Gateway for ICMAP Students

(For ICMAP Students Passed up to Semester-4)

Financial Reporting

MCQs/MTQs	25 Mins	25
Short Questions	65 Mins	25

Pakistan Institute of Public Finance Accountants
SAMPLE PAPER
GATEWAY Exam – Financial Reporting

<u>All Questions are compulsory</u>.

Objective Part – A <u>[2 marks each]</u>

1. At 31st October 20X5 the capital structure of a company was as follows:

Ordinary share capital	
36,000 shares of Rs. 5/- each	Rs. 180,000/-
Share premium account	Rs. 130,000/-

During the year ended 31 October 20X6, the company made a bonus issue of 2 shares for every 3 held, using the share premium account for the purpose, and later issued for cash another 7,500 shares at Rs. 8/- per share.

What is the company's capital structure at 31 October 20X6?

	Ordinary Share Capital Rs.	**Share Premium Account Rs.**
a)	180,000	130,000
b)	217,500	152,500
c)	337,500	32,500
d)	487,500	Nil

<u>Correct Answer</u>
Option C

Working for understanding

	Rs.
BONUS ISSUE	
Number of shares issued in bonus issue (36,000 x 2/3)	24,000
Increase in share capital (24,000 x Rs.5/-)	120,000
Decrease in share premium	120,000
RIGHT ISSUE	
Share capital (7,500 x Rs. 5/-)	37,500
Share premium (7,500 x Rs. 3/-)	22,500
Share capital at 31 October 20X6 (180,000+120,000+37,500)	337,500
Share premium at 31 October 20X6 (130,000-120,000+22,500)	32,500

2. The following information is relevant to Banaspati:

	Rs.
Purchases	560,000
Opening inventory	120,000
Closing inventory	136,000
Administration expenses	210,000
Distribution expenses	196,000
Depreciation	88,000
Carriage inwards	54,000
Carriage outwards	48,000
Audit fee	41,000

Banaspati's 25% depreciation relates to its factory, 60% to office and rest to distribution vehicles.

What is the cost of sales of Banaspati?

Rs. ____________

Correct Answer
Rs. 620,000

Working for understanding

	Rs.
Opening inventory	120,000
Purchases	560,000
Closing inventory	(136,000)
Carriage inwards	54,000
Depreciation (88,000 x 0.25)	22,000
Total	**620,000**

3. Identify which TWO of the following are TRUE accounting treatments when recognizing an acquisition of a subsidiary:

i) Contingent consideration must be measured at fair value at the time of business combination
ii) Bargain purchase gain should be debited to statement of profit or loss
iii) Consolidation is done on the basis of accounting concept of substance over form
iv) All acquisition costs including the expenses directly related to the acquisition must be accounted for within equity

a) i) & ii)
b) i) & iii)
c) ii) & iv)
d) iii) & iv)

Correct Answer
Option B

4. Pitcher acquired 75% share capital of Spoon on 1 April 20X6. Following are the extracts of statement of profit or loss for both companies for the year ended 30 September 20X6.

	Pitcher Rs.	**Spoon Rs.**
Revenue	85,000	40,700
Cost of sales	(57,400)	(19,700)
Gross profit	27,600	21,000

Pitcher sold goods to Spoon for Rs. 16,000/- throughout the year. Pitcher made a gross profit of 30% on these sales. Unrealised profit on this inventory of Spoon at 30 September 20X6 was Rs. 1,200/-. The inter-company sales accrued evenly throughout the year.

What will be the value of consolidated gross profit for the year ended 30 September 20X6?

a) Rs. 36,900
b) Rs. 38,100
c) Rs. 48,600
d) Rs. 58,050

Correct Answer
Option A

Working for understanding

	Rs.
Revenue [85,000 + (40,700 x 6/12) – (16,000 x 6/12)]	97,350
Cost of sales [57,400 + (19,700 x 6/12) – 8,000 + 1,200	(60,450)
Gross profit	**36,900**

5. Sarmad Co. owns a building with depreciation on a straight-line basis and no residual value:

Estimated useful life at acquisition	10 years
	Rs. 'million'
Cost on 1 February 20X4	300
Accumulated depreciation (three years)	90
Revaluation on 1 February 20X7:	
Revalued amount	240
Revised estimated remaining useful life	5 years

What will be the carrying value of machinery to be shown in statement of financial position of Sarmad Co. at 31 January 20X8?

a) Rs. 180 million
b) Rs. 192 million
c) Rs. 205.72 million
d) Rs. 240 million

Correct Answer
Option B

Working for understanding

	Rs. million
Carrying value at 1 February 20X7	210
Revalued value at 1 February 20X7	240
Depreciation for the year ended 31 January 20X8 (240/5)	48
Carrying value at 31 January 20X8 (240 – 48)	**192**

6. Aircel Co. bought a license from the government on 1 January 20X5 for Rs. 650 million and it has a 10 year life. It is amortized on a straight line basis. In December 20X6, a review of the sales of the products related to the license showed them to be very disappointing. As a result of this review the estimated recoverable amount of the license at 31 December 20X6 was estimated at only Rs. 475 million.

What will be the impairment charge to statement of profit or loss for Aircel Co. for the year ended 31 December 20X6?

- **a)** Rs. 45 million
- **b)** Rs. 65 million
- **c)** Rs. 110 million
- **d)** Rs. 175 million

Correct Answer
Option B

Working for understanding

Amortization per year (650/10)	= Rs. 65 million
Carrying value at 31 December 20X6 [650 - (65*2)]	= Rs. 520 million
Recoverable value	= Rs. 475 million
Impairment (520 – 475)	= Rs. 45 million

7. Prisma Co. requires a provision for current tax for the year ended 31 October 20X6 of Rs. 5·6 million. There was an over provision of Rs. 0.7 million of the current tax liability and a deferred tax liability of Rs. 4.8 million for the year ended 31 October 20X5. At 31 October 20X6, the tax base of Prisma's net assets was Rs.14 million less than their carrying amounts. The income tax rate of Prisma is 25%.

What will be the charge to Prisma's statement of profit or loss for income tax expense for the year ended 31 October 20X6?

- **a)** Rs. 1.3 million
- **b)** Rs. 4.9 million
- **c)** Rs. 6.2 million
- **d)** Rs. 7.6 million

Correct Answer
Option C

Working for understanding

	Rs. million
Current tax charge (5.6 – 0.7)	4.9
Opening deferred tax liability	4.8
Closing deferred tax liability (14*0.25)	3.5
Deferred tax charge (4.8 – 3.5)	1.3
Total charge to P&L (4.9 + 1.3)	**6.2**

8. Fizdrink Co. has a claim on it from an employee for wrongful dismissal. The lawsuit was filed in January 20X7. The initial estimated outcomes by Fizdrink's legal advisors are as follows:

15% chance of no damages awarded
65% chance of damages of Rs. 5 million
20% chance of damages of Rs. 8 million

What is the provision which Fizdrink would report in its statement of financial position as at 30 April 20X7 in respect of the lawsuit?

a) Rs. 8 million
b) Rs. 4.85 million
c) Rs. 5 million
d) No provision required

<u>**Correct Answer**</u>
Option C

For the lawsuit the most probable single likely outcome is normally considered to be the best estimate of the liability, i.e. Rs. 5 million..

9. On 1 July 20X7, Crisps Co. entered into an agreement to finance lease a specialist plant from the manufacturer for Rs. 1,200,000. The lease required four annual payments in advance of Rs. 300,000 each commencing on 1 July 20X7. The plant would have a useful life of four years and would be scrapped at the end of this period. The lease has an implicit rate of 9%

What amount of finance cost would be charged to Crisps' statement of profit or loss for the year ended 31 March 20X8?

a) Rs. 108,000
b) Rs. 81,000
c) Rs. 60,750
d) Rs. 54,000

<u>**Correct Answer**</u>
Option C

Working for understanding

Cost	1,200,000
Deposit	(300,000)
	900,000
Finance cost (900,000*9%*9/12)	**60,750**

10. On 1 July 20X5, Usman had capitalized development expenditure related of Rs. 640,000. During the year, further costs of Rs. 90,000 were incurred on the project before its completion on 31 January 20X6. Production and sales of the new product commenced on 1 March 20X6 and are expected to last 25 months.

What will be the value of intangible asset to be shown in Usman's statement of financial position at 30 June 20X6 under IAS 38?

Rs. ___________

<u>Correct Answer</u>
Rs. 613,200

Working for understanding

	Rs.
Total cost (Rs. 640,000 + 90,000)	= 730,000
Amortization 730,000 x 4/25	= 116,800
Carrying value (730,000 – 116,800)	= 613,200

Objective Part – B [1 mark each]

11. Which of the following is NOT a change in accounting policy in accordance with IAS 8 *Accounting Policies, Changes in Accounting Estimates and Errors*?

a) Changing inventory valuation method from FIFO to AVCO
b) Shifting from cost model to revaluation model in subsequent measurement under IAS 16
c) Changing the value of a subsidiary's inventory in line with the group policy for inventory valuation when preparing the consolidated financial statements
d) The depreciation of the production facility has been reclassified from administration expenses to cost of sales in the current and future years

Correct Answer
Option C

12. Which of the following events which occur after the reporting date of a company but before the financial statements are authorised for issue is classified as ADJUSTING event in accordance with IAS 10 *Events after the Reporting Period*?

a) Announcement by the company of plan to discontinue an operation
b) A right issue of shares
c) A change in tax rate announced after the reporting date, but affecting the current tax liability
d) The determination of the sale proceeds of an item of plant sold before the year end

Correct Answer
Option D

13. Identify which of the following statements are TRUE as per IFRS 8?

i) The chief operating decision maker is the individual, or group of individuals, who makes decisions about segment performance and resource allocation
ii) Two or more operating segments below the thresholds may be aggregated to produce a reportable segment
iii) At least 70% of total external revenue must be reported by operating segments. Where this is not the case, additional segments must be identified (even if they do not meet the 10% thresholds)

a) i) & ii)
b) ii) & iii)
c) i) & iii)
d) none of the above

Correct Answer
Option A

14. Which of the following is NOT a qualifying asset under IAS 23 *Borrowing costs*?

a) Intangible assets during development period
b) Inventories manufactured in large quantities on repetitive basis
c) Investment property during construction period
d) Made-to-order inventories

Correct Answer
Option B

15. The guidance in IAS 38 *Intangible Assets* under recognition and initial measurement of intangible assets takes account of the way in which an entity obtained the asset.
Identify which of the following methods are allowed by IAS 38 for recognition of intangible assets in a business?

i. They are purchased separately from other assets
ii. They are obtained as part of acquiring the whole of a business
iii. They are developed internally
iv. They are acquired by way of a government grant

a) i), ii) & iii)
b) ii), iii) & iv)
c) i) , ii) & iv)
d) All of them

Correct Answer
Option D

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Pakistan Institute of Public Finance Accountants

SAMPLE PAPER

GATEWAY Exam – Financial Reporting

Subjective Part

Question-1:

On 1 February 20X6 Primer began the construction of a new property. Purchase of land for the construction of building cost Rs. 45 million. Cost of leveling the land prior to beginning construction was Rs. 100,000. A borrowing cost of Rs. 2.5 million was incurred on the loan for construction of this property.

Cost of materials needed to construct the property was Rs. 12 million. Monthly labour costs of the construction staff were Rs. 700,000. Payments to professional advisors relating to the construction were of Rs. 300,000. Primer had to incur a cost of Rs. 590,000 for relocating the staff to work in the new building.

Primer earned an income of Rs. 410,000 from temporary use of part of the site as a car park during the construction period. Construction work was suspended for a month because of bad weather condition and some unforeseen power generation issue.

Required:

Calculate the total cost of property of Primer when the construction is completed on 31 December 20X6. **(8 marks)**

Ans-1

	Rs. Million
Cost of land	45
Cost of leveling the land	0.1
Borrowing cost	2.5
Cost of materials in construction	12
Labour cost (0.7*10)	7
Payment to professional advisors	0.3
TOTAL	**66.9**

Cost of relocation of employees and income from temporary use will not be adjusted in the cost of asset.

Question-2:

Pharma is a listed entity preparing its financial statements for the year ended 31 March 20X8.

On 1 October 20X6 Pharma began a project to find a new vaccination. Expenses relating to the project of Rs. 4 million were charged in the statement of profit or loss in the year ended 31 March 20X7. Further costs of Rs. 3 million were incurred in the three-month period to 30 June 20X7. On that date it became apparent that the project was technically feasible and commercially viable.

Further expenditure of Rs. 6 million was incurred in the six-month period from 1 July 20X7 to 31 December 20X7. The production of the new product, which began on 1 January 20X8, was expected to generate revenue of at least Rs. 1.2 million per annum over the 10-year period commencing 1 January 20X8.

Required:

Calculate the impact of the above transactions on financial statements of Pharma for the year ended 31 March 20X8. **(7 marks)**

Ans-2

As per IAS 38 *Intangible Assets*, only costs incurred after the conditions have been satisfied can be capitalized. Therefore, the development cost capitalized in this case will be Rs. 6 million. All previous costs must be expensed to statement of profit or loss, even those arising earlier in the same accounting
period.

Amortization of the capitalized costs begins when the commercial production of the product begins. In this case, amortization of only three months will be charged as commercial production began on 1 January 20X8. A full years charge would be Rs. 600,000 (6 million/10). The charge in the year ended 31 March 20X8 is Rs. 150,000 (600,000 x 3/12).

The carrying value at the 31 March 20X8 will be calculated by deducting accumulated amortization from the cost of development expenditure. The working would be as follows:

Carrying value in statement of financial position	= Cost less Accumulated amortization
	= 6,000,000 – 150,000
	= Rs. 5,850,000

The relevant expenses to be shown in statement of profit or loss for the year ended 31 March 20X8 are as follows:

Research expense	= Rs. 3,000,000
Amortization expense	= Rs. 150,000

<u>Question-3:</u>

During the year ended 30 June 20X6, Belta sold a specialist machinery to a customer that proved to have a manufacturing fault. The customer has returned the machine to Belta and demanded repayment of the purchase price of Rs. 7 million plus compensation for lost sales of Rs. 600,000. It is highly likely that Belta will make this payment in September 20X6. The directors of Belta consider it probable that the Rs. 5·9 million of the above amount can be recovered from the original manufacturer of the machine and this amount could reasonably be expected to be received in November 20X6.

Required:
Explain how both the claim and the counter-claim will be treated in the financial statements of Belta for the year ended 30 June 20X6. **(5 marks)**

<u>Ans-3</u>

The international financial reporting standard that is relevant to this issue is IAS 37 – *Provisions, contingent liabilities and contingent assets*. The amount payable by Belta to the customer of Rs. 7.6 million should be recognized as a provision in the statement of financial position at 30 June 20X6. The obligating event is the sale of goods under the warranty. There is a probable outflow of economic benefits that can be reliably estimated.

Rs. 5.9 million, the amount potentially recoverable from the manufacturer, is a contingent asset which should not be recognized in the financial statements unless the recovery is virtually certain. Where (as in this case) the recovery is probable the contingent asset should be disclosed in the notes to the financial statements.

Question-4:

Define an operating segment as per IFRS 8 *Operating segments*. List the criteria for aggregating two or more operating segments. **(5 marks)**

Ans-4

Definition

a) An *operating segment* is a component of an entity:
b) That engages in business activities from which it may earn revenues and incur expenses (including revenues and expenses relating to transactions with other components of the same entity),
c) Whose operating results are regularly reviewed by the entity's chief operating decision maker to make decisions about resources to be allocated to the segment and assess its performance, and for which discrete financial information is available.

Aggregation criteria

Two or more operating segments may be aggregated if the segments have similar economic characteristics, and the segments are similar in **each** of the following aspects:

a. The nature of the products or services;

b. The nature of the production process;

c. The type or class of customer for their products or services;

d. The methods used to distribute their products or provide their services; and

e. If applicable, the nature of the regulatory environment.

Gateway for ICMAP Students

(For ICMAP Students Passed up to Semester-4)

Audit, Assurance, & Ethics

MCQs/MTQs	25 Mins	25
Short Questions	65 Mins	25

Pakistan Institute of Public Finance Accountants
SAMPLE PAPER
GATEWAY Exam – Audit Assurance & Ethics

All Questions are compulsory.

Objective Part – A [2 marks each]

1. Which of the following are typical matters for which auditors normally get management representations?

1. Confirmation that the directors believe the company to be a going concern for the foreseeable future
2. Confirmation that all books, records, information and explanations have been supplied to the auditors
3. Confirmation that there are no contingent liabilities other than those disclosed to the auditors
4. Explanation of reasons why errors passed on by the auditors have not been adjusted
5. Confirmation that there are no further events after the balance sheet date that require revision to the accounts

a) 1, 2, 3 & 5
b) 1, 2, 4 & 5
c) 2, 3, 4 & 5
d) 1, 2, 3, 4 & 5

Correct Answer
Option D

2. Which of the following is incorrect regarding fraud?

a) Auditors can increase the likelihood of detecting fraud by approaching their work with professional skepticism
b) Auditors should clarify to the client that the responsibility of detecting fraud lies with the auditor whereas that for preventing fraud lies with the client
c) Auditors should understand their clients, to appreciate how fraud could occur
d) Auditors should be aware of pressures on directors and management (both personal and business)

Correct Answer
Option B

3. Which of the following statements is correct regarding auditor's reliance on the work of others (for e.g. experts, internal auditors) during an external audit?

a) The expert need not be independent
b) The level of technical competence does not need to be evaluated
c) Reference to the auditor's use of expert should be made in the audit report only if required by law.
d) The auditor does not need to evaluate the adequacy of the expert's work

Correct Answer
Option C

4. Once the deficiencies have been identified in the client's internal control systems, what is the next course of action for the auditors?

a) Carry out the going concern review
b) Report weaknesses to the management in the form of a management letter
c) Re-design the controls for the management
d) Mention the control weaknesses in the audit report

Correct Answer
Option B

5. Which of the following is true regarding the audit of liabilities?

a) Greatest risk with liabilities is overstatement.
b) Supplier statements are a good source of audit evidence.
c) All suppliers send statements on a regular basis.
d) The supplier statements are the only source of evidence required to carry out supplier statement reconciliations.

Correct Answer
Option B

6. Which of the following is an example of an unmodified audit opinion:

a) "In our opinion, except for the possible effects of the matter described, the financial statements of ABC Co. give a true and fair view."
b) "In our opinion, the financial statements of ABC Co. do not give a true and fair view."
c) "We are unable to express an opinion on the financial statements of ABC Co."
d) "In our opinion, the financial statements of ABC Co. give a true and fair view."

Correct Answer
Option D

7. Which of the following should NOT be a content of an audit engagement letter?

a) The scope of the audit with reference to appropriate legislation
b) The form of any report or other communication of the results of the engagement
c) Provision of access to the auditor of all relevant books and records
d) The materiality level that will be used to evaluate misstatements in the financial statements

Correct Answer
Option D

8. Which of the following may be an appropriate control to mitigate the risk of incorrect goods dispatched to the customer?

a) Goods dispatch notes prepared from order form.
b) Credit limits applied and adhered to
c) Credit notes matched to original invoice
d) Open' order file, which is regularly checked.

Correct Answer
Option A

9. Which of the following is an example of 'arithmetic and accounting' as a control?

a) Lines of authority defined within an organization
b) Use of reconciliation procedures
c) Recruiting the right people for the right job
d) cash being received and recorded by two different people

Correct Answer
Option B

10. Which one of the following is NOT a fundamental principle of Code of Ethics?

a) Objectivity
b) Confidentiality
c) Independence
d) Professional Behaviour

Correct Answer
Option C

Pakistan Institute of Public Finance Accountants
SAMPLE PAPER
GATEWAY Exam – Audit Assurance & Ethics

Objective Part – B [1 mark each]

1. ‘The materiality level calculated at the planning stage should NOT be revised during later stages of the audit.’
   Is this statement true or false?

   a) True
   b) False

Correct Answer
Option B

2. ‘The authority of International Standards on Auditing always overrides national regulations governing the audit of the financial statements of companies in any given country.’
   Is this statement true or false?

   a) True
   b) False

Correct Answer
Option B

3. A prospective audit client has offered to double the audit fees if the auditor issues an unmodified (‘clean’) report at the end of the audit.
   This may be construed as a threat to independence.
   Which of the following is the **most** appropriate description of this threat?

   a) Intimidation
   b) Advocacy
   c) Self-interest
   d) Self-review

Correct Answer
Option C

4. Which of the following is an incorrect example of subsequent events that may provide confirming evidence (in support of assertions) when auditing the financial statements of a large manufacturing company?

   a) The receipt of payments from trade receivable customers owing amounts at the yearend date.
   b) Payments to trade payable customers in existence at the yearend date.
   c) The existence of a cash balance, facilitating the reconciliation of the cash held at the yearend date after considering subsequent receipts and payments.
   d) The sale of goods which represented inventory items bought post the year end

Correct Answer
Option D

5. An expert is defined as 'a person or firm possessing special skill, knowledge and experience in a particular field other than accounting and audit'.

   Which of the following are likely to be the factors considered if an expert is to be used?

   1. The expert's competence
   2. The expert's objectivity
   3. Availability of other evidence regarding the area for which an expert is being used

   a) 1 & 2 only
   b) 1 & 3 only
   c) 2 & 3 only
   d) 1,2 & 3

Correct Answer
Option D

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Pakistan Institute of Public Finance Accountants
SAMPLE PAPER
GATEWAY Exam – Audit Assurance & Ethics

Subjective Part

Question-1:

Your firm is the auditor of Snoopy Co, a small engineering company which makes parts for car engines. The company maintains a general ledger, together with trade receivables and trade payables ledgers. It also maintains a non-current assets register.

You have been assigned to the audit of the company's financial statements for the year ended 30 November 2015 and are aware that:

(1) In May 2015 the company disposed of a large cutting machine for Rs.30,000 and replaced it by purchasing two small but costly machines.

(2) The company's trade receivables ledger included several customers, with large credit balances on their accounts as at 30 November 2015.

(3) Throughout the year the company's cashier has been responsible for bank payments, the receipt and banking of trade receivables monies and the recording of all bank transactions in the company's accounting records. As the cashier is a very trusted employee the company's directors expect your firm to restrict its audit procedures in this area.

(4) Your firm's audit procedures will include checking a sample of Snoopy Co's year-end supplier statement balances.

Required:

a) **Describe TWO audit tests your firm should carry out with regard to the disposal of the cutting machine (2 marks)**

b) **Describe TWO audit tests that should be carried out with regard to the purchase of the two additional machines. (2 marks)**

c) **State TWO possible causes as to why the credit balances could have arisen on customer accounts within the trade receivables ledger of Snoopy Co as at 30 November 2015. (2 marks)**

d) **Explain the extent of the substantive procedures your firm should carry out in the bank area of Snoopy Co. (2 marks)**

Ans-1

a) **Procedures on the disposal of the cutting machine- 1 mark per procedure- up to a maximum of 2 marks**

- Check authorising documentation to ensure that the disposal was appropriately authorised and for proceeds of Rs.30,000.
- Examine the sales documentation relating to the disposal and ensure that the sale details match those in the authorising documentation.
- Check that accounting entries with regard to documentation are recorded correctly in the general ledger with credit being made to non-current assets disposal account.
- Check accounting entries in the non-current assets register and general ledger relating to disposal ensuring correct removal from non-current assets account (credit) and opposite entries in non-current assets disposal account. Also check validity of entries relating to accumulated depreciation.
- Check calculations of profit/loss on disposal and corresponding entries in income statement.

b) **Procedures on purchase of new machines- 1 mark per procedure- up to a maximum of 2 marks**

- Check authorising documentation to ensure that additions were appropriately authorised.
- Check cost information from purchase invoice/purchase documentation.
- Check accounting entries in non-current assets register and general ledger with regard to cost of additions.
- Check that useful life on which depreciation rates have been based is reasonable.
- Check accuracy of depreciation charge.
- Ensure existence of new machines by physically verifying at balance sheet date.

c) **Causes of credit balances- 1 mark per reason- up to a maximum of 2 marks**

Possible reasons for the credit balances on customer accounts include:

- Payment being received from the customer in advance of supplies being made by Snoopy Co.
- Duplicated payment of an invoice from Snoopy Co.
- Omission of posting of an invoice to the specified customer account.
- Incorrect posting of an invoice from Snoopy Co to another customer account.
- Incorrect posting of payment received from another customer of Snoopy Co to the specified customer account.
- Incorrect posting of a credit note or journal credit to the specified customer account.
- Posting of a credit note to the specified customer account in lieu of goods paid for, being returned.
- Posting of a credit note to the specified customer account on settlement of dispute.

d) **Extent of substantive procedures on 'bank'- marking for each point given below-- up to a maximum of 2 marks**

In order to minimise audit risk our firm should carry out extensive substantive procedures in the bank area. **0.5 mark**

This is due to the high inherent risk factor associated with bank transactions .**0.5 mark**

The fact that Snoopy Co's internal control in this area is fundamentally weak. **0.5 mark**

Irrespective of the point that the cashier may be a very trusted employee of the company: the lack of segregation of duties in the bank payments, bank receipts and recording functions is of a particular concern. The fact that these functions are not segregated considerably increases the possibility of undetected fraud and error. **1 mark**

Consequently, in directing additional audit resources to substantive procedures in this area, my firm would be seeking to reduce the detection risk with regard to fraud and error. **1 mark**

Question-2:

You are the auditor of P Petroleum, a limited liability company which extracts, refines and sells oil and petroleum related products. The financial statements have not yet been approved by the directors.

The audit of P Petroleum for the year ended 30 June 2015 had the following events:

Event 1- 15 August 2015- Bankruptcy of major customer representing 11% of the trade receivables on the balance sheet.

Event 2- 21 September 2015- Accidental release of toxic chemicals into the sea from the company's oil refinery resulting in severe damage to the environment.

Required:

a) **For BOTH events above, explain, with reasons, whether they are adjusting or non-adjusting according to IAS 10 Events After the Balance Sheet Date (3 marks)**

b) **Explain FOUR audit procedures that should be carried out on the above events. (4 marks)**

Ans-2

a) The bankruptcy of a major customer provides additional evidence of conditions existing at the balance sheet date. The customer will not be able to pay debts due, therefore receivables are overstated and the bad debt provision on the profit and loss account is understated. An adjustment for the amount of the receivable should be made in the financial statements. **(0.5 mark for identification- 1 mark for explanation)**

The accidental release of toxic chemical occurred after the balance sheet date - the spill is indicative of conditions that arose subsequent to the year end. No adjustment appears to be necessary. However, the event may be significant in terms of the operations of the company (a large legal claim could arise) and so disclosure of the event would be expected. **(0.5 mark for identification- 1 mark for explanation)**

b) Procedures- 1 mark per procedures- up to a maximum of 4 marks

Event 1 – Specific procedures undertaken include:

- Confirming that the customer will not pay to a letter from the receiver or similar authorised person.
- Confirming the amount due from the customer to invoices raised prior to the year end, and if possible to a positive direct confirmation letter.
- Auditing the adjustment to the financial statements decreasing the receivable balance and increasing the bad debt write off in the profit and loss account.
- Including the amount in the management representation letter to confirm no other amounts are due from the customer.

Event 2 – Specific procedures to be undertaken include:

- Obtain information concerning the chemical release from management, reading local press and if possible the company's lawyers – the latter may be able to indicate whether there is any legal liability.
- Discuss the appropriate accounting treatment with the directors, confirming that disclosure is required in the circumstances.
- Read the disclosure note to confirm that the matter is adequately explained in the financial statements.
- Obtain a letter of representation from the directors confirming that there are no other events requiring disclosure.

Question-3:

The Board of Directors of BB Co met recently to discuss the company's audited annual financial statements, in readiness for the company's forthcoming annual general meeting.

At the board meeting, the following statements were made by the various directors:

- Noting that the company's auditors had recommended that the company should have an internal audit department, the sales director enquired, 'What are the differences between external auditors and internal auditors?'

- Whilst reading the auditors' report, the production director commented, 'The term true and fair is meaningless audit jargon. For the fee they charge us, it would be reasonable for us to expect the auditors to confirm whether the accounts are correct and error free.'

- Recalling that the managing director and financial director had signed a letter of representation in connection with the audited financial statements, the technical director stated, 'I still don't understand the purpose of that letter.'

Required:

a) **Explain TWO differences between external and internal auditors. (2 marks)**

b) **Explain why the production director's comments about 'true and fair' and his expectation of the auditors are unreasonable. (2 marks)**

c) **Describe the actions auditors should take if management refuses to provide them with written representations. (1 mark)**

Ans-3

a) **1 mark per difference up to a maximum of 2 marks (other relevant differences should also be give full marks)**

	External Auditor	**Internal Auditor**
Appointment process	Determined by statute- appointed by members. Formal auditing qualifications are required.	Determined by management- appointed by management. Qualification requirements are determined by management.
Report to	Members – formally in an auditor's report on the truth and fairness of the financial statements of the company.	Management – formally or informally by verbal/written communication on any matter deemed appropriate by management.

Responsibilities	Determined by statute.	Determined by management, will often encompass responsibilities focusing on business risk assessment/evaluation and evaluation and effectiveness of internal control.
Scope of work	To express an opinion on whether financial statements show a true and fair view.	Determined by management, governed by the extent of responsibilities (above).

b) 1 mark per relevant discussion point- up to a maximum of 2 marks

When reporting to members on a set of financial statements, auditors are required by statute to report whether those financial statements show a true and fair view. Thus, the term 'true and fair' is a legal term and the production director is wrong in asserting that it is 'meaningless audit jargon'.

There is however no statutory definition of the term 'true and fair'. Consequently the content of the concept is subject to continuous change and development as commentators in academia, the professions, industry and commerce continue to debate its meaning. There is a general consensus by all of the above that 'true and fair' does not mean 'correct and error free'.

'Correct' is an absolute term, whereas 'true and fair' is an abstract term with both words incorporating subjective notions.

Certainly the term does not mean 'error free'. There is however consensus that it means, 'based on fact and reality, objective and free from bias'.

In arriving at a conclusion as to whether financial statements do show a true and fair view, auditors use subjective judgement and should carry out procedures in accordance with International Standards on Auditing in arriving at that conclusion.

Procedures are often extensive in terms of time taken, resources and cost. It is generally accepted that if financial statements have not been prepared in accordance with generally accepted accounting principles and International Accounting Standards, then they will not show a true and fair view.

Similarly, if they contain a material error, or there is a material omission from them, the financial statements will not show a true and fair view. Information is material if its omission or misstatement could influence the economic decision of users taken on the basis of the financial statements.

In summary, when carrying out their work, auditors seek only to assure readers that the financial statements confirm with reality and factual information and that they have been prepared objectively and without bias in accordance with relevant statute(s) and standards. They also seek to assure readers that the financial statements are free from *material* error or omission.

c) 1 mark

If management refuses to provide a written representation, then the auditor should again review the possibility of obtaining sufficient audit evidence from alternative sources in connection with the matter or issue under review.

If evidence is unobtainable then the auditor should express a qualified opinion or a disclaimer of opinion on the basis of inability to get sufficient appropriate evidence.

Question-4:

Rania Co. is a computer software design company. Its directors recently approached the audit engagement partner of RTC Co, an audit firm, to appoint the firm as the company's new auditors. At a brief meeting between the directors and the partner, the formalities of the audit appointment process, including a letter of engagement and auditors' rights were discussed. The partner is now about to commence his client screening procedures with regard to Rania Co.

Required:

a) State TWO matters that the audit engagement partner of RTC & Co should consider when screening Rania Co. (2 marks)

b) Explain THREE important matters that should be included in a letter of engagement. (3 marks)

Ans-4

a) 1 mark per point (other valid points should also considered)- up to a maximum of 2 marks

The audit engagement partner should consider the following matters:

- The state of the computer software design commercial sector and prospects for businesses engaged in it.
- The reason for the resignation/removal of the company's previous auditor.
- The extent to which previous years' audit reports relating to Rania Co have been qualified.
- The experience and qualifications of the company's management and their attitude towards control environment issues.
- The current operating and financial position of the company.
- The directors' understanding of the role of the external auditor.
- The availability of adequate audit resources within the firm to carry out an effective audit on Rania Co's financial statements.
- The accounting policies used by Rania Co.
- Indications that Rania Co or its management may be engaged in fraudulent activity.

b) 1 mark per point (other valid points should also considered)- up to a maximum of 3 marks

- The objective of the audit of financial statements
- Management's responsibility for the financial statements
- The scope of the audit, including reference to applicable legislation, regulations, or pronouncement of professional bodies to which the auditor adheres
- The form of any reports or other communication of results of the engagement
- The fact that because of the test nature and other inherent limitations of internal controls, there is an unavoidable risk that material misstatements may remain undiscovered
- Unrestricted access to whatever records, documentation and other information requested in connection with the audit
- Arrangements regarding the planning and performance of the audit
- Basis of audit fee
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit
- Request for the client to confirm the terms of engagement by acknowledging receipt of the letter
- Description of any other letters or reports the auditor expects to issue to the client
- Basis on which fees are computed and any billing arrangements.