

UNIVERSITY OF SWAZILAND

DEPARTMENT OF ACCOUNTING

SUPPLEMENTARY EXAMINATION QUESTION PAPER

DEGREE/YEAR OF STUDY : B COM IV

TITLE OF PAPER : AUDITING

COURSE CODE : AC 417

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

- (a) **Explain the difference between the interim audit and the final audit.** (5 marks)

You are an audit manager in NAB & Co, a large audit firm which specializes in the audit of retailers. The firm currently audits Goofy Co, a food retailer, but Goofy Co's main competitor, Mickey Co, has approached the audit firm to act as auditors. Both companies are highly competitive and Goofy Co is concerned that if NAB & Co audits both companies then confidential information could pass across to Mickey Co.

Required:

- (b) **Explain the safeguards that your firm should implement to ensure that this conflict of interest is properly managed.** (4 marks)

Goofy Co's year end is 31 December, which is traditionally a busy time for NAB & Co. Goofy Co currently has an internal audit department of five employees but they have struggled to undertake the variety and extent of work required by the company, hence Goofy Co is considering whether to recruit to expand the department or to outsource the internal audit department. If outsourced, Goofy Co would require a team to undertake monthly visits to test controls at the various shops across the country, and to perform ad hoc operational reviews at shops and head office.

Goofy Co is considering using NAB & Co to provide the internal audit services as well as remain as external auditors.

Required:

- (c) **Discuss the advantages and disadvantages to both Goofy Co and NAB & Co of outsourcing their internal audit department.** (10 marks)
- (d) The audit engagement partner for Goofy Co has been in place for approximately six years and her son has just accepted a job offer from Goofy Co as a sales manager; this role would entitle him to shares in Goofy Co as part of his remuneration package. If NAB & Co is appointed as internal as well as external auditors, then Goofy Co has suggested that the external audit fee should be renegotiated with at least 20% of the fee being based on the profit after tax of the company as they feel that this will align the interests of NAB & Co and Goofy Co.

Required:

From the information in (d) explain the ethical threats which may affect the independence of NAB & Co in respect of the audit of Goofy Co, and for each threat explain how it may be reduced. (6 marks)

(25 marks)

QUESTION 2

- (a) (i) Define a 'test of control' and a 'substantive procedure'; (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) Cosmo is a high-quality, private motor manufacturing company. It has recently joined a consortium for the purchase of parts. Cosmo'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 levels fall below a given level in the context of scheduled production. This system does not work well because the system 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 Cosmo. (16 marks)

(25 marks)

QUESTION 3

- (a) 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:

- (i) **Explain the purpose of risk assessment procedures.** (3 marks)
(ii) **Outline the sources of audit evidence the auditor can use as part of risk assessment procedures.** (3 marks)

- (b) **Explain the term 'audit risk' and the three elements of risk that contribute to total audit risk.** (4 marks)

The EuKaRe charity was established in 1960. The charity's aim is to provide support to children from disadvantaged backgrounds who wish to take part in sports such as tennis, badminton and football.

EuKaRe has a detailed constitution which explains how the charity's income can be spent. The constitution also notes that administration expenditure cannot exceed 10% of income in any year.

The charity's income is derived wholly from voluntary donations. Sources of donations include:

- (i) Cash collected by volunteers asking the public for donations in shopping areas,
(ii) Cheques sent to the charity's head office,

- (iii) Donations from generous individuals. Some of these donations have specific clauses attached to them indicating that the initial amount donated (capital) cannot be spent and that the income (interest) from the donation must be spent on specific activities, for example, provision of sports equipment. The rules regarding the taxation of charities in the country EuKaRe is based are complicated, with only certain expenditure being allowable for taxation purposes and donations of capital being treated as income in some situations.

Required:

- (c) **Identify areas of inherent risk in the EuKaRe charity and explain the effect of each of these risks on the audit approach.** (12 marks)
- (d) **Explain why the control environment may be weak at the charity EuKaRe.** (3 marks)
- (25 marks)**

QUESTION 4

- (a) **Contrast the role of internal and external auditors.** (8 marks)
- (b) Conoy 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. Conoy 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 Conoy Co's jurisdiction does not require any. The executive directors are very successful in running Conoy Co, partly from their training in production and management techniques, and partly from their 'hands-on' approach providing motivation to employees.

The board are 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 Conoy Co. The board are delaying provision of additional financial information until a new FD is appointed.

Conoy Co does have an internal audit department, although the chief internal auditor frequently comments that the board of Conoy Co do not understand his reports or provide sufficient support for his department or the internal control systems within Conoy Co. The board of Conoy 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 focuses work on control systems, not financial reporting. Anders & Co are appointed by and report to the board of Conoy Co.

The board of Conoy Co are 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 Conoy Co of forming an audit committee. (12 marks)

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

Required:

List FIVE factors that influence the reliability of audit evidence. (5 marks)

(25 marks)

End of Question Paper