# UNIVERSITY OF SWAZILAND

## DEPARTMENT OF ACCOUNTING

## MAIN EXAMINATION QUESTION PAPER

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| DEGREE/YEAR OF STUDY | : | B COM IV |
| TITLE OF PAPER | : | AUDITING 1 |
| COURSE CODE | : | AC 417 |
| TOTAL MARKS | : | 100 MARKS |
| TIME ALLOWED | : | THREE (3) HOURS |
| INSTRUCTIONS | 1. | TOTAL NUMBER OF QUESTIONS ON THIS PAPER: FOUR (4) |
| | 2. | ANSWER ALL QUESTIONS |
| | 3. | WHERE APPLICABLE ALL WORKINGS SHOULD BE SHOWN |
| | 4. | ALL CALCULATIONS ARE TO BE MADE TO THE NEAREST LILANGENI. |

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 THE LAYOUT AND PRESENTATION OF YOUR FINAL ANSWER.

SPECIAL REQUIREMENT: NONE

THIS PAPER IS NOT TO BE OPENED UNTILL PERMISSION HAS BEEN GRANTED BY THE INVIGILATOR.

## QUESTION 1

Ingwe Enterprises Co (Ingwe) has been trading for 15 years selling insurance and has recently become a listed company. In accordance with corporate governance principles Ingwe maintains a small internal audit department. The directors feel that the team needs to increase in size and specialist skills are required, but they are unsure whether to recruit more internal auditors, or to outsource the whole function to their external auditors, Vusi & Co.

Ingwe is required to comply with corporate governance principles in order to maintain its listed status; hence the finance director has undertaken a review of whether or not the company complies.

John Dube is the chairman of Ingwe, until last year he was the chief executive. John is unsure if Ingwe needs more non-executive directors as there are currently three non-executive directors out of the eight board members. He is considering appointing one of his close friends, who is a retired chief executive of a manufacturing company, as a non-executive director.

The finance director, Mary Zondo, decides on the amount of remuneration each director is paid. Currently all remuneration is in the form of an annual bonus based on profits. Mary is considering setting up an audit committee, but has not undertaken this task yet as she is very busy. A new sales director was appointed nine months ago. He has yet to undertake his board training as this is normally provided by the chief executive and this role is currently vacant.

There are a large number of shareholders and therefore the directors believe that it is impractical and too costly to hold an annual general meeting of shareholders. Instead, the board has suggested sending out the financial statements and any voting resolutions by email; shareholders can then vote on the resolutions via email.

**Required:**

**(a) Explain the advantages and disadvantages for each of Ingwe Enterprises Co AND Vusi & Co of outsourcing the internal audit department.**

Note: The total marks will be split as follows:

| | | |
|---|---|---|
| Ingwe Enterprises Co | (8 marks) | |
| Vusi & Co | (2 marks) | (10 marks) |

**(b) In respect of the corporate governance of Ingwe Enterprises Co:**

**(i) Identify and explain FIVE corporate governance weaknesses; and**
**(ii) Provide a recommendation to address each weakness.**

Note: *The total marks will be split equally between each part.* (10 marks)

**(c)** Veli Industries is considering establishing an internal audit (IA) department next year. The finance director has asked whether the work performed by the IA department can be relied upon by Sipho & Co (a firm of external auditors of Veli Industries).

**Required:**

**Explain the factors that should be considered by an external auditor before reliance can be placed on the work performed by a company's internal audit department.**

(5 marks)

**(25 marks)**

## QUESTION 2

You are a member of the recently formed internal audit department of Orange Co (Orange). The company manufactures tinned fruit and vegetables which are supplied to large and small food retailers. Management and those charged with governance of Orange have concerns about the effectiveness of their sales and despatch system and have asked internal audit to document and review the system.

**Sales and despatch system:**

Sales orders are mainly placed through Orange's website but some are made via telephone. Online orders are automatically checked against inventory records for availability; telephone orders, however, are checked manually by order clerks after the call. A follow-up call is usually made to customers if there is insufficient inventory. When taking telephone orders, clerks note down the details on plain paper and afterwards they complete a three part pre-printed order form. These order forms are not sequentially numbered and are sent manually to both despatch and the accounts department.

As the company is expanding, customers are able to place online orders which will exceed their agreed credit limit by 10%. Online orders are automatically forwarded to the despatch and accounts department.

A daily pick list is printed by the despatch department and this is used by the warehouse team to despatch goods.

The goods are accompanied by a despatch note and all customers are required to sign a copy of this. On return, the signed despatch notes are given to the warehouse team to file.

The sales quantities are entered from the despatch notes and the authorised sales prices are generated by the invoicing system. If a discount has been given, this has to be manually entered by the sales clerk onto the invoice.

Due to the expansion of the company, and as there is a large number of sale invoices, extra accounts staff have been asked to help out temporarily with producing the sales invoices. Normally it is only two sales clerks who produce the sales invoices.

**Required:**

**(a) Describe TWO methods for documenting the sales and despatch system; and for each explain an advantage and a disadvantage of using this method.** (6 marks)

**(b) List TWO control objectives of Orange Co's sales and despatch system.** (2 marks)

**(c) Identify and explain SIX deficiencies in Orange Co's sales and despatch system and provide a recommendation to address each of these deficiencies.** (12 marks)

**(d) List and explain the purpose of FIVE items that should be included on every working paper prepared by the audit team.** (5 marks)

**(25 marks)**

## QUESTION 3

Cheese & Polony & Co (Cheese & Polony) is a firm of Chartered Certified Accountants which has seen its revenue decline steadily over the past few years. The firm is looking to increase its revenue and client base and so has developed a new advertising strategy where it has guaranteed that its audits will minimise disruption to companies as they will not last longer than two weeks. In addition, Cheese & Polony has offered all new audit clients a free accounts preparation service for the first year of the engagement, as it is believed that time spent on the audit will be reduced if the firm has produced the financial statements.

The firm is seeking to reduce audit costs and has therefore decided not to update the engagement letters of existing clients, on the basis that these letters do not tend to change much on a yearly basis. One of Cheese & Polony's existing clients has proposed that this year's audit fee should be based on a percentage of their final pre-tax profit. The partners are excited about this option as they believe it will increase the overall audit fee.

Cheese & Polony has recently obtained a new audit client, Ham Brothers Co (Ham), whose year end is 31 December. Ham requires their audit to be completed by the end of February; however, this is a very busy time for Cheese & Polony and so it is intended to use more junior staff as they are available. Additionally, in order to save time and cost, Cheese & Polony have not contacted Ham's previous auditors.

**Required:**

**(a) Describe the steps that Cheese & Polony should take in relation to Ham:**
**(i) Prior to accepting the audit; and** (5 marks)
**(ii) To confirm whether the preconditions for the audit are in place.** (3 marks)

**(b) State FOUR matters that should be included within an audit engagement letter.** (2 marks)

**(c) (i) Identify and explain FIVE ethical risks which arise from the above actions of Cheese & Polony & Co; and**
**(ii) For each ethical risk explain the steps which Cheese & Polony & Co should adopt to reduce the risks arising.**

Note: The total marks will be split equally between each part. (10 marks)

**(d) In the context of ISA 530 *Audit Sampling and Other Means of Testing*, explain and provide examples of the terms 'sampling risk' and 'non-sampling' risk.** (5 marks)

**(25 marks)**

**QUESTION 4**

**(a)** ISA 300 *Planning an Audit of Financial Statements* provides guidance to assist auditors in planning an audit.

**Required:**

**Explain the benefits of audit planning.** (3 marks)

**(b)** ISA 530 *Audit Sampling* provides guidance on methods for selecting a sample of items for testing.

**Required:**

**Identify and explain THREE methods of selecting a sample.** (3 marks)

Horizon Stores Co (Horizon) operates 25 food supermarkets. The company's year-end is 31 December 2014.
The audit manager and partner recently attended a planning meeting with the finance director and have provided you with the planning notes below.
You are the audit senior, and this is your first year on this audit. In order to familiarise yourself with Horizon, the audit manager has asked you to undertake some research in order to gain an understanding of Horizon, so that you are able to assist in the planning process. He has then asked that you identify relevant audit risks from the notes below and also consider how the team should respond to these risks.
Horizon has spent $1·6 million in refurbishing all of its supermarkets; as part of this refurbishment programme their central warehouse has been extended and a smaller warehouse, which was only occasionally used, has been disposed of at a profit. In order to finance this refurbishment, a sum of $1·5 million was borrowed from the bank.
This is due to be repaid over five years.
The company will be performing a year-end inventory count at the central warehouse as well as at all 25 supermarkets on 31 December. Inventory is valued at selling price less

an average profit margin as the finance director believes that this is a close approximation to cost.

Prior to 2014, each of the supermarkets maintained their own financial records and submitted returns monthly to head office. During 2014 all accounting records have been centralised within head office. Therefore at the beginning of the year, each supermarket's opening balances were transferred into head office's accounting records. The increased workload at head office has led to some changes in the finance department and in November 2014 the financial controller left. His replacement will start in late December.

**Required:**

**(c) List FIVE sources of information that would be of use in gaining an understanding of Horizon Stores Co, and for each source describe what you would expect to obtain.** (5 marks)

**(d) Using the information provided, describe FIVE audit risks and explain the auditor's response to each risk in planning the audit of Horizon Stores Co.** (10 marks)

**(e) Explain the external auditors' responsibilities in relation to the prevention and detection of fraud and error.** (4 marks)

**(25 marks)**

## End of Question Paper