

UNIVERSITY OF SWAZILAND
DEPARTMENT OF ACCOUNTING AND FINANCE
SECOND SEMESTER EXAMINATION
MAY 2012

PROGRAMME OF STUDY	:	Diploma in Commerce
YEAR OF STUDY	:	Three (3) (Full Time)
TITLE OF THE PAPER	:	Principles of Auditing
COURSE CODE	:	AC 316 (M) (Full Time)
TIME ALLOWED	:	Three (3) Hours
TOTAL MARKS	:	100
INSTRUCTIONS	1	There are SEVEN (7) questions, <u>ANSWER ALL.</u>
	2	Begin the solution to each question on a new page.
	3	The marks awarded for a question are indicated at the end of each question.
	4	Show your necessary workings.

NOTE: You are reminded that in assessing your work, account will be taken of accuracy of the language and the general quality of expression, together with layout and presentation of your answer.

THIS PAPER IS NOT TO BE OPENED UNTIL PERMISSION HAS BEEN GRANTED BY THE INVIGILATOR / SUPERVISOR.

SPECIAL REQUIREMENT: CALCULATOR

QUESTION 1

- a) Distinguish between business failure and audit risk. Why is business failure a concern to auditors? (5 marks)
- b) What is meant by contributory negligence? Under what conditions will this likely be a successful defense? (4 marks)
- c) The audit firm of Bhembe, Chidende, and Dlamini was expanding rapidly. Consequently, it hired several junior accountants, including a man named Mlondie. The partners of the firm eventually became dissatisfied with Mlondie's production and warned him they would be forced to discharge him unless his output increased significantly.

At that time, Mlondie was engaged in audits of several clients. He decided that to avoid being fired, he would reduce or omit some of the standard auditing procedures listed in audit programs prepared by the partners. One of the firm's clients, Gcinile Corporation, was in serious financial difficulty and had adjusted several of the accounts being audited by Mlondie to appear financially sound.

Mlondie prepared fictitious audit documentation in his home at night to support purported completion of auditing procedures assigned to him, although he in fact did not examine the adjusting entries. The audit firm rendered an unqualified opinion on Gcinile's financial statements, which were grossly misstated. Several creditors, relying on the audited financial statements, subsequently extended large sums of money to Gcinile Corporation.

Will the audit firm be liable to the creditors who extended the money because of their reliance on the erroneous financial statements if Gcinile Corporation should fail to pay them? Explain your answer. (6 marks)

(Question 1 : Total marks 15)

QUESTION 2

- a. Distinguish between fraudulent financial reporting and misappropriation of assets. Discuss the likely difference between these two types of fraud on the fair presentation of financial statements. (6 marks)
- b. As senior auditor on a new client, Tanele Industries, you have been assigned the task of developing the audit procedures for the Accounts Receivable Allowance (A/R Allowance).

Required:

- a. What attitude must an auditor take when evaluating the A/R Allowance as developed by management? Why? **(3 marks)**
- b. For the following tasks, discuss whether ultimate responsibility falls on management or the auditors:
 - i. Develop and record the estimate of the A/R Allowance.
 - ii. Test the A/R Allowance for material misstatements.
 - iii. Evaluate the adequacy of the A/R Allowance.
 - iv. Record adjustments to the A/R Allowance on the financial statements. **(8 marks)**
- c. Define material misstatement(s). **(2 marks)**
- d. The A/R Allowance calculated by management is different from than the estimate prepared by you, the auditor. How do you determine if the difference needs to be addressed with management? What steps should be taken if you determine that an adjustment needs to be made. **(4 marks)**

(Question 2 : Total marks 23)**QUESTION 3**

- a. Explain why external evidence is more reliable than internal evidence. **(2 marks)**
- b. The following are examples of audit procedures:
 1. Examine an insurance policy stating the amount of the fire insurance coverage on buildings and equipment.
 2. Calculate the ratio of cost of goods sold to sales as a test of overall reasonableness of gross margin relative to the preceding year.
 3. Obtain a letter from the client's attorney addressed to the audit firm stating that the attorney is not aware of any existing lawsuits.
 4. Extend the cost of inventory times the quantity on an inventory listing to test whether it is accurate.
 5. Trace the total in the cash disbursements journal to the general ledger.

Required:Classify each of the preceding items according to the eight types of audit evidence. **(5 marks)**

- c. The following are audit procedures from different transaction cycles:
 1. Use audit software to foot and cross-foot the cash disbursements journal and trace the balance to the general ledger.
 2. Examine documentation for acquisition transactions before and after the statement of financial position date to determine whether they are recorded in the proper period.

3. Inquire of the credit manager whether each account receivable on the aged trial balance is collectible.
4. Compute inventory turnover for each major product and compare with previous years.
5. Confirm a sample of notes payable balances, interest rates, and collateral with banks.

Required:

For each substantive audit procedure, identify whether it is a substantive test of transactions, a test of details of balances, or an analytical procedure. (5 marks)

(Question 3 : Total marks 12)

QUESTION 4

Nontobeko Zikalala & Co, a medium sized audit firm, was engaged to audit Maseko Supply Company. Several staff were involved in the audit, all of whom had attended the firm's inhouse training program on effective auditing methods. Throughout the audit, Zikalala spent most of her time in the field planning the audit, supervising the staff, and reviewing the work.

A significant part of the audit entailed verifying the physical count, cost and summarization of inventory. Inventory was highly significant to the financial statements, and Zikalala knew the inventory was pledged as collateral for a large loan to First City National Bank Swaziland. In reviewing Maseko's inventory count procedures, Zikalala told the president Nomcebo Maseko that she believed the method of counting inventory at different locations on different days was highly undesirable.

The president stated that it was impractical to count all inventory on the same day because of personnel shortages and customer preferences. After a considerable discussion, Zikalala agreed to permit the practice if the president would sign a statement that no other method was practical. The audit firm had at least one person at each site to audit the inventory count procedures and actual count. There were more than 40 locations.

Eighteen months later, Zikalala found out that the worst had happened. Management below the president's level had conspired to materially overstate inventory as a means of covering up obsolete inventory and inventory losses resulting from mismanagement. The misstatement occurred by physically transporting inventory at night to other locations after it had been counted in a given location. The accounting records were inadequate to uncover these illegal transfers.

Both Maseko Supply Company and First City National Bank Swaziland sued Nontobeko Zikalala & Co.

Required:

Answer the following questions, setting forth reasons for any conclusions stated:

- a) What defense should Nontobeko Zikalala & Co. use in the lawsuit by Maseko? **(3 marks)**
- b) What defense should Nontobeko Zikalala & Co. use in the suit by First City National Bank Swaziland? **(3 marks)**
- c) Is Zikalala likely to be successful in her defenses? **(3 marks)**

(Question 4 :Total marks 9)

QUESTION 5:

For the following independent situations, assume you are the audit partner on the engagement.

1. Your client, Affordable Car Hire, recently changed its depreciation method from straight-line to sum-of-the-years' digits. The effect of the change on the current year's income is not material, but in future years, you suspect the effect will become material. The facts are adequately disclosed in footnotes.
2. Ngwenya Iron Ore Minerals recently decided to change its direction and spent the last 8 months developing business in the potash mining business. There are significant potential rewards, but the company's management recognizes that there are significant risks in the business that could jeopardize the success of its existing mining business. Since starting the new adventure, the company has had no success and some decline in profits. The facts are adequately disclosed in footnotes.
3. You recently noticed that Matsapha Builders Discount Warehouse routinely excludes their statement of cash flows in the company's annual financial statements. Their reasoning, as explained to you, is that the statements are confusing to their readers, so they prefer to leave the information out.
4. A group of longtime friends decided to try their hand at online art auctions and online trade in antiquities. Although their venture started out well enough, a market-wide downturn in e-commerce sales abruptly plunged the start-up into the red. The future of the company looks bleak, both sales and cash position have declined substantially. If the market does not turn around soon, you think the company may not be able to continue to operate.
5. The controller of Sun International Hotel will not allow you to confirm the receivable balances from any of its customers. However, the amounts of the receivables are material in relation to Sun International's financial statements. You cannot use any other methods to check the receivables balances.

- 6. Your firm has been unusually busy, so you asked another audit firm to do about 30% of the audit for Spar Supermarkets, Inc. After a thorough review of their working papers, you are convinced that they did an excellent job on their portion of the audit. However, you are reluctant to take complete responsibility for their work.

Required:

For each situation, do the following:

- a) Identify which of the conditions requiring a modification of or a deviation from an unqualified standard report is applicable. **(6 marks)**
- b) State the level of materiality as immaterial, material, or highly material. If you cannot decide the level of materiality, state the additional information needed to make a decision. **(6 marks)**
- c) Given your answers in parts **a** and **b**, state the type of audit report that should be issued. If you have not decided on one level of materiality in part **b**, state the appropriate report for each alternative materiality level. **(6 marks)**

For neatness sake, tabulate your answers.

(Question : 5 Total marks 18)

QUESTION 6

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and nonfinancial data. They range from simple comparisons to the use of complex models involving many relationships and elements of data. They involve comparisons of recorded amounts, or ratios developed from recorded amounts, to expectations developed by the auditor.

Required:

- a) Describe the broad purposes of analytical procedures. **(4 marks)**
- b) When are analytical procedures required during an audit? Explain why auditors use analytical procedures extensively in all parts of the audit. **(3 marks)**
- c) Describe the factors that influence the extent to which an auditor will use the results of analytical procedures to reduce detailed tests in meeting audit objectives. **(3 marks)**

(Question 6 : Total marks 10)

QUESTION 7

- a) Why is independence so essential for auditors? **(3 marks)**
- b) Explain the difference between independence in appearance and of mind. **(4 marks)**
- c) Assume that a partner of an audit firm owns two shares of stock of a large audit client on which he serves as the engagement partner. The ownership is an insignificant part of his total wealth.
 - 1) Explain whether the ownership is likely to affect the partner's independence of mind.
 - 2) Explain the reason for the strict requirements about stock ownership in the rules of conduct. **(6 marks)**

(Question 7 : Total marks 13)

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