

MULTIPLE CHOICE/TRUE-FALSE. (1 point each = 45 points)

NOTE: Questions MUST be answered on the answer card provided separately. Any answers not recorded on the answer card will be given a mark of zero (0). Responses in this examination booklet will NOT be marked.

Choose the the one alternative that best completes the statement or answers the question.

Correct responses are noted in red

- 1) In the audit of historical financial statements by PA firms, the criteria used are
 - A) regulations of the Canada Revenue Agency.
 - B) generally accepted auditing standards.
 - C) generally accepted accounting principles.**
 - D) regulations of the provincial securities commissions.

- 2) Auditing should be done by
 - A) a professional accountant.
 - B) a certified management accountant.
 - C) a competent and independent person.**
 - D) a chartered accountant.

- 3) It is important for the auditor to be independent because
 - A) the audit conclusions cannot be relied upon if the auditor was biased in accumulating and evaluating evidence.**
 - B) the auditor would not charge a fair rate to the client.
 - C) the auditor might not be as knowledgeable of the subject matter and the criteria.
 - D) the Canadian Tax Authorities require that the auditor be independent.

- 4) Joe is recording sales transactions in the accounting system so that they can be summarized in a logical manner for the purpose of providing financial information for decision-making. Joe is doing
 - A) management consulting.
 - B) review.
 - C) accounting.**
 - D) auditing.

- 5) What type of organizations use auditing services?
 - A) Non-for-profit organizations
 - B) Businesses
 - C) Governments
 - D) All of the above**

- 6) An accountant records information. When conducting an audit, the distinguishing abilities are the
 - A) requirement to possess education beyond the bachelor's degree.
 - B) accumulation and interpretation of evidence.**
 - C) ability to interpret generally accepted accounting principles.
 - D) organize and summarize economic events.

- 7) A reason for private companies to be audited is
 - A) having a professional accountant perform their bookkeeping.
 - B) facilitating access to capital.**
 - C) complying with the laws requiring them to be audited.
 - D) ensuring that their financial statement do not contain errors.

- 8) The auditor must have a thorough understanding of the entity and its environment. The auditor must also consider the client's business strategies, processes, and measurement indicators for critical success factors related to those strategies. This analysis helps the auditor
- A) decide if they want to accept the engagement.
 - B) identify risks associated with the client's strategy that could affect the financial statements.**
 - C) assess the level of materiality that is appropriate for the audit.
 - D) identify the potential for fraud in the financial reporting process.
- 9) A review of any part of an organization's procedures and methods for the purpose of evaluating efficiency and effectiveness is classified as a(n)
- A) audit of financial statements.
 - B) operational audit.**
 - C) compliance audit.
 - D) production audit.
- 10) A typical objective of an operational audit is for the auditor to
- A) determine whether the financial statements fairly present the entity's operations.
 - B) evaluate the feasibility of attaining the entity's operational objectives.
 - C) report on the entity's relative success in attaining profit maximization.
 - D) make recommendations for improving performance.**
- 11) To operate effectively, an internal auditor must be independent of
- A) the line functions of the organizations.**
 - B) the employer-employee relationship which exists for other employees in the organization.
 - C) the entity.
 - D) all of the above.
- 12) The internal auditor typically reports directly to
- A) the management of the company.
 - B) the audit committee and the management of the company.
 - C) the audit committee and the board of director.**
 - D) the board of director and the external auditor
- 13) The objective of the audit of financial statements by the auditor is the expression of an opinion on
- A) the accuracy of the financial statements.
 - B) the fairness of the financial statements.**
 - C) the balance sheet and income statement.
 - D) the annual report.
- 14) The responsibility for the preparation of the financial statements and the accompanying footnotes belongs to
- A) both management and the auditor equally.
 - B) management for the statements and the auditor for the notes.
 - C) the auditor.
 - D) management.**
- 15) The requirement for an attitude of scepticism means that the auditor should
- A) plan and conduct the audit with an attitude of distrust in management.
 - B) not be blind to evidence that suggests the documents, books or records have been altered or are incorrect.**
 - C) perform additional tests of controls to increase the probability of discovering fraud or errors.
 - D) not consider management's explanation as evidence on any subject.

16) The auditor has considerable responsibility for notifying users as to whether or not the statements are properly stated. This imposes upon the auditor a duty to

- A) be equally responsible with management for the preparation of the financial statements.
- B) be a guarantor of the fairness in the statements.
- C) be an insurer of the fairness in the statements.
- D) provide reasonable assurance that material misstatements will be detected.**

17) The factor which distinguishes an error from fraud and other irregularity is

- A) whether it is a dollar amount or a process.
- B) intent.**
- C) materiality.
- D) whether it is caused by the auditor or the client.

18) After the auditor has completed all the procedures, it is necessary to combine the information obtained to reach an overall conclusion as to whether the financial statements are fairly presented. This is a highly subjective process that relies heavily on

- A) the auditor's professional judgment.**
- B) generally accepted accounting principles.
- C) the provincial institutes' Rules of Professional Conduct.
- D) generally accepted auditing standards.

19) Frankfurter Limited decided that it wanted to improve earnings. To do this, they understated their expenses by omitting unpaid expenses from the accrued liabilities account at year end. Which management assertion has been violated?

- A) rights and obligations
- B) completeness**
- C) existence
- D) disclosure

20) XYZ Brick Company decided to inflate sales by recording fictitious sales. Several non-existent clients were created and the sales were added into the sales journal throughout the year. The general transaction-related audit objective affected with these actions is

- A) posting and summarization.
- B) completeness.
- C) accuracy.
- D) occurrence or existence**

21) When considering each material type (or class) of transactions during the audit, which general transaction-related audit objectives are assessed during the audit?

- A) all five transaction-related audit objectives**
- B) those transaction-related audit objectives where there are poor internal controls
- C) those transaction-related audit objectives where there is the highest risk of error
- D) primarily completeness, existence and valuation, since this is where most errors occur

22) Heavy Manufacturing Company is in the business of making steel plates, forming heavy metal slabs and drilling and scoring metals. Recently, it upgraded many of its forming machines. There were five machines purchased on four different invoices. Unfortunately, one of the invoices was recorded twice, resulting in five invoices being recorded. The general balance-related audit objective affected by this activity is

- A) presentation.
- B) completeness.
- C) existence.**
- D) accuracy.

- 23) Radio Supplies Limited sells parts and components to organizations that repair radios and other forms of audio equipment. They have many parts on their inventory listing at cost that were purchased up to fifteen years ago. Some of these parts have not seen any movement in the last ten years. The general balance-related audit objective affected by this activity is
- A) accuracy.
 - B) existence.
 - C) valuation.
 - D) completeness.
- 24) The audit risk model is used primarily
- A) while doing tests of controls.
 - B) to determine the type of opinion to express.
 - C) for planning purposes in determining how much evidence to accumulate.
 - D) to evaluate the evidence which has been gathered.
- 25) Audit risk is a measure of
- A) the probability that errors in the financial statements that were not detected by the internal controls of the firm are not detected by the auditor.
 - B) the auditor's assessment of the likelihood that a material misstatement might occur in the first place.
 - C) the probability that the financial statements contain errors.
 - D) how willing the auditor is to accept that the financial statements may be materially misstated after the audit is completed.
- 26) If it is probable that the judgment of a reasonable person would have been changed or influenced by the omission or misstatement of information, then that information is, as defined in the CICA Handbook,
- A) relevant.
 - B) insignificant.
 - C) material.
 - D) significant.
- 27) Materiality in planning and performing an audit defines materiality in terms of three key concepts. The first and second concepts are that a material misstatement should be considered in the context of knowledgeable users and the effect on decision making and that material is relative to circumstances surrounding the decision and nature of the information. The third concept is
- A) that the auditor should consider users of financial statements as a group.
 - B) that the auditor should consider users of financial statements individually.
 - C) that the auditor should be conservative in setting the materiality level.
 - D) that the users should be informed and approve of the materiality used by the auditor.
- 28) If an auditor determines that there is a material misstatement, brings it to the client's attention, and the client refuses to correct the statements, the auditor will issue
- A) either a qualified or an adverse opinion, depending on how material the misstatement is.
 - B) an unqualified or qualified opinion.
 - C) a denial of opinion.
 - D) an adverse opinion.
- 29) Silka is in the process of performing the audit. In this process, Silka decided to change the materiality. A valid reason for this would be
- A) the reviewing partner indicated he would feel more comfortable if additional tests were performed and materiality was lower.
 - B) a new user of the financial statement was identified in the process.
 - C) the planning materiality required the auditors to perform too many tests.
 - D) a fraud was discovered in the accounts payable section.
- 30) If the auditor sets a low dollar amount as the preliminary judgment about materiality,

- A) less evidence is required than for a high amount.
B) more evidence is required than for a high amount.
 C) the same amount of evidence is required as for a high dollar amount.
 D) it has no effect on the amount of evidence required.
- 31) The auditors have decided upon a materiality level of \$100,000 for their audit of ABC Manufacturing. Which one of the following errors would be considered more important by the auditors? An
 A) error in accounts receivable cut-off of \$50,000
 B) error in allocation between accounts receivable and accounts payable by \$75,000
C) illegal payment of \$5,000
 D) overstatement of accounts payable by \$15,000
- 32) The purpose of allocating planning materiality to balance sheet accounts is to
A) assess the appropriate evidence to accumulate for each account on both the balance sheet and income statement.
 B) reduce the amount of procedures done in the course of the audit.
 C) increase the possibility that fraud or illegal activities would be detected by audit procedures.
 D) assess the appropriate evidence to accumulate for each account on the balance sheet.
- 33) Inherent risk is the
 A) Probability that some accounts are more susceptible to misstatement than others.
 B) Probability that the client's internal control policies and procedures will fail to detect material misstatements.
C) Probability that material misstatements have occurred in transactions entering the accounting system used to develop financial statements.
 D) Probability that the auditor may not detect material misstatements in the financial statements.
- 34) The ultimate purpose of assessing control risk is to contribute to the auditor's evaluation of the
 A) Factors that raise doubts about the auditability of the financial statements.
 B) Operating effectiveness of internal control policies and procedures.
C) Risk that material misstatements exist in the financial statements.
 D) Possibility that the nature and extent of substantive tests may be reduced.
- 35) The risk that an auditor's procedures will lead to the conclusion that a material misstatement does not exist in an account balance when, in fact, such misstatement actually does exist is
 A) Audit risk
 B) Sampling risk.
 C) Control risk.
D) Detection risk.
- 36) The existence of audit risk is recognized by the statement in the auditor's standard report that the auditor
A) Obtains reasonable assurance about whether the financial statements are free of material misstatement.
 B) Assesses the accounting principles used and also evaluates the overall financial statement presentation.
 C) Realizes some matters, either individually or in the aggregate, are important while other matters are not important.
 D) Is responsible for expressing an opinion on the financial statements, which are the responsibility of management.
- 37) On the basis of audit evidence gathered and evaluated, an auditor decides to increase the assessed level of control risk from that originally planned. To achieve an overall audit risk level that is substantially the same as the planned audit risk level, the auditor would
 A) Decrease substantive testing.
B) Increase substantive testing.

- C) Increase inherent risk.
D) Increase materiality.
- 38) Internal control includes the following components:
A) Control activities and inherent risks.
B) Information systems and external influences.
C) The control environment and risk assessment processes.
D) Financial reporting and control activities.
- 39) A combination of evidence gathering techniques provides more persuasive than evidence gathered from a single technique.
A) True
B) False
- 40) Substantive procedures give direct evidence about the financial amounts reported in the financial statements.
A) True
B) False
- 41) Spoken and written representations given by the auditee's officers, directors, owners, and employees are generally considered reliable enough to stand on its own.
A) True
B) False
- 42) Analysis is most useful in providing evidence of:
A) Existence, completeness, and ownership.
B) Existence, ownership, and valuation.
C) Completeness, ownership, and presentation.
D) Completeness, valuation, and presentation.
- 43) In considering the effectiveness of evidence gathering procedures, it was found that most companies have adjustments. Research also shows that:
A) Both receivables and payables are usually overstated.
B) Receivables are usually overstated and payables are usually understated.
C) Receivables are usually understated and payables are usually overstated.
D) Both receivables and payables are usually understated.
- 44) The strongest form of audit evidence:
A) Auditor's direct personal knowledge.
B) Evidence gathered directly from independent third parties.
C) Evidence produced by independent third parties.
D) Comprehensive analysis performed by the auditor.
- 45) An auditor selects audit procedures which will provide:
A) The most evidence.
B) The most persuasive evidence.
C) The most reliable evidence that can be obtained in a cost-effective manner.
D) The most relevant information to the audit assertion.

PART II – Essay Questions (7 Questions – TOTAL = 45 POINTS)

1) (10 points) In the following table, there are listed common audit objectives for accounts payable or purchases. For each procedure, list the management assertion, and the related general audit objective. State whether the audit objective is transaction-related or balance-related.

Accounts payable or purchases objectives	Management assertion (1 mark)	Transaction-related? (Y/N) (0.5 mark)	Balance-related? (Y/N) (0.5 mark)
1. Accounts payable in the accounts payable trial balance are for valid purchases.			
2. Recorded acquisitions are for goods and services received, consistent with the best interests of the client			
3. All acquisition transactions are recorded.			
4. The accounts payable recorded in liabilities are obligations of the company.			
5. Liabilities and contingent liabilities are properly presented and disclosed.			

Suggested Solution

Accounts payable or purchases objectives	Management assertion	Transaction-related? (Y/N)	Balance-related? (Y/N)
1. Accounts payable in the accounts payable trial balance are for valid purchases.	Existence		Y
2. Recorded acquisitions are for goods and services received, consistent with the best interests of the client	Occurrence (or existence)	Y	
3. All acquisition transactions are recorded.	Completeness	Y	
4. The accounts payable recorded in liabilities are obligations of the company.	Ownership or Rights and obligation		Y
5. Liabilities and contingent liabilities are properly presented and disclosed.	Presentation / Disclosure		Y

2) (6 Points two marks for each part) To do an audit, it is necessary to have information in a verifiable form and some criteria by which the auditor can evaluate the information.

(A) What information and criteria would a public accounting firm use when auditing a company's financial statements?

(B) What information and criteria would a Canada Revenue Agency auditor use when auditing that same company's tax return?

(C) What information and criteria would an internal auditor use when performing an operational audit to evaluate whether the company's computerized payroll processing system is operating efficiently and effectively?

Suggested Solution

1) (A) The information used by a public accounting firm in a financial statement audit is the financial information in the company's financial statements. The criteria used are Canadian generally accepted accounting principles.

(B) The information used by a Canada Revenue Agency auditor is the financial information in the auditee's federal tax return. The criterion is the Income Tax Act and interpretations.

(C) The information used by an internal auditor when performing an operational audit of the payroll system could include various items such as the number of errors made, costs incurred by the payroll department, and number of payroll records processed each month. The criteria would consist of company standards for departmental efficiency and effectiveness.

3) (6 Points) Lauralye Leasing Limited (LLL) provides lease financing to companies and individuals for equipment other than automobiles. Leases on commercial signs make up 50% of total leases, computer and telecommunications equipment are 30% and restaurant equipment makes up most of the remainder. LLL's customers arrange to buy new equipment from equipment dealers, then contact LLL to arrange lease financing.

LLL was founded over thirty years ago by Laura and Al Ye. It is now run by Mr. and Mrs. Ye's daughter, Betsy, who is the President of LLL. LLL owns a small building downtown, where the offices of the business are located. Unused office space is rented out to other commercial tenants.

Betsy was a classmate of yours at University of Waterloo, and you have kept loosely in touch over the years. This year, she moved the audit to your firm (a local firm with five partners), deciding that the firm her parents had hired many years ago did not really understand her business' needs.

LLL has a small loan that is used to cover blips in working capital. The company has two salespeople. Most loans are received from stores throughout the city, with whom LLL has standing agreements. If customers require financing, they fill in an application at the store, which is faxed to LLL for approval. LLL will reply within two business days.

The company has been profitable for many years. There are no extraordinary items in the current year's financial statements.

Selected financial information is as follows:

Current assets	\$9,910,000
Long term assets	\$46,500,000
Short term liabilities	\$30,700,000
Shareholders' equity	\$25,710,000
Revenue	\$10,200,000
Expenses	\$5,600,000
Income before tax	\$4,600,000
(and before bonus)	

Required:

- A) Which base would you use to calculate materiality? Why?
- B) Calculate materiality. Choose a specific number, and explain why you chose that amount.

Suggested Solution

- A) Normally, net income before income taxes and bonus would be used to calculate materiality. The company has been profitable for many years, and there is no need to consider other bases. Gross profit applies more to companies that sell products or have direct costs associated with products. Total assets, equity and revenue are used as bases if net income fluctuates or if the company is experiencing losses.
- B) The range applied to net income is 5% to 10%, which would result in a materiality range of \$230,000 to \$460,000. The company is a private company, with the shareholders and the bank as users. Due to the few users, we would likely go towards the larger end of this range, i.e. \$460,000.

4) (10 Points) Alan Fallon was recently promoted to senior accountant. He was put in charge of the Mellow Markets audit because of his experience with other grocery clients. Mellow Markets has a small, but growing chain of natural food stores. This is the first year Mellow Markets has been audited. Because of their growth Mellow needs additional capital. Mellow intends to take its audited financial statements to a bank to secure a loan.

Alan has been assigned two inexperienced staff assistants for the audit. Because this is his first audit as a senior, he intends to bring the job in on budget. To save time, he gave the assistants the audit program for Happy Time Food Stores. He told his staff that this would make things go more quickly. He also told them that he could not spend much time with them at the client's place of business because "my time is billed out at such a high rate, we'll go right over budget." He did call them once a day from another audit on which he was working. The assistants told Alan that the audit program did not always match up with what they found at Mellow Markets. Alan responded, "Just cross out whatever is not relevant in the audit program and don't add anything—it will only make us go over the budget."

When Alan came out near the end of fieldwork, one assistant communicated her concern that they had not attended the inventory counts at any of the out-of-town locations of Mellow Markets. The audit program had stipulated that inventory should be observed for in-town stores only. Happy Time had only one store not in town while Mellow Markets had three of their five stores in other cities. Alan told the assistant to get inventory sheets from the client for the other stores. He added, "Make sure that the inventory balance in the general ledger agrees with the total for all the inventory sheets." The next day, Alan reviewed all work papers and submitted the job for review by the manager.

Required: Do you believe that the Mellow Markets audit is in compliance with these GAAS standards? Explain.

Suggested Solution

1. The Mellow Markets audit is not in compliance with these GAAS examination standards. A proper audit program was not prepared. This, along with the emphasis on cutting time, means that it is also doubtful that a meaningful knowledge of the client's business was obtained. It appears that the planning portion of the first examination standard was clearly violated. The lack of time and attention the inexperienced staff received from Alan Fallon is indicative of a violation of the supervision part of the first examination standard.

2. There is no indication of any steps taken to understand, evaluate, or test the internal control of Mellow Markets. This is a violation of the second examination standard.

3. The third examination standard also seems to have been violated. First, the deficiencies in meeting the first two examination standards suggest that the auditors could not have obtained sufficient appropriate evidence. In addition, the failure to observe any of the inventory counts in other cities is an additional deficiency – particularly since Mellow is a new client. Finally, ensuring that the inventory sheets agree with the balance in the general ledger account is merely a first step in the audit of inventory. By itself it is not sufficient appropriate evidence.

5) (7 points) Describe the purpose and components of the Audit Risk Model.

Suggested Solution

Four audit risks and their descriptions are:

Inherent risk: the probability that material errors or irregularities have entered the data processing system.

Control risk: the probability that the auditee's system of internal control will fail to detect material errors and irregularities, provided any enter the accounting system in the first place.

Detection risk: the probability that audit procedures will fail to find material errors and irregularities, provided any have entered the system and have not been detected or corrected by the auditee's internal control system.

Audit risk

(also sometimes called "overall risk" or "tolerable risk" or "ultimate risk"): a concept applied both to the probability of giving an inappropriate opinion and to the probability of failing to discover material errors and irregularities in a particular disclosure or account balance. It represents the amount of risk the audit is accepting, for example if audit risk is 5% the auditor is accepting a 5% probability of giving the wrong audit opinion. Another way of thinking of audit risk is the complement of assurance - so at 5% audit risk the auditor is 95% sure that the financial statements are not misstated

The audit risk model is a conceptual model of how the four risks are related. Audit risk is a combination of the other risks:

$$\text{Audit Risk} = \text{Inherent Risk} \times \text{Control Risk} \times \text{Detection Risk}.$$

6) (6 points) Identify and discuss some of the advantages and disadvantages of the audit technique of enquiry.

Suggested Solution

Advantages: Enquiries, interviews, and other oral evidence are significant because management's explanations are an important part of obtaining an understanding of the business and the nature of specific transactions.

Enquiry is especially useful in determining management's strategic plan such as its intentions to invest in new products, divest old product lines or expand into new markets.

Informal discussion with client personnel may reveal a great deal of information which more formal procedures may not uncover.

It is a relatively inexpensive means of gathering audit evidence.

Disadvantages: Enquiry can only produce spoken representations, which are the least reliable form of evidence.

The auditor may misunderstand statements made during a discussion or fail to properly document the discussion, or the interviewee may later deny statements made during the discussion.

Evidence gathered by formal and informal enquiry of auditee personnel generally cannot stand alone and must be corroborated by the findings of other procedures.