

UNIVERSITY OF ESWATINI
DEPARTMENT OF ACCOUNTING
SUPPLEMENTARY EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY : B COM IV / B COM IV
TITLE OF PAPER : AUDITING 1
COURSE CODE : AC 417 /ACF 415
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

- (a) (i) Define the following terminologies: 'test of controls' and 'substantive procedures' (2 marks)

(ii) State ONE test of control and ONE substantive procedure in relation to sales invoicing. (2 marks)

- (b) Internal control systems are designed, amongst other things, to prevent error and misappropriation.

Required:

Describe the errors and misappropriations that may occur if purchases and capital expenditure are not properly controlled. (5 marks)

- (c) Khwesha is a high-quality, private motor manufacturing company. It has recently joined a consortium for the purchase of parts. Khwesha's purchases and capital expenditure systems are not integrated.

Purchases and capital expenditure

There are complex internal rules relating to what constitutes a purchase, and what constitutes capital expenditure and the budgets for both are tightly controlled. Problems associated with the internal rules result in a significant number of manual adjustments to the management accounts which take up an excessive amount of management time. The system for authorizing capital expenditure is not well controlled which results in some capital items being acquired without proper consideration, at the monthly meetings of the capital expenditure committee.

Purchase orders

Purchase orders are generated automatically by the computerized inventory system when inventory quantities fall below a given level in the context of scheduled production. This system does not work well because it uses outdated purchasing and production patterns and many manual adjustments are required. The orders are reviewed by the production controller and her junior managers and changes are made informally by junior clerical staff in the production controller's department.

Some of the purchases are input into the buying consortium system which shows the optimum supplier for any combination of cost, delivery time and specification. This system has only been in operation for a few months. The system takes up a substantial amount of disk space on the company's computers and is suspected of causing problems in other systems. It is difficult to use and so far, only two of the production controller's junior managers are able to use it. As a result, the parts ordered through the system are sometimes of the incorrect specification or are delivered late. The remaining purchases are ordered directly from

manufacturers, as before, through a reasonably well-controlled buying department.

Required:

Set out, in a form suitable for inclusion in a report to management, the weaknesses, potential consequences and your recommendations relating to the purchases and capital expenditure systems of Khwasha. (16 marks)

(25 marks)

QUESTION 2

(a) Contrast the role of internal and external auditors. (8 marks)

(b) Wagon Co designs and manufactures luxury motor vehicles. The company employs 2,500 staff and consistently makes a net profit of between 10% and 15% of sales. Wagon Co is not listed; its shares are held by 15 individuals, most of them from the same family. The maximum shareholding is 15% of the share capital.

The executive directors are drawn mainly from the shareholders. There are no non-executive directors because the company legislation in Wagon Co's jurisdiction does not require any. The executive directors are very successful in running Wagon Co, partly from their training in production and management techniques, and partly from their 'hands-on' approach providing motivation to employees.

The board is considering a significant expansion of the company. However, the company's bankers are concerned with the standard of financial reporting as the financial director (FD) has recently left Wagon Co. The board is delaying provision of additional financial information until a new FD is appointed.

Wagon Co does have an internal audit department, although the chief internal auditor frequently comments that the board of Wagon Co does not understand his reports or provide sufficient support for his department or the internal control systems within Wagon Co. The board of Wagon Co concur with this view. Anders & Co, the external auditors have also expressed concern in this area and the fact that the internal audit department's work focuses on control systems, not financial reporting. Anders & Co are appointed by and report to the board of Wagon Co.

The board of Wagon Co is considering a proposal from the chief internal auditor to establish an audit committee.

The committee would consist of one executive director, the chief internal auditor as well as three new appointees.

One appointee would have a non-executive seat on the board of directors.

Required:

Discuss the benefits to Wagon Co of forming an audit committee.

(12 marks)

(c) ISA 500 *Audit Evidence* requires audit evidence to be reliable.

Required:

List FIVE factors that may influence the reliability of audit evidence.

(5 marks)

(25 marks)

QUESTION 3

(a) Explain what is meant by 'corporate governance' and why it is important. (4 marks)

(b) Ingwe Co has been trading for over 20 years and obtained a listing on a stock exchange five years ago. It provides specialist training in accounting and finance.

The listing rules of the stock exchange require compliance with corporate governance principles, and the directors are fairly confident that they are following best practice in relation to this. However, they have recently received an email from a significant shareholder, who is concerned that Ingwe Co does not comply with corporate governance principles.

Ingwe Co's board is comprised of six directors of which four are executives who originally set up the company and two non-executive directors who joined Ingwe Co just prior to the listing. Each director has a specific area of responsibility and only the finance director reviews the financial statements and budgets. The chief executive officer, Vusi Dube, set up the audit committee and he sits on this sub-committee along with the finance director and the non-executive directors. As the board is relatively small, and to save costs,

Vusi Dube has recently taken on the role of chairman of the board. It is the finance director and the chairman who make decisions on the appointment and remuneration of the external auditors. Again, to save costs, no internal audit function has been set up to monitor internal controls.

The executive directors' remuneration is proposed by the finance director and approved by the chairman. They are paid an annual salary as well as a generous annual revenue related bonus.

Since the company's listing, the directors have remained unchanged and none have been subject to re-election by shareholders.

Required:

Describe SIX corporate governance weaknesses faced by Ingwe Co and provide recommendations to address each weakness, to ensure compliance with corporate governance principles (12 marks)

(c) Explain the auditor's ethical responsibilities with regard to client confidentiality and when they have an:

(i) obligatory responsibility; and

(ii) voluntary responsibility to disclose client information. (5 marks)

(d) ISA 315 *Understanding the Entity and its Environment and Assessing the Risks of Material Misstatement* states 'the auditor should perform . . . risk assessment procedures to obtain an understanding of the entity and its environment, including its internal control.'

Required:

Explain the purpose of risk assessment procedures. (4 marks)

(25 marks)

QUESTION 4

Mthunzi & Co (Mthunzi) is a firm of Chartered Certified Accountants which has seen its revenue decline steadily over the past few years. The firm is planning 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, Mthunzi 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 Mthunzi'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.

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

Required:

- (a) Describe the steps that Mthunzi should take in relation to Qwabe:
- (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 Mthunzi & Co; and
- (ii) For each ethical risk explain the steps which Mthunzi & 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)

End of Question Paper