

UNIVERSITY OF SWAZILAND
DEPARTMENT OF ACCOUNTING
MAIN EXAMINATION QUESTION PAPER

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

Prosper Enterprises Co (Prosper) has been trading for 15 years selling insurance and has recently become a listed company. In accordance with corporate governance principles Prosper 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, Sam & Co.

Prosper 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.

Henry Brown is the chairman of Prosper, until last year he was the chief executive. Henry is unsure if Prosper 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, Jane Lukhele, decides on the amount of remuneration each director is paid. Currently all remuneration is in the form of an annual bonus based on profits. Jane 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 Prosper Enterprises Co AND Sam & Co of outsourcing the internal audit department.

Note: The total marks will be split as follows:

Prosper Enterprises Co (8 marks)

Sam & Co (2 marks)

(10 marks)

(b) In respect of the corporate governance of Prosper 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) Safe 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 Muzi & Co (a firm of external auditors of Safe 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

Trends Co is a retailer of ladies clothing and accessories. It operates in many countries around the world and has expanded steadily from its base in Europe. Its main market is aimed at 15 to 35 year olds and its prices are mid to low range. The company's year-end was 30 September 2016.

In the past the company has bulk ordered its clothing and accessories twice a year. However, if their goods failed to meet the key fashion trends then this resulted in significant inventory write downs. As a result of this the company has recently introduced a just in time ordering system. The fashion buyers make an assessment nine months in advance as to what the key trends are likely to be, these goods are sourced from their suppliers but only limited numbers are initially ordered.

Trends Co has an internal audit department but at present their only role is to perform regular inventory counts at the stores.

Ordering process

Each country has a purchasing manager who decides on the initial inventory levels for each store, this is not done in conjunction with store or sales managers. These quantities are communicated to the central buying department at the head office in Europe. An ordering clerk amalgamates all country orders by specified regions of countries, such as Central Europe and North America, and passes them to the purchasing director to review and authorise.

As the goods are sold, it is the store manager's responsibility to re-order the goods through the purchasing manager; they are prompted weekly to review inventory levels as although the goods are just in time, it can still take up to four weeks for goods to be received in store.

It is not possible to order goods from other branches of stores as all ordering must be undertaken through the purchasing manager. If a customer requests an item of clothing, which is unavailable in a particular store, then the customer is provided with other branch telephone numbers or recommended to try the company website.

Goods received and Invoicing

To speed up the ordering to receipt of goods cycle, the goods are delivered directly from the suppliers to the individual stores. On receipt of goods the quantities received are checked by a sales assistant against the supplier's delivery note, and then the assistant produces a goods received note (GRN). This is done at quiet times of the day so as to maximize sales. The checked GRNs are sent to head office for matching with purchase invoices.

As purchase invoices are received they are manually matched to GRNs from the stores, this can be a very time consuming process as some suppliers may have delivered to over 500 stores. Once the invoice has been agreed then it is sent to the purchasing director for authorisation. It is at this stage that the invoice is entered onto the purchase ledger.

Required:

(a) As the external auditors of Trends Co, write a report to management in respect of the purchasing system which:

- (i) Identifies and explains FOUR deficiencies in that system;**
- (ii) Explains the possible implication of each deficiency;**
- (iii) Provides a recommendation to address each deficiency.**

A covering letter is required.

Note: Up to two marks will be awarded within this requirement for presentation. (14 marks)

(b) ISA 315 *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its*

Environment requires auditors to obtain an understanding of control activities relevant to the audit.

Control activities are the policies and procedures that help ensure that management directives are carried out; and which are designed to prevent and detect fraud and error occurring. An example of a control activity is the maintenance of a control account.

Required:

Apart from maintenance of a control account, explain FIVE control activities a company may undertake to prevent and detect fraud and error. (5 marks)

(c) Describe additional assignments that the internal audit department of Trends Co could be asked to perform by those charged with governance. (6 marks)

(25 marks)

QUESTION 3

Greens & Co (Greens) 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, Greens 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 Greens'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.

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

Required:

(a) Describe the steps that Greens should take in relation to Craig:

- (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 Greens & Co; and**
- (ii) For each ethical risk explain the steps which Greens & 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 2016.

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 2016, each of the supermarkets maintained their own financial records and submitted returns monthly to head office. During 2016 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 2016 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