

UNIVERSITY OF SWAZILAND
DEPARTMENT OF ACCOUNTING
MAIN EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY : B COM IV

TITLE OF PAPER : AUDITING 2

COURSE CODE : AC 418

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 INVIGILATER.

QUESTION 1

Leafnet Co (Leafnet) is a computer hardware specialist and has been trading for over five years. The company is funded partly through overdrafts and loans and also by several large shareholders; the year end is 30 April 2015.

Leafnet has experienced significant growth in previous years; however, in the current year a new competitor, Webnet Design Co (Webnet), has entered the market and through competitive pricing has gained considerable market share from Leafnet. One of Leafnet's larger customers has stopped trading with them and has moved its business to Webnet.

In addition, a number of Leafnet's specialist developers have left the company and joined Webnet. Leafnet has found it difficult to replace these employees due to the level of their skills and knowledge. Leafnet has just received notification that its main supplier who provides the company with specialist electrical equipment has ceased to trade.

Leafnet is looking to develop new products to differentiate itself from the rest of its competitors. It has approached its shareholders to finance this development; however, they declined to invest further in Leafnet. Leafnet's loan is long term and it has met all repayments on time. The overdraft has increased significantly over the year and the directors have informed you that the overdraft facility is due for renewal next month, and they are confident it will be renewed.

The directors have produced a cash flow forecast which shows a significantly worsening position over the coming 12 months. They are confident with the new products being developed, and in light of their trading history of significant growth, believe it is unnecessary to make any disclosures in the financial statements regarding going concern.

At the year end, Leafnet received notification from one of its customers that the hardware installed by Leafnet for the customers' online ordering system has not been operating correctly. As a result, the customer has lost significant revenue and has informed Leafnet that they intend to take legal action against them for loss of earnings. Leafnet has investigated the problem post year end and discovered that other work-in-progress is similarly affected and inventory should be written down. The finance director believes that as this misstatement was identified after the year end, it can be amended in the 2016 financial statements.

Required:

(a) Describe the procedures the auditors of Leafnet Co should undertake in relation to the uncorrected inventory misstatement identified above. (5 marks)

(b) Explain SIX potential indicators that Leafnet Co is not a going concern. (6 marks)

(c) Describe the audit procedures which you should perform in assessing whether or not Leafnet Co is a going concern. (8 marks)

(d) The auditors have been informed that Leafnet's bankers will not make a decision on the overdraft facility until after the audit report is completed. The directors have now agreed to include some going concern disclosures.

Required:

Describe the impact on the audit report of Leafnet Co if the auditor believes the company is a going concern but that this is subject to a material uncertainty. (6 marks)

(25 marks)

QUESTION 2

(a) Describe the auditor's responsibility for subsequent events occurring between:

(i) The year-end date and the date the auditor's report is signed; and

(ii) The date the auditor's report is signed and the date the financial statements are issued.
(7 marks)

(b) Savemore Co operates a chain of food wholesalers across the country and its year end was 31 March 2015.

The final audit is nearly complete and it is proposed that the financial statements and audit report will be signed on 13 June 2015. Revenue for the year is E78 million and profit before taxation is E7.5 million. The following events have occurred subsequent to the year end.

Receivable

A customer of Savemore Co has been experiencing cash flow problems and its year-end balance is E0.3 million.

The company has just become aware that its customer is experiencing significant going concern difficulties.

Savemore believe that as the company has been trading for many years, they will receive some, if not full, payment from the customer; hence they have not adjusted the receivable balance.

Lawsuit

A key supplier of Savemore Co is suing them for breach of contract. The lawsuit was filed prior to the year end, and the sum claimed by them is E1 million. This has been disclosed as a contingent liability in the notes to the financial statements; however correspondence has just arrived from the supplier indicating that they are willing to settle the case for a payment by Savemore Co of E0.6 million. It is likely that the company will agree to this.

Warehouse

Savemore Co has three warehouses; following extensive rain on 10 May 2015 significant rain and river water flooded the warehouse located in Bass. All of the inventory was damaged and has been disposed of. The insurance company has already been contacted. No amendments or disclosures have been made in the financial statements.

Required:

For each of the three events above:

(i) discuss whether the financial statements require amendment;

(ii) describe audit procedures that should be performed in order to form a conclusion on the amendment; and

(iii) explain the impact on the audit report should the issue remain unresolved. (18 marks)

Note: *The total marks will be split equally between each event.*

(25 marks)

QUESTION 3

(a) You are the audit manager in John & Co. One of your new clients this year is Sweets Co, a company having net assets of E15 million. The audit work has been completed, but there is one outstanding matter you are currently investigating; the directors have decided not to provide depreciation on buildings in the financial statements, although International Accounting Standards suggest that depreciation should be provided.

Required:

State the additional audit procedures and actions you should now take in respect of the above matter. (7 marks)

(b) Unfortunately, you have been unable to resolve the matter regarding depreciation of buildings; the directors insist on not providing depreciation. You have therefore drafted the following extracts for your proposed audit report.

1. *'We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement (remaining words are the same as a normal unmodified report).'*

2. *As discussed in Note 15 to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Accounting Standards.*

3. *The charge for the year ended 31 March 2015, should be E420,000 based on the straight-line method of depreciation using an annual rate of 5% for the buildings.*

4. *Accordingly, the non-current assets should be reduced by accumulated depreciation of E1,200,000 and the profit for the year and accumulated reserve should be decreased by E420,000 and E1,200,000, respectively.*

5. *In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements give a true and fair view ... (remaining words are the same as for an unmodified opinion paragraph).'*

The extracts have been numbered to help you refer to them in your answer.

Required:

Explain the meaning and purpose of each of the above extracts in your draft audit report. (12 marks)

(c) State the effect on your audit report of the following alternative situations:

(i) Depreciation had not been provided on any non-current asset for a number of years, the effect of which if corrected would be to turn an accumulated profit into a significant accumulated loss.

(ii) John & Co were appointed auditors after the end of the financial year of Sweets Co. Consequently, the auditors could not attend the year-end inventory count. Inventory is material to the financial statements.

Note: you are not required to draft any audit reports.

(6 marks)

(25 marks)

QUESTION 4

Kitchenmaster (Pty) assembles fridges, microwaves, washing machines and other similar domestic appliances from parts procured from a large number of suppliers. As part of the interim audit work two weeks prior to the company year-end, you are testing the procurement and purchases systems and attending the inventory count.

Procurement and purchases system:

Parts inventory is monitored by the store's manager. When the quantity of a particular part falls below re-order level, an e-mail is sent to the procurement department detailing the part required and the quantity to order. A copy of the e-mail is filed on the store manager's computer.

Staff in the procurement department check the e-mail allocates the order to an authorised supplier and send the order to that supplier using Electronic Data Interchange (EDI). A copy of the EDI order is filed in the order database by the computer system. The order is identified by a unique order number.

When goods are received at Kitchenmaster, the stores clerk confirms that the inventory agrees to the delivery note and checks the order database to ensure that the inventory were in fact ordered by Kitchenmaster. (Delivery is refused where goods do not have a delivery note.)

The order in the order database is updated to confirm receipt of goods, and the perpetual inventory system updated to show the receipt of inventory. The physical goods are added to the parts store and the paper delivery note is stamped with the order number and is filed in the goods inwards department.

The supplier sends a purchase invoice to Kitchenmaster using EDI; invoices are automatically routed to the accounts department. On receipt of the invoice, the accounts clerk checks the order database, matches the invoice details with the database and updates the database to confirm receipt of invoice. The invoice is added to the purchases database, where the purchase day book (PDB) and suppliers individual account in the payables ledger are automatically updated.

Required:

(a) Explain FOUR audit procedures that an auditor will normally perform prior to attending the client's premises on the day of the inventory count.

(4 marks)

(b) On the day of the inventory count, you attended depot nine at Kitchenmaster. You observed the following activities:

1. Prenumbered count sheets were being issued to client's staff carrying out the count. The count sheets showed the inventory ledger balances for checking against physical inventory.
2. All count staff were drawn from the inventory warehouse and were counting in teams of two.
3. Three counting teams were allocated to each area of the stores to count, although the teams were allowed to decide which pair of staff counted which inventory within each area. Staff was warned that they had to remember which inventory had been counted.
4. Information was recorded on the count sheets in pencil so amendments could be made easily as required.
5. Any inventory not located on the pre-numbered inventory sheets was recorded on separate inventory sheets – which were numbered by staff as they were used.
6. At the end of the count, all count sheets were collected and the numeric sequence of the sheets checked; the sheets were not signed.

Required:

- (i) List the weaknesses in the control system for counting inventory at depot nine.** (4 marks)
 - (ii) For each weakness, explain why it is a weakness and state how that weakness can be overcome.** (12 marks)
- (c) (i) State the aim of a test of control and the aim of a substantive procedure.**
- (ii) In respect of your attendance at Kitchenmaster's inventory count, state one test of control and one substantive procedure that you should perform.** (5 marks)

(25 marks)

End of Question Paper