New Bank gave Ace a loan. Ace defaulted on the loan. If New Bank sues Jupp, Jupp will most likely:
 - a. win because there is *insufficient* proximity between Jupp and New Bank
 - b. lose because Jupp knew that the banks would be relying on the financial report
 - c. win because New Bank was contributorily negligent in granting the loan
 - d. lose because Jupp was negligent in performing the audit

9. Which of the following procedures is not conducted as part of the review of an interim financial report?
 - a. Review of ratios and trends.
 - b. Review of computer controls.
 - c. Inquiry of management.
 - d. Reading the minutes of directors' meetings.

10. Which of the following must accompany a financial report compiled by an auditor?
 - a. A disclaimer of opinion.
 - b. An unqualified opinion with an emphasis of matter paragraph.
 - c. An unqualified opinion.
 - d. A qualified opinion.

Part B

Seven (7) questions carrying ninety (90) marks which require written answers in the script book provided.

Question 1

The audit partner has just advised you that he has been approached to accept the appointment of auditor to Games Limited. Games Limited is a manufacturer of gaming machines and has been named in a recent anti-corruption enquiry as having offered incentives to state government members to support a proposed bill which would allow an increased number of gaming machines in licensed premises. No charges have yet been laid against Games Limited or any of its employees. The audit partner explains to you that Games Limited's auditors were re-appointed for the current financial year at the Annual General Meeting held two months ago. However, Games Limited's managing director is unhappy with the existing auditing firm as the audit partner assigned to Games Limited has been changed.

Required:

The audit partner is unsure whether he should accept the appointment and has asked you to outline any ethical, legal and other factors to be considered in his decision about whether to accept the appointment for the current year, and to indicate the steps that need to be taken prior to the appointment.

[10 marks]

Question 2

You are the audit senior responsible for the audit of Sampson Limited. You are currently planning the audit for the year ended 31 December 20X7. During your initial planning meeting held with the financial controller, he told you of the following changes in the company's operations.

- (i) Due to the financial controller's workload, the company has employed a treasurer. The financial controller is excited about the appointment because in the two months that the treasurer has been with the company he has realised a small profit for the company through foreign-exchange transactions in yen.
- (ii) Sampson has planned to close an inefficient factory in country New South Wales before the end of 20X7. It is expected that the redeployment and disposal of the factory's assets will not be completed until the end of the following year. However, the financial controller is confident that he will be able to determine reasonably accurate closure provisions.
- (iii) To help achieve the budgeted sales for the year, Sampson is about to introduce bonuses for its sales staff. The bonuses will be an increasing percentage of the gross sales made, by each salesperson, above certain monthly targets.
- (iv) The company is using a new general ledger software package. The financial controller is impressed with the new system, because management accounts are easily produced and allow detailed comparisons with budgets and prior-period figures across product lines and geographical areas. The conversion to

the new system occurred with a minimum of fuss. As it is a popular computer package, it required only minor modifications.

- (v) As part of the conversion, the position of systems administrator was created. This position is responsible for all systems maintenance, including data backups and modifications. These tasks were the responsibility of the accountant.
- (vi) The managing director has returned from the USA, where he signed a contract to import a line of clothing that has become the latest fashion fad in the USA. The company has not previously been engaged in the clothing industry.

Required:

For each of the scenarios above, explain how the components of audit risk (inherent, control or detection risk) are affected.

[12 marks]

Question 3

You are the audit senior on the audit of EasyFit Pty Limited, a large manufacturer of shoes. EasyFit Pty Limited's main market lies with 18 to 24 year olds.

This is the first year in which your firm has performed the audit. As part of the planning work, you have performed analytical procedures on an annualised basis and compared the results to industry averages and last year's audited financial information. The results are given below:

Ratio	<u>Industry average</u>		<u>EasyFit Pty Limited</u>	
	20X7	20X6	20X7	20X6
1 Current ratio	2.84	3.27	1.89	2.24
2 Receivables turnover ratio	4.9	4.6	6.3	7.0
3 Inventory turnover ratio	3.7	3.8	5.0	5.5
4 Return on total assets	7%	5%	13%	11%
5 Net profit ratio	0.06	0.06	0.04	0.04
6 Gross margin	0.20	0.26	0.20	0.18

Required:

Explain the general meaning of each of the above ratios, discuss the conclusions that you can draw about EasyFit's financial position and identify potential audit risks to be investigated further.

[12 marks]

Question 4

You are the audit senior on the MyPet Pty Limited audit. MyPet is a distributor of pet care products including shampoos, lotions and a small range of toys.

MyPet uses an on-line computer system. No goods are manufactured in-house; rather, MyPet maintains a stock of raw materials and sub-contracts the manufacture of its products to third parties. Approximately 50 suppliers and sub-contractors are used and all have proven to be reliable. You have made the following notes about the inventory system:

Procedures for raw materials

- Separate systems, staff and warehouses are maintained for both raw materials and finished goods.

- Purchase orders are automatically generated by the computer when stocks of any raw material fall below 70% of the prior month's usage. The purchase orders contain the following details:
 - date;
 - supplier name and address;
 - raw material needed.
- Three copies of the purchase order are produced and distributed as follows:
 - Copy 1—to warehouse to enable follow up of late orders.
 - Copy 2—filed by accounts clerk in date order.
 - Copy 3—sent to supplier.
- When raw material stocks are received, the bar codes attached to the delivery boxes by the supplier are scanned into the system. A two-part Goods Received Note (GRN) is then produced:
 - Copy 1—matched to warehouse copy of purchase order by stores staff.
 - Copy 2—filed by accounts clerk.
 The scanning process is aborted if the codes do not match those on the masterfile.

Procedures for finished goods

- Production orders are automatically generated when finished goods fall below 60% of the prior month's sales. The production orders contain the following details:
 - date;
 - sub-contractor's name;
 - raw materials required;
 - finished goods needed.
- Two copies of the production order are produced:
 - Copy 1—to raw materials store for use as a picking slip, then it is packed with goods and sent to the supplier.
 - Copy 2—filed by production controller in date order.
- When the finished goods stocks are received, the bar codes attached to the delivery boxes by the supplier are scanned into the system. A two-part GRN is then produced:
 - Copy 1—matched to production controller's copy of production order.
 - Copy 2—filed by accounts clerk.
 The scanning process is aborted if the codes do not match those on the masterfile.

General notes

- The computer automatically selects the supplier of both raw materials and finished goods based on:
 - the latest price (as per their most recent invoice).
 - their delivery times (based on the number of days between the date the purchase/ production order is raised and the date the goods are scanned by the warehouse).
- Password access is as follows:

Stores staff	Purchase order printing for raw materials only.
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(raw materials)
Stores staff
(finished goods)
Production controller
Accounts clerk

GRN printing for raw materials.
GRN printing for finished goods.

Production order printing, masterfile amendments.
Masterfile amendments.

Masterfile amendments

- The stock masterfile contains details of:
 - existing stock items including codes and warehouse location;
 - approved suppliers and sub-contractors.
- Orders will only be generated to suppliers and sub-contractors recorded on the masterfile.
- Masterfile changes are made by the production controller for both raw materials and finished goods inventory. A masterfile amendment form is completed by the production controller as a record of the changes made.

Required:

- (a) Identify six weaknesses in the internal controls described. Discuss the implications of each of the weaknesses you have identified.
- (b) Assume your IT audit division is to perform testing of controls for the inventory systems described. Identify two tests that you would recommend they perform.
- (c) Identify two Computer Assisted Audit Techniques (CAATs) that you would request the IT auditors run to assist you in testing the valuation of inventory.
- (d) Assume your IT auditors ran a CAAT on inventory data contained in MyPet's management accounts. You intend to use this data to assist in your analytical procedures work. Identify two tests that you would perform on the data produced by the CAAT, prior to placing reliance on the data.

[12 + 2 + 2 + 2 = 18 marks]

Question 5

Consider each of the following independent and material situations. In each case:

- the balance date is 31 October 20X7.
 - the fieldwork was completed on 5 December 20X7.
 - the financial report and audit report were signed on 12 December 20X7.
 - the financial report and audit report were mailed to the members on 20 December 20X7.
- (i) Your client, Outback Mining, owns a mineral exploration licence in Central Australia. At 31 October this licence was valued by an independent expert at \$50,000,000. This valuation is reflected in the financial report. On 8 December Outback Mining received notice that a claim was being lodged under the Native Titles Act for land which included that subject to the exploration licence. If the claim is successful the exploration licence will be worthless.
 - (ii) Your client, Bird Pty Limited, derives approximately 10% of revenues from selling aviary supplies to city-based bird breeders.

A draft copy of a government report, leaked to the press and reported in the media on 11 November, recommends that strict limits be placed on the number of birds that are allowed to be kept in suburban areas. Bird Pty Limited estimates that if the recommendations are enacted, about 70% of its customers will have to cut their flocks by 50% or more. This would affect not only future

sales but also their ability to pay existing debts. No further information, other than the draft report, is available as at 12 December.

- (iii) Your client, Gem Pty Limited, made an out of court settlement on 1 December 20X7 of \$300,000. The settlement related to a litigation case dating back 4 years. A provision of \$150,000 was recorded in the 31 October 20X7 financial report.
- (iv) On 14 December 20X7, you discover that a debtor of your client, Galaxy Ltd, was placed in provisional liquidation on 8 December. The debtor owed \$600,000 as at 31 October; a specific provision of \$300,000 of this amount was made at this date. On very preliminary information, the likely payout to unsecured creditors is zero.
- (v) A flood occurred in the warehouse of your client SuperSpring Ltd on 2 November 20X7. Inventory valued at \$2m was destroyed. The directors believe only half of this value will be recovered from the insurers.

Required:

- (a) Identify the periods during which the auditor is responsible for identifying subsequent events and indicate the extent of the auditor's responsibility.
- (b) For each of the above events (i) to (v), state the appropriate action (A) to (D) that the auditor would require in order to issue an unqualified opinion for the situation and justify your response. The alternative actions are as follows:
 - (A) Client to adjust the 31 October 20X7 financial report.
 - (B) Client to disclose the information in the notes to the 31 October 20X7 financial report.
 - (C) Client to recall the 31 October 20X7 financial report for revision.
 - (D) No action is required.

[4 + 10 = 14 marks]

Question 6

Skyblue Pty Ltd is a large private company that manufactures special reinforced concrete and other products used in the construction of airport runways and heavy use motor vehicle freeways. During the course of the audit for the year ended 30 June 20X7, the government announced that it intends to scrap its proposed third runway project. You know that Skyblue Pty Ltd's projections include a major share of the work expected to flow from this project.

The company has been experiencing some cash flow difficulties, although this is not unusual in the industry. Management has recently fully extended their overdraft facility in order to pay day-to-day expenses such as wages and salaries. The audit partner is concerned that the company may be facing going concern problems, but the managing director maintains that future capital expenditure can be cut back to alleviate the going concern issue. In addition, surplus assets can be sold to the growing Asian market and long-term debt can be rescheduled if necessary.

Required:

- (a) Give examples of three other possible mitigating factors that have not yet been mentioned.

- (b) What evidence should you obtain with respect to management’s representation about the various mitigating factors presented in question 6 and identified in part (a) above?
- (c) The engagement partner has decided to qualify the financial report on the basis of uncertainty as to going concern. However, the managing director argues that, as the company is privately held and all the shareholders are involved in the business, going concern problems should not be viewed as seriously as if the company was publicly listed and, therefore, an unqualified report should be signed. How would you respond to the managing director’s comments?
- (d) What would be the impact on the audit of a comfort letter from a related company promising to provide financial support in the event that Skyblue Pty Ltd was unable to meet its debts?

[3 + 6 + 3 + 2 = 14 marks]

Question 7

You have just completed the audit fieldwork on Pioneer Pty Limited for the year ended 30 June, 20X7. The following summary points have been raised on the audit completion summary.

- (a) Going concern—the company and the economic entity have incurred substantial trading losses for the current year. While the company and the economic entity still have a positive net asset position, further losses in future years may result in the deterioration of the capital base. The continuation of the company and the economic entity as a going concern is dependent on the continued financial support of the company’s bankers and the ability of the trading businesses within the economic entity to generate a positive cash flow.

Discussions with the bankers indicate that it is their present intention to continue to support the group in the hope that the group can reverse its current trading position.

The following historical information is relevant.

	Turnover \$'000	Profit/(loss) after tax \$'000	Net current Assets/(liab) \$'000	Net assets \$'000
20X7	20,000	(4,000)	(500)	3,200
20X6	25,000	(1,000)	(200)	7,200
20X5	26,000	1,000	400	8,200
20X4	24,000	2,000	600	7,200
20X3	22,000	5,000	800	5,200

A review of the company’s budget in respect of future trading periods indicate that the reversal in trading performance will be gradual and is expected to take at least five years.

- (b) Stock valuation—the audit of stock valuation identified two issues;

- (i) Use of LIFO basis—the company used the LIFO basis of valuation of closing inventories. Had the client used the FIFO basis of valuation, the value of closing inventories would be increased from \$2,000,000 to \$2,500,000.
 - (ii) Provision for stock obsolescence—the client has failed to make any provision in respect of stock obsolescence. The audit work has raised serious questions about the valuation of the company's spare parts stock. The auditors were not able to quantify a provision. The total value of the spare parts stock is \$300,000.
- (c) Statutory records—the audit of the statutory records area has revealed several deficiencies in the preparation of the statutory records and registers. Some of the problems identified include:
- failure to update the members' register for changes in shareholders
 - failure to obtain written consent from directors to act
 - directors and shareholders' minutes not prepared in respect of the current year
- (d) Subsidiary qualification—the financial report of Little G Inc, a wholly owned subsidiary of Pioneer Pty Limited, was qualified by its auditors for failing to account for tax temporary differences. The financial effect of this departure is to increase profit by \$A400,000. The auditors of Little G Inc are not related to the auditors of Pioneer Pty Limited. No adjustments were made on consolidation to bring the policies of Little G Inc into line with the economic entity.

These matters were discussed with the client, who has refused to take any action on these points and has given you the following responses:

- Going concern—it is management's view that the company is a going concern and they do not intend to include a note in the financial report in respect of accounts preparation. The directors' declaration will not be qualified.
- Stock—the company believes that the use of the LIFO method for the valuation of inventory is more appropriate to the company's operations and, therefore, no amendments are contemplated. Further, management do not believe it is necessary to make any provision in respect of the spare parts inventory.

The company made no comment in respect of the failure to keep properly updated statutory registers.

Both Pioneer Pty Limited and the Pioneer Pty Limited economic entity are reporting entities.

Required

Prepare a report to the audit partner outlining the effect that each of the above issues is likely to have on your audit opinion.

[10 marks]