

1. (25%)

Ray, the owner of a small company, asked Holmes, a CPA, to conduct an audit of the company's records. Ray told Holmes that an audit was to be completed in time to submit audited financial statements to a bank as part of a loan application. Holmes immediately accepted the engagement and agreed to provide an auditor's report within three weeks. Ray agreed to pay Holmes a fixed fee, plus a bonus if the loan was granted.

Holmes hired two accounting students to conduct the audit and spent several hours telling them exactly what to do. Holmes told the students not to spend time reviewing the internal controls, but instead to concentrate on proving the mathematical accuracy of the ledger accounts, and summarizing the data in the accounting records that supported Ray's financial statements. The students followed Holmes' instructions and after two weeks gave Holmes the financial statements, which did not include footnotes. Holmes reviewed the statements and prepared an unqualified auditor's report. The report, however, did not refer to generally accepted accounting principles.

Required:
 Briefly describe each of the generally accepted auditing standards and indicate how the action(s) of Holmes resulted in a failure to comply with each standard. Organize your answer as follows:

Brief Description of Generally Accepted Auditing Standards	Holmes' Actions Resulting in failure to comply with Generally Accepted Auditing Standards
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2. (25%)

Savage, CPA, has been requested by an audit client to perform a non-recurring engagement involving the implementation of an EDP information and control system. The client requests that in setting up the new system and during the period prior to conversion to the new system, Savage

- a. Counsel on potential expansion of business activity plans.
- b. Search for and interview new personnel.
- c. Hire new personnel.
- d. Train personnel.

In addition, the client requests that during the three months subsequent to the conversion, Savage

- a. Supervise the operation of the new system.
- b. Monitor client-prepared source documents and make changes in basic EDP-generated data as Savage may deem necessary without concurrence of the client.

Savage responds that he may perform some of the services requested, but not all of them.

Required:
 Which of these services may Savage perform and which of these services may Savage not perform? Explain.

(背面仍有題目,請繼續作答)

3. (25%)

Dunbar Camera Manufacturing, Inc., produces high-priced precision motion picture cameras in which the specifications of component parts are vital to the manufacturing process. Dunbar buys valuable camera lenses and large quantities of sheetmetal and screws. Screws and lenses are ordered by Dunbar and billed by the vendors on a unit basis. Sheet metal is ordered by Dunbar and is billed by the vendors on the basis of weight. The receiving clerk is responsible for documenting the quality and quantity of merchandise received. A preliminary review of the internal control system indicates that the following procedures are being followed:

Receiving Report: Properly approved purchase orders, which are prenumbered, are filed numerically. The copy sent to the receiving clerk is an exact duplicate of the copy sent to the vendor. Receipts of merchandise are recorded on the duplicate copy by the receiving clerk.

Sheet metal: The company receives sheet metal by railroad. The railroad independently weighs the sheet metal and reports the weight and date of receipt on a bill of lading (waybill), which accompanies each delivery. The receiving clerk checks only the weight on the waybill against that on the purchase order.

Screws: The receiving clerk opens cartons containing screws, then inspects and weighs the contents. The weight is converted to number of units by means of conversion charts. The receiving clerk then checks the computed quantity against the purchase order.

Camera Lenses: Each camera lens is delivered in a separate corrugated carton. Cartons are counted as they are received by the receiving clerk and the number of cartons is checked against each purchase order.

Required:

- a. Explain why the internal control activities, as they apply individually to receiving reports and the receipt of sheet metal, screws, and camera lenses, are adequate or inadequate. Do not discuss recommendations for improvements.
- b. What financial statement distortions may arise because of the inadequacies in Dunbar's internal controls, and how may they occur?

4. (25%)

Devon Incorporated engaged Robert Smith to audit its financial statements for the year ended December 31, 1996. The financial statements of Devon Incorporated for the year ended December 31, 1995 were audited by Alice Jones, whose March 31, 1996 auditor's report expressed an unqualified opinion. This report of Jones is not presented with the 1995-96 comparative financial statements.

Smith's working papers contain the following information that does not appear in the footnotes to the 1996 financial statements as prepared by Devon Incorporated:

- a. One director, appointed in 1996, was formerly a partner in Jones' accounting firm. Jones' firm provided financial consulting services to Devon during 1990 and 1991, for which Devon paid approximately \$1,600 and \$9,000 respectively.
- b. The company refused to capitalize certain lease obligations for equipment acquired in 1996. Capitalization of the leases in conformity with generally accepted accounting principles would have increased assets and liabilities by \$312,000 and \$387,000 respectively; decreased retained earnings as of December 31, 1996 by \$75,000; and decreased net income and earnings per share by \$75,000 and \$.75 respectively for the year then ended. Smith has concluded that the leases should have been capitalized.
- c. During the year, Devon changed its method of valuing inventory from the first-in, first-out method to the last-in, first-out method. This change was made because management believes LIFO more clearly reflects net income by providing a closer matching of current costs and current revenues. The change had the effect of reducing inventory at December 31, 1996 by \$65,000 and net income and earnings per share by \$38,000 and \$.38 respectively, for the year then ended. The effect of the change on prior years was immaterial; accordingly, there was no cumulative effect of the change. Smith firmly supports the company's position. After completion of the field work on February 28, 1997, Smith concludes that the expression of an adverse opinion is not warranted.

Required:

Prepare the body of Smith's report, dated February 28, 1997, and addressed to the board of directors to accompany the 1996-95 comparative financial statements.