

# Specimen Exam 1

**Exam Name:** Audit, Risk and Control (E3)

**Time Allowed:** 3 hours

**Pass Mark:** 50%

This exam contains 3 sections:

**Section A:**

**15** questions, each worth 2 marks

**30** marks in total

**Section B:**

**3** questions, each worth 10 marks

**30** marks in total

**Section C:**

**2** questions, each worth 20 marks

**40** marks in total

## Section A

### Question 1

David is a member of the audit team working on the audit of Galifrey Co. David's sister has recently applied for a job with Galifrey Co and David has provided her with confidential information to help her with her job application. You are the audit manager in charge of the audit of Galifrey Co and have been made aware of this breach of the ACCA Code of Ethics and Conduct.

**Which of the following steps should you take?**

- (1) Consider reporting the breach to ACCA
- (2) Consider the type of information given to David's sister
- (3) Report the breach to Galifrey Co's management

- A 1 only  
B 2 and 3 only  
C 1 and 3 only  
D 1, 2 and 3

## Question 2

The audit of Lotus Co is due to commence with the following audit team:

Audit engagement partner	Poppy
Audit manager	Rowan
Audit supervisor	Avery
Audit juniors	Dakota and Eden

Rowan will visit the client one day each week to check on progress and review audit work. Avery, Dakota and Eden will be at the client’s premises each day with Avery providing supervision for the audit juniors.

**Select whether each of the following statements in relation to the quality management procedures which should be implemented during the audit of Lotus Co are true or false.**

		True	False
1.	Avery has sole responsibility for ensuring quality management procedures are followed during the audit of Lotus Co		
2.	Poppy must review all audit documentation at appropriate points during the audit engagement		
3.	Poppy is responsible for ensuring that Rowan, Avery, Dakota and Eden represent sufficient resource for the audit of Lotus Co		

## Question 3

You are an audit supervisor auditing the cash balance of Sydney Co. You have identified a number of unusual cash deposits but the client is unable to provide you with supporting documentation which shows the source of the cash.

**Which of the following is the MOST appropriate course of action you should now take?**

- A Contact the police to report the matter
- B Discuss the matter with those charged with governance
- C Report the matter to the firm’s money laundering reporting officer
- D Document the suspicions on the audit file for the audit manager to consider

**Question 4**

Select the correct option from each drop-down list to complete the sentence.

Detection risk is the risk that procedures performed by the

will not detect a

Select... ▼
misstatement
control deficiency
irregularity

Select... ▼
client
external auditor
Internal auditor

**Question 5**

Which of the following should be included in the permanent audit file?

- A Financial disclosure checklist
- B Documentation of the client's accounting system
- C Results of analytical procedures performed
- D Written representation from management

**Question 6**

Which TWO of the following are advantages of using flowcharts for documenting systems of internal control?

- A Allows missing controls to be easily identified
- B Gives an overview of the entire system
- C Can ensure all common controls are present
- D Quick to prepare as can be used for all clients
- E They are simple to record
- F Easy to understand for all audit staff

**Question 7**

Which of the following is NOT a limitation of internal control?

- A Collusion between employees
- B Human error
- C Management override
- D Cost of implementation

**Question 8**

**Which of the following statements about sampling is/are true?**

- (1) A particular risk of using the haphazard sampling method is that the selection of the sample may be unconsciously biased
- (2) Systematic selection is when a number of adjacent terms in a population is selected for testing

- A 1 only
- B 2 only
- C Both 1 and 2
- D Neither 1 nor 2

**Question 9**

You are auditing the revenue figure of Natsu Co. During the risk assessment, overstatement of revenue was identified as a significant risk due to the sales team being paid a sales-related bonus.

**Which TWO of the following procedures are appropriate to address the risk in relation to revenue?**

- A Select a sample of customer orders and trace through to goods dispatched notes, sales invoices and into the detailed sales listing
- B Perform a reasonableness test by creating an expectation for revenue, comparing to actual revenue and investigating any significant variances
- C Inspect credit notes after the year end to identify if they relate to pre-year-end sales and agree the sale has been reversed
- D Recalculate discounts and sales taxes for a sample of invoices

**Question 10**

ISA 620 *Using the Work of an Auditor's Expert* requires the auditor to consider certain matters before an auditor's expert is appointed and when evaluating the work of the expert.

**Match the matters which the auditor should consider to the appropriate timing of when they should be considered.**

Matter to consider	When considered
Qualifications of the expert	Before the expert is appointed
Reasonableness of the expert's assumptions	Before the expert is appointed
Reliability of the source data used by the expert	When evaluating the work of the expert
Whether there are any conflicts of interest between the expert and the client	When evaluating the work of the expert

**Question 11**

**Which TWO of the following must the auditor consider when determining the sufficiency of evidence gathered?**

- A The materiality of the item
- B The amount of time available
- C The results of controls testing
- D The experience of the audit team

**Question 12**

Heureux & Co have recently resigned as auditors of Feliz Co. Lyckling & Co have been appointed as their replacement.

**Which of the following procedures should Lyckling & Co perform to obtain evidence over the opening balances of Feliz Co?**

- (1) A particular risk of using the haphazard sampling method is that the selection of the sample may be unconsciously biased
- (2) Systematic selection is when a number of adjacent terms in a population is selected for testing

- A 1 only  
 B 2 only  
 C Both 1 and 2  
 D Neither 1 nor 2

**Question 13**

**Which of the following actions is the auditor NOT required to take when facts become known after the date of the auditor's report but before the date the financial statements are issued?**

- A Obtain an understanding of how management identifies subsequent events  
 B Inquire how management intends to address the matter in the financial statements  
 C Carry out audit procedures on any amendment made by management  
 D Provide a new auditor's report on the amended financial statements

**Question 14**

**Select whether each of the following items should be included or NOT included in a written representation letter.**

		<b>Included</b>	<b>Not included</b>
1.	Signature of the audit engagement partner		
2.	A caveat that the letter is not a comprehensive list of management representations		
3.	A statement of management responsibilities		

**Question 15**

The audit of Koira Co, a listed company, is complete and you are drafting the auditor's report. No material issues were identified during the audit and an unmodified opinion will be given.

**Which of the following must be included in the auditor's report for Koira Co?**

- (1) Basis of opinion section
- (2) Key audit matters
- (3) Going concern section
- (4) Title and addressee

- A 1 and 4 only
- B 2, 3 and 4 only
- C 1, 2 and 3 only
- D 1, 2, 3 and 4

## Section B

**The following scenario relates to questions 16 to 20.**

It is 1 July 20X5. Pastel Co is a clothing manufacturer which operates from its head office and has four factories and five warehouses located across the country. You are an audit supervisor with Neon & Co and you are reviewing extracts from the internal control's documentation relating to the purchases and non-current assets systems.

### Purchases system

When raw materials are required, a purchase requisition is submitted to the purchasing department which contains details of the materials required but does not include current inventory levels.

The purchasing department generates a purchase order; the purchasing manager authorises all orders below \$2,500 and the purchasing director authorises orders of \$2,500 and above. The company maintains an approved supplier list which only the purchasing manager and director can access. This was last updated in 20X3.

As soon as goods are received into the warehouse, a member of the warehouse team agrees the quantity received to the supplier's delivery note only and creates a goods received note (GRN) in the purchases system.

The purchasing and inventory systems are integrated so the inventory records are updated as soon as the GRN is created.

A payables clerk enters the purchase invoices into the purchases system in batches utilising batch control totals and hash totals.

### Non-current assets system

When new equipment is acquired, the finance department classifies the expenditure as assets to be recognised in the statement of financial position or expenditure to be charged to the statement of profit or loss and records the classification on the purchase order. The classification is made based on guidelines established by the finance director.

### Question 16

**Which TWO of the following control objectives are addressed by direct controls present in Pastel Co's purchases system?**

- A Only goods ordered by the company are accepted
- B Purchases are only made for a valid business use
- C All purchases and related payables are recorded
- D Only suppliers which have been checked for quality and price are used

**Question 17**

**Which of the following are control deficiencies in Pastel Co’s purchases system?**

- (1) Purchase requisitions contain details of the materials required but do not include inventory levels
- (2) The quantity of goods received is only agreed to the supplier’s delivery note
- (3) Only the purchasing manager and purchasing director can access the approved supplier list

- A 1 and 2 only
- B 2 and 3 only
- C 1 only
- D 1, 2, and 3

**Question 18**

Neon & Co plans to perform audit procedures using the automated tools and techniques of test data and audit software in the audit of Pastel Co’s purchases and payables.

**Match the type of automated tool/technique which would be used to the appropriate audit procedure.**

**Note: each tool/technique can be used more than once.**

Type of automated tool/technique	Audit procedure
Test data	Reperform the batch control process, where the batch control total differs to the number of the individual invoices
Audit software	Recalculate the total of the purchases listing
	Reperform the ageing of invoices in the payables list at the year end

**Question 19**

Select whether each of the following procedures would be appropriate or not appropriate to assess the effectiveness of the direct controls described in the non-current assets system of Pastel Co.

		Appropriate	Not appropriate
1.	Select a sample of purchase orders for assets and review evidence of the classification being noted		
2.	For a sample of orders, compare the classification recorded on the purchase order with the finance director's guidelines		
3.	For a sample of items classified as non-current assets in the general ledger, verify the nature by reviewing the relevant invoice		

**Question 20**

Which of the following issues could occur if the direct control in the non-current assets system of Pastel & Co is not operating effectively?

- (1) The purchase of new equipment may be delayed and impact production
- (2) The non-current asset register may not accurately reflect equipment being used in production
- (3) Depreciation may be incorrectly calculated

- A 3 only
- B 1 and 2 only
- C 2 and 3 only
- D 1, 2 and 3

**The following scenario relates to questions 21 to 25.**

It is 1 July 20X5. You are an audit senior at Vale & Co and you have been assigned to the final audit of Lobo Co, a manufacturer of bamboo homeware products, for the year ended 31 March 20X5. You have been asked to complete the audit of payroll and inventory.

**Payroll**

Factory employees are paid an hourly rate for the number of hours worked which are recorded on timesheets. Employees in the administration functions are paid an annual salary. You have been provided with the following information relating to payroll:

- (1) Payroll costs for the year ended 31 March 20X4 were \$30m
- (2) As at 31 March 20X4, Lobo Co had 350 employees
- (3) Due to an increase in demand, on 1 April 20X4, Lobo Co increased the number of employees by 6%
- (4) On 1 August 20X4, all employees received a 3% pay rise
- (5) A bonus of \$1,000 was paid to each employee on 31 March 20X5

**Inventory**

A year-end inventory count was performed on 31 March 20X5 which was attended by members of the audit team. Some of the final audit procedures relating to inventory have been performed but procedures in relation to existence of inventory have not yet been completed. Lobo Co also holds inventory at a warehouse owned by a third party.


**Question 21**

**Which TWO of the following substantive procedures would provide evidence in relation to the accuracy assertion when auditing the payroll expense of Lobo Co?**

- A Obtain a breakdown of the payroll expense by department and ensure the correct amounts are included in cost of sales and operating expenses
- B For a sample of employees, agree the number of hours recorded on timesheets to payslips
- C Select a sample of leavers from the HR records and inspect payroll records to ensure they are no longer included
- D Recalculate the gross and net pay for a sample of employees and agree to the payroll records

**Question 22**

Move the sources of audit evidence into the correct order based on their reliability with the most reliable at the top and the least reliable at the bottom.

Item	Response area
Internal audit reports documenting tests of controls over payroll	
Monthly payroll reports detailing payroll costs per employee	
Bank statements showing the total payroll paid each month	

**Question 23**

Calculate the expected payroll expense for Lobo Co for the year ended 31 March 20X5.

\$ ,000

**Question 24**

Which of the following is a substantive procedure which could be used when auditing the payroll expense of Lobo Co?

- A For a sample of joiners, agree start dates to employment contracts and ensure they have been included in the payroll records from the correct date
- B Review supporting documentation, such as board minutes, to confirm the amount and effective date of the pay rise
- C Agree the total net pay per the bank transfer listing of payments and the bank ledger account to the payroll records
- D Compare the current year total payroll expense to the prior year and investigate any significant differences

**Question 25**

**Which TWO of the following substantive procedures provides evidence in relation to the existence of Lobo Co's inventory?**

- A Select a sample of goods dispatched notes immediately prior to the year end and ensure the goods have been removed from the inventory listing
- B For a sample of items included in work in progress and finished goods, review correspondence to identify any cancelled orders
- C Obtain direct confirmation from the third party regarding the quantity of inventory held in the warehouse
- D Review the notes to the financial statements to ensure compliance with IAS 2 *Inventories*

**The following scenario relates to questions 26 to 30.**

It is 1 July 20X5. You are an audit manager at Sunny & Co, responsible for the audits of Golden Co, Dune Co and Parasol Co. All audits are nearing completion and the auditor’s reports are being drafted.

**Golden Co**

Golden Co is a sustainable fashion retailer with 25 stores nationally and 8 internationally. The company’s draft profit before income taxes for the year ended 31 March 20X5 is \$0.2m (20X4: \$3.5m).

You are evaluating the going concern assessment performed by Golden Co’s management. The following issues have been identified:

<b>Legal claim</b>	Golden Co is being sued by another clothing company for copying one of its designs. If Golden Co loses the case, damages and legal costs could amount to \$17m.
<b>Ocean Co</b>	Ocean Co, a major supplier of Golden Co, went out of business in April 20X5. An alternative supplier was found in June 20X5.
<b>Distribution centre</b>	A fire at Golden Co's distribution centre in June 20X5 resulted in losses of \$4m. The company has found alternative distribution premises and correspondence received from the insurance company indicates it will pay out the insurance claim.
<b>Late payments to suppliers</b>	A number of suppliers have withdrawn credit as Golden Co has been paying invoices significantly later than agreed credit terms.
<b>Bank loan</b>	Golden Co has a loan of \$25m from Merlin Bank Co which is due for repayment on 30 September 20X5. Golden Co’s cash flow forecast shows that it is unlikely it will be able to repay the loan when it is due. Negotiations with the bank to extend the loan for a further two years are ongoing, but no confirmation has yet been received.
<b>Management’s going concern assessment</b>	Golden Co’s management has performed its own going concern assessment up to 31 March 20X6 and has decided that the going concern basis of accounting is appropriate and no material uncertainty exists. On this basis, no disclosures have been included in the 20X5 financial statements in respect of any of the matters described above.

**Dune Co**

The audit of the financial statements for the year ended 31 March 20X5 is complete. No uncertainties relating to going concern have been disclosed by management to the auditors and audit work performed has not identified any issues.

The directors have performed a going concern assessment covering the six-month period to 30 September 20X5.

**Parasol Co**

The company has announced it will cease trading four months after the year end.

The financial statements have been prepared using the break-up basis of accounting with adequate disclosure of the situation.

**Question 26**

**Which TWO of the following issues would cast doubt over Golden Co's ability to continue as a going concern?**

- A Legal claim
- B Ocean Co going out of business
- C Distribution centre
- D Late payments to suppliers

**Question 27**

**Which TWO of the following procedures should Sunny & Co perform in respect of going concern for Golden Co?**

- A Write to Golden Co's bank to ask if it will extend the company's bank loan
- B Assess the reasonableness of the assumptions used to prepare the cash flow forecast
- C Calculate Golden Co's current and quick (acid test) ratios at 31 March 20X5
- D Enquire of management whether alternative finance options are available if the bank does not extend the loan

**Question 28**

The audit engagement partner disagrees with Golden Co’s conclusion on going concern and believes a material uncertainty does exist. Golden Co’s management has refused to include any disclosure.

**Which of the following correctly describes the opinion within the auditor’s report which should be issued on the financial statements of Golden Co for the year ended 31 March 20X5?**

- A Unmodified opinion with no additional communication
- B Unmodified opinion with a material uncertainty related to going concern paragraph
- C Adverse opinion due to material misstatement
- D Qualified opinion due to an inability to obtain sufficient appropriate evidence

**Question 29**

**Select whether each of the following actions Sunny & Co should take in respect of Dune Co are appropriate or not appropriate.**

		<b>Appropriate</b>	<b>Not appropriate</b>
1.	Ask Dune Co’s management to extend the going concern assessment to at least twelve months from the date of approval of the financial statements		
2.	Sunny & Co should prepare a cash flow forecast for Dune Co to cover the period to 31 March 20X6		
3.	Issue a qualified opinion on the grounds of material misstatement if the issue is not resolved		

**Question 30**

Select the correct option from each drop-down list to complete the sentences in respect of Parasol Co.

The audit opinion will be

Select... ▼
unmodified
qualified
adverse

The auditor's report will need to include

Select... ▼
a material uncertainty relating to going concern section
an emphasis of matter paragraph
an other matter paragraph

## Section C

### Question 31

The following scenario relates to two requirements.

It is 1 July 20X5. You are an audit supervisor at Dill & Co, planning the audit of Basil Co, a new client, for the year ending 30 September 20X5. Basil Co is a manufacturer and retailer of kitchens. At a recent planning meeting with the financial controller, you obtained the following information:

#### Planning meeting notes

**Attendees:** Financial controller of Basil Co, Audit supervisor

**Date:** 25 June 20X5

**Subject:** Audit planning of Basil Co for year ending 30 September 20X5

Raw materials are sourced from international suppliers with foreign currency purchases initially translated using the spot rate at the invoice date. Trade payables will be retranslated at the year-end using the average rate for the year.

Timber (wood) is sourced from a region affected by climate change, and during the year, severe flooding occurred. This led to a decrease in supply causing a significant increase in timber prices which Basil Co did not pass on to its customers. Timber supplies have now recovered and prices have stabilised.

In January 20X5, Basil Co launched a range of high quality, custom built kitchens made from premium materials. This new range has been successful, and to provide additional production capacity, a new factory is being built. Construction of the new factory commenced on 1 March 20X5 and is expected to be completed and available for use at the end of November 20X5. To finance the construction, a five-year bank loan of \$4m was taken out with an interest rate of 6% on 1 April 20X5.

As a result of the growth in the business, a new integrated accounting system was introduced in May 20X5. The new system was fully tested with a parallel run prior to its implementation to identify and correct any errors. Once testing was complete, the data was transferred from the old to the new system with no further checks performed.

In June 20X5, a customer suffered an injury from a faulty installation of an electrical appliance. A legal claim has been filed against Basil Co however the company's lawyers believe the claim is only possible to succeed. The finance director has stated that no provision will be recognised and the claim will not be disclosed in the financial statements until the outcome is known.

**Requirements:**

**(a) Assess FOUR business risks relevant to the audit of Basil Co.**

**(8 marks)**

**(b) Analyse the following audit risks and recommend audit work to be included in the audit plan to address each risk:**

- **Foreign exchange transactions**
- **Assets under construction**
- **Borrowing costs in relation to the five-year bank loan taken out to finance the new factory**
- **New accounting software system**
- **Legal claim from customer.**

**(12 marks)**

**(20 marks)**

## Question 32

**The following scenario relates to three requirements.**

It is 1 July 20X5. You are an audit manager at Penguin & Co. You have been asked to consider the acceptance of Iceberg Co as a new client, and respond to a complaint from Weddell Co, an audit client of your firm.

### **Iceberg Co**

It is 1 July 20X5. Penguin & Co has been approached by a prospective client, Iceberg Co, to perform an audit of its financial statements for the year ending 31 December 20X5 as it is no longer exempt. Iceberg Co has previously had a limited assurance review of its financial statements performed by Glacier & Co, but the firm is not a registered auditor and therefore cannot be appointed as auditor. Iceberg Co is a manufacturer and retailer of high-quality winter sports clothing. The company receives certification from a global organisation which assesses companies on social and environmental performance, transparency and accountability, and has met these standards for the last six years.

The finance director of Iceberg Co will be leaving the company in September 20X5 to join Penguin & Co as a partner in the audit department. It has been proposed that the finance director could take on the role of audit engagement partner for the audit of Iceberg Co as their knowledge of the company will be useful in the first year of the audit.

The CEO of Iceberg Co has said that all members of the audit team will be entitled to a discount of 30% on any items of clothing purchased from Iceberg Co. This is the same level of discount given to all staff.

### **Weddell Co**

The finance director of Weddell Co has contacted your firm to complain that the audit for the year ended 31 January 20X5 was not carried out properly as a fraud has been discovered in the sales department which was not detected by the audit team.

The sales department consists of six sales representatives who are each paid a commission rate of 10% for sales they generate. It has been discovered that one of the sales team has created fictitious sales to earn additional commission. The total sales generated by this person amounted to \$500,000 in the year ended 31 January 20X5 of which \$50,000 were fictitious. Weddell Co's total revenue for the year was \$3m.

Weddell Co has been audited by Penguin & Co for five years. No significant issues have arisen in previous years, and therefore, when determining the audit approach for the current year, it was decided to place reliance on the controls testing performed in the prior year.

The audit team member assigned to the revenue section of Weddell Co was taken off the audit to assist with another client's audit which was running behind schedule. Another member of the audit team performed the audit of revenue, however, limited substantive

analytical procedures and no tests of detail were performed due to time pressure. The auditor's report of Weddell Co was issued in April 20X5 expressing an unmodified opinion.

**Requirements:**

**(a) In respect of Iceberg Co, identify and assess the ethical threats arising from the following matters and recommend an appropriate safeguard which could be implemented by Penguin & Co to reduce the threats to an acceptable level:**

- **FD joining the firm and may undertake role of audit partner**
- **30% discount given to the audit team.**

(7 marks)

**(b) Assess the matters, EXCLUDING the ethical threats covered in (a), which should be considered by Penguin & Co before accepting Iceberg Co as an audit client.**

(6 marks)

**(c) Assess whether Penguin & Co should have detected fraud in the sales department of Weddell Co.**

(7 marks)

**(20 marks)**