

Applied Skills

Audit and Assurance

Mock Exam 2 – Questions

Time allowed: 3 hours

This examination is divided into two sections:

Section A

- Three OT cases, each containing a scenario which relates to five OT questions, each worth 2 marks
- 30 marks in total

Section B

- Three constructed response questions, each containing a scenario which relates to one or more requirement(s)
- Each constructed response question is worth 20 or 30 marks in total
- 70 marks in total

All questions are compulsory

Section A

This section of the exam contains **three OT cases**.
Each OT case contains a scenario which relates to **five OT questions**.
Each question is worth **2 marks** and is compulsory.
This exam section is worth **30 marks** in total.

The following scenario relates to questions 1 – 5

It is 1 July 20X5. You are the audit manager for Angus Hotels Co (Angus), which runs a chain of eight four-star hotels. The audit senior has prepared an audit completion report for the year ended 31 March 20X5 in which he has noted three contentious issues requiring your attention:

Food poisoning

The Angus Premier Hotel received a solicitor's letter in April 20X5 claiming that the hotel was negligent in failing to ensure that the food provided at a business luncheon on 24 March 20X5 was "fit for consumption". Many of the guests required hospitalisation because of food poisoning. The food had been provided by a specialist catering company, Delights Catering, whose staff, together with hotel staff, had prepared the lunch in the hotel kitchens. Angus's lawyers believe that although the claim against Angus will probably succeed, it will be offset by Angus's claim against Delights Catering for compensation.

Storm damage

The Angus Resort Hotel was severely damaged by a storm on 30 March 20X5. Fortunately, the hotel was empty at the time of the storm. In April 20X5, the company's insurers unconditionally agreed, in writing, to pay for the rebuilding of the hotel and its facilities in full, in accordance with the terms of the insurance contract.

Bank overdraft

The manager of the company's bank has just informed the board that the bank is unwilling to continue to provide Angus with an overdraft facility. This will place the company under considerable financial strain unless alternative funding can be raised within the next nine months. The senior considers this to be a material uncertainty and appropriate disclosure should be made.

The draft financial statements as prepared by the client do not yet reflect these material issues. However, management's use of the going concern basis is appropriate.

1 Which of the following describes the auditor's responsibilities for the events that occurred after 31 March 20X5?

- To consider all events between the end of the reporting period and the date the financial statements are issued to shareholders
- To consider only material adjusting events that are required to be recognised in the financial statements before signing the auditor's report
- To respond appropriately to facts that become known only up to the date of the auditor's report that might lead to the amendment of the audit opinion
- To obtain sufficient appropriate evidence whether material events up to the date of the auditor's report have been appropriately reflected in the financial statements

2 In relation to the food poisoning, which TWO of the following treatments in the financial statement for the year ended 31 March 20X5 should, in combination, result in an unmodified audit opinion?

- (1) No adjustment to the financial statements as the claim was made in the following financial year
- (2) No adjustment to the financial statements as the claim can be offset against the claim against Delights Catering
- (3) Disclose the pending litigation against Angus Hotels Co in the notes to the financial statements
- (4) Disclose the claim against Delights Catering in the notes to the financial statements
- (5) Recognise the most likely damages to be paid to the guests in the financial statements
- (6) Recognise the most likely compensation to be received from Delights Catering in the financial statements

3 Angus Hotels Co has recognised a receivable for the claim made to the insurance company in respect of the storm damage to the Angus Report Hotel.

Which of the following audit procedures would provide the MOST reliable audit evidence to support the VALUATION assertion for the insurance receivable?

- Agreeing the details of the insurer's letter to the terms of the insurance contract
- Confirming receipt from the insurer to the bank statement
- Recalculating management's estimate of the restoration costs to be claimed
- Requesting a written representation from management supporting the assertion that the insurer will pay

- 4 The managing director of Angus Hotels Co has expressed some confusion over management’s responsibilities relating to the use of the going concern assumption in the preparation of the financial statements.

Identify, by clicking on the relevant box, whether each of the following statements is true or false.

Management must provide the auditor with a cash forecast for a period that is at least, but not limited to, 12 months from the end of the reporting period	TRUE	FALSE
Management is required to take into account all available information regardless of the degree of uncertainty associated with the outcome of an event or condition	TRUE	FALSE
Management is required to provide the auditor with written representations regarding their plans for future action	TRUE	FALSE
Management must assess Angus Hotel Co’s ability to continue as a going concern for a period of at least 12 months from the date of the financial statements	TRUE	FALSE

- 5 The finance director has asked you to outline the appropriate audit opinions that will be provided depending on whether the disclosure made in Angus Hotel Co’s financial statements for the year ended 31 March 20X5 about the going concern uncertainty is adequate or inadequate.

Complete the following sentences by dragging and dropping the appropriate audit opinion.

If the uncertainty is adequately disclosed, our opinion will be

If the uncertainty is inadequately disclosed, our opinion will be

Audit opinions	
adverse	qualified “except for”
unmodified with emphasis of matter paragraph	qualified “except for” with emphasis of matter paragraph
unmodified	unmodified with a going concern section

The following scenario relates to questions 6 – 10

It is 1 July 20X5. You are an audit senior assigned to a new client, Gravela Co. You have been asked to assist the audit manager in drafting an audit programme for non-current assets. The client has provided draft financial statements including the non-current asset note shown below:

	<i>Land and buildings</i>	<i>Plant and equipment</i>	<i>Motor vehicles</i>	<i>Robotic trucks</i>	<i>Total</i>
Cost	\$000	\$000	\$000	\$000	\$000
(1) 1 July 20X4	100	875	1,500	–	2,475
(2) Additions	10	125	525	995	1,655
(3) Disposals	–	(100)	(325)	–	(425)
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
30 June 20X5	110	900	1,700	995	3,705
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Depreciation					
(4) 1 July 20X5	60	550	750	–	1,360
(5) Expense	2	180	425	199	806
(6) Disposals	–	(80)	(325)	–	(405)
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
30 June 20X5	62	650	850	199	1,761
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Carrying amount					
30 June 20X5	48	250	850	796	1,944
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>
Carrying amount					
30 June 20X6	40	325	750	–	1,115
	<hr/>	<hr/>	<hr/>	<hr/>	<hr/>

6 Which THREE of the following documents and procedures are required to establish whether the preconditions for the audit of Gravela Co's financial statements for the year ended 30 June 20X5 are present?

- Audit strategy
- Work programmes
- Engagement letter
- Discussions with management and those charged with governance
- Understanding the entity's reporting requirements
- Written representations
- Completion of internal control evaluation questionnaires

7 The audit strategy document has identified a risk of overstatement in the valuation of property, plant and equipment in the financial statements.

Which of the lines in Gravela Co's non-current asset note must be tested for overstatement?

- 1, 2 and 6
- 1, 3 and 4
- 2, 4 and 5
- 3, 5 and 6

- 8 Audit tests to be carried out on a sample selected from a schedule of additions to Gravela Co's non-current assets.

Match each financial statement assertions to the appropriate audit test.

Assertion	Audit test
Accuracy	Agree to delivery received confirmation (GRN for capital items) and purchase invoice
Classification	Agree value, treatment of tax, description and account allocation to purchase invoice
Completeness	Agree all additions correctly posted to asset register
Occurrence	Review expense accounts to ensure no capital items have been charged to profit and loss

- 9 Having reviewed the depreciation method for motor vehicles management has decided to change it in the financial statements for the year ended 30 June 20X5 from a straight-line basis over four years to 40% on the reducing balance. A full year's depreciation is charged on acquisitions and none in the year of disposal under both methods.

The draft financial statements show profit before tax of \$2.2 million.

Complete the following sentence to correctly summarise the effect of the change.

The change is and profit and assets will .

Materiality	Financial statement impact
material	decrease
not material	increase

- 10 The robotic trucks are self-driving. They have been shown as a separate category because of their specialised nature.

Which of the following correctly summarises the audit procedures to be carried out on the depreciation expense for the robotic trucks for the year ended 30 June 20X5?

- Discuss with management, compare the useful life with similar assets in comparable companies and recalculate the depreciation expense
- Accept management's estimate of useful life, recalculate the depreciation expense and obtain a written representation supporting their estimate
- Ask management to obtain an expert's opinion to support their estimate of the expected useful life and depreciation expense calculation
- Obtain evidence from an auditor's expert

The following scenario relates to questions 11 – 15

You are a Chartered Certified Accountant and the newly appointed head of internal audit of Birch Co. The directors of Birch Co have recently decided to seek a listing on a recognised stock exchange. Your responsibilities include ensuring that Birch Co complies with the stock exchange's corporate governance requirements. After reviewing the structures, environment and procedures of Birch Co, you note the following corporate governance issues:

- (1) The CEO and chairman of the company are brothers.
- (2) The directors have appointed the majority of the five non-executive directors from the workforce.
- (3) There is no risk committee.
- (4) Three of the executive directors each hold two non-executive directorships with other companies.

Your review of the draft financial statements for the year appeared to show that Birch Co failed to maintain specified liquidity ratios, asset to liability ratios and gross profit margins in breach of a loan covenant. The draft profit was significantly affected by allowances for trade receivables and depreciation. The finance director suggested that as these are accounting estimates they could be changed. There is a real risk that if the bank withdraws its funding, Birch Co will not be able to apply for the listing. The finance director has asked you, as head of internal audit, to sign off on certain internal records that have been altered in order to show that the bank's conditions have been met.

- 11** The Human Resources director has asked for your advice on a presentation she is preparing to give to employees on the impact of corporate governance on Birch Co.

Which of the following describes "corporate governance"?

- Overseeing the strategic direction of Birch Co's business
- Empowering the board to conduct Birch Co's operations for the long-term benefit of shareholders
- Enabling Birch Co to increase long-term shareholder value by enhancing economic performance
- The system by which Birch Co's directed and controlled

- 12** **Identify, by clicking on the relevant box in the table below, whether each of the corporate governance issues noted in the scenario, will have a direct impact on the composition of Birch Co's audit committee.**

(1)	YES	NO
(2)	YES	NO
(3)	YES	NO
(4)	YES	NO

13 The chairman has asked you for clarification of the roles and responsibilities of the following:

- (1) Audit committee
- (2) Internal audit
- (3) Board of directors
- (4) Risk committee

Which of the following correctly identifies who should be responsible for reviewing the internal financial controls of Birch Co in accordance with good corporate governance requirements?

- 1 only
- 1 or 4 only
- 2 or 4 only
- 1, 3 or 4

14 In relation to the finance director's request that you sign off on the altered internal records:

Which fundamental principle of ACCA's Code of Ethics and Conduct is under threat?

- Professional behaviour
- Integrity
- Objectivity
- Professional competence

15 Complete the following sentence regarding the finance director's request that you sign off on the altered internal records.

In relation to the finance director's request, the immediate threat(s) to the fundamental principles is/are and the best course of action to take is to .

Threat	Action
<input type="text" value="advocacy"/>	<input type="text" value="report to those charged with governance"/>
<input type="text" value="advocacy and intimidation"/>	<input type="text" value="resign"/>
<input type="text" value="intimidation"/>	<input type="text" value="sign off the internal records"/>
<input type="text" value="self-interest"/>	
<input type="text" value="self-interest and intimidation"/>	

Section B

This section of the exam contains **three constructed response questions**. Each question contains a scenario which relates to one or more requirement(s). Each question is worth **20 or 30 marks** and is compulsory. This exam section is worth **70 marks** in total.

16 This scenario relates to three requirements.

You are the audit senior of Wicket Co, a company which manufactures high-class furniture. Wicket Co employs 200 weekly-paid employees comprising upholsterers, carpenters, joiners and general labourers. All employees are paid directly by bank transfer.

The payroll is processed using a desktop computer which stores the payroll program, standing (master file) and transactions data relating to employees. On completion of payroll processing, the data is copied onto a removable hard drive which is stored in one of the filing cabinets in the accounts office.

Hours worked are recorded on electronic clock cards. Each card is embossed with the employee's name, department, employee number and photo. The card contains a chip for storing data and requires a unique PIN to be entered each time the card is used. Employees clock in and out on arrival at and departure from the premises. This process is not supervised. At the end of each week, the factory manager, Mr Lamb, gives the accounts supervisor, Mrs Gooch, the clock cards for that week and collects processed clock cards, prepared by Mrs Gooch, for the following week.

Mrs Gooch (from the clock cards) prints out a detailed summary showing for each employee the hours worked (split between basic and overtime) with departmental sub-totals and factory total. The printout is passed to Miss Smith, the payroll clerk, who enters the individual employee hours into the computer. The figures for gross and net pay are calculated by the program and the following reports are generated:

Payroll: details per employee of gross pay, deductions and net pay; departmental and factory totals thereof and total hours split between basic and overtime;
Summary: cumulative details to date per employee;
Payslips: details of gross pay, deductions and net pay;
Payment list: bank account details, net pay per employee and total net pay.

The finance director, Mr Lewis, signs the payroll bank transfer after agreeing it to the total net pay on the payment list and passes the transfer to the managing director, Mr Stewart, who countersigns it.

Mr Lamb gives a list detailing starters and leavers to Miss Smith, who enters these changes into the computer as and when the situation arises. She uses the same password as for payroll preparation even though there is a facility within the software for hierarchical passwords. Miss Smith then files the list with the personnel records in her filing cabinet.

Your enquiries about the system indicate that there are no relevant procedures or controls other than those described above.

Requirements:

(a) In respect of the system of internal control of Wicket Co:

- (i) Identify and explain SIX deficiencies;**
- (ii) Recommend a control to address each of these deficiencies; and**
- (iii) Describe a test of control the auditor would perform to assess whether each of these controls, if implemented, is operating effectively.**

Control deficiency	Control recommendation	Test of control

Note: The total marks will be split equally between each part. (18 marks)

(b) Define audit software and describe how it could be used in auditing Wicket Co's current payroll system. (5 marks)

(c) Mr Stewart has informed you that he is considering outsourcing the payroll system.

Explain the impact that outsourcing the payroll system to a service provider would have on the planning of the audit. (7 marks)

(30 marks)

17 This scenario relates to two requirements.

You are an audit manager in ASD & Co responsible for the audit of Five Dock Co, a public listed company. Five Dock Co researches, develops, designs and manufactures bespoke engineering solutions in solar power generation. The company employs 150 people on two sites; the research and development team and head office staff are located on one site and the manufacturing and engineering facilities on the other. The company uses state-of-the-art windows-based computer technology in its design and manufacturing processes including firm-wide integrated management and finance systems that allow any of the directors to “drill down” to the minutest detail of their function.

You have attended, along with the engagement partner, a series of separate audit planning meetings with the finance director and the audit committee of Five Dock Co and are now reviewing your notes in order to produce the audit strategy and plan for the December year end.

During the year, on the recommendation of its non-executive Chairman, Five Dock Co has invested a substantial amount in the shares of Burwood, a private alternative energy company, of which the Chairman is managing director and major shareholder.

Development project 21A is behind schedule. Unexpected problems have emerged that will substantially increase the cost of the development and the production cost of the new product; this may negatively affect its future use. \$1,200,000 of development cost was recognised as an asset in the statement of financial position for the previous year. A further \$150,000 has been spent so far this year. The original budget was for a total of \$900,000 development expenditure.

In order to encourage performance, a bonus scheme has been introduced for senior management. In total, 25% of the company’s reported profits before tax in excess of the previous period’s profits will be set aside to provide for bonuses. No bonus will be paid if profits do not exceed the previous period.

Ever since the incorporation of Five Dock Co (six years ago) the audit committee has never considered it necessary to have an internal audit function, this role being undertaken on an ad-hoc basis by departmental managers. Because of pressure from several corporate investors, an independent internal audit function reporting directly to the audit committee was established during the year.

During the year, Five Dock Co took out a substantial bank loan to finance investment in new projects. The loan agreement states that the company’s gearing ratio (the proportion of loan capital to equity capital) must not exceed 30%. Any breach of the loan covenants would result in the loan being immediately repayable which would cause significant financial difficulties. Last year’s financial statements had a gearing ratio of 20% and the management accounts for November show a gearing ratio of 27% for the current year to date.

Requirements:

- (a) Explain the purpose of the main contents of an audit strategy document and provide an example relevant to the audit of Five Dock Co for each of these contents. (8 marks)**
- (b) Using the information provided, identify and describe SIX audit risks and explain the auditor’s response to each risk, in planning the audit of Five Dock Co.(12 marks)**

Audit risk	Auditor’s response

(20 marks)

18 This scenario relates to four requirements.

Jayne Co buys and sells antique designs of garden statues made of stone, cast iron, bronze and marble for gardens. The company has retail outlets in several large garden centres. However, as space in the retail outlets is limited, many statues are stored in a self-storage units located around the country.

Credit terms are offered to major customers such as national conservation organisations and heritage hotels. Sales to the general public are for cash.

During the year, Jayne Co financed the purchase of non-current assets with a bank loan. This loan is repayable in equal annual instalments for the next five years.

Shortly after the reporting date, an employee of one of the self-storage facilities was seriously injured when a large statue toppled over. He is now claiming damages against Jayne Co.

Requirements:

- (a) **State FOUR examples of external confirmation relevant to the audit of Jayne Co.** (2 marks)
- (b) **For EACH of the examples in (a) explain:**
ONE audit assertion that the external confirmation supports; and
ONE audit assertion that the external confirmation does NOT support. (8 marks)
- (c) **Explain the procedures to obtain a bank report for audit purposes from Jayne Co's bank and the substantive procedures that should be carried out on that report.** (5 marks)
- (d) **List the further substantive procedures that should be carried out on the bank balances in Jayne Co's financial statements.** (5 marks)
- (20 marks)**

End of Question Paper