

KASNEB

CPA PART III SECTION 6

ADVANCED AUDITING AND ASSURANCE

PILOT PAPER

September 2015.

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

- (a) Your audit firm has tendered for the audit of Hekima Group of Companies.

Required:

Evaluate six matters that should be considered before accepting the audit engagement in the event your firm is successful in the tender. (6 marks)

- (b) You are an audit manager in Hasibu and Co. working on the audit of Safari Group (The Group), whose financial year ended on 31 March 2015. This is the first time you have worked on group audit. The draft consolidated financial statements recognise profits before tax of Sh.600 million (2014 - Sh.900 million) and total assets of Sh.900 million (2014 - Sh.820 million). The group manufactures equipment used in telecommunication industry.

Goodwill of Sh.100 million is recognised in the group statement of financial position having arisen on several business combinations over the last few years. An impairment review was conducted in March 2015 by the group finance director, from which an impairment of Sh.5,000,000 is to be recognised in respect of goodwill.

The group finance director has prepared a file documentation to support the results of the impairment review, including notes on the assumptions used, his calculations and conclusions. He made the following comment:

"I don't think you need any evidence other than that contained in my file. The assumptions used are straightforward, so you need to look into them in detail. The assumptions are consistent with how we conducted impairment reviews in previous years and your firm has always agreed with the assumptions used; so you can check that back to last year's audit file. All of the calculations have been checked by the head of group internal audit department".

The group finance director has also informed you that two members of the sales team are suspected of paying bribes in order to secure lucrative customer contracts. The internal audit team were alerted of this when they were auditing cash payments and found significant payments to several new customers being made prior to the contract being signed. The Director has asked if Hasibu & Co. could perform a forensic investigation into the alleged bribery payments.

Required:

- (i) Discuss how professional skepticism should be applied to the statement made by the group finance director. (2 marks)
- (ii) Explain the principal audit procedures to be performed on the impairment of goodwill. (6 marks)
- (iii) Recommend two procedures to be used in performing a forensic investigation on alleged bribery payments. (6 marks)

(Total: 20 marks)

QUESTION TWO

- (a) Define the term "environmental matters" and discuss the implication environmental matters have on company's financial statements. (6 marks)
- (b) You are the audit manager of Kilimanjaro Co., a company which designs and manufactures aircraft engine parts. The audit of the financial statements for the year ended 31 December 2015 is nearing completion and you are reviewing the papers addressing the going concern section of the audit file. The draft financial statements recognise a loss of Sh.50 million (2014 - profit Sh.76 million) and total assets of Sh.138 million (2014 - Sh.144 million).

The audit senior has left the following note for your attention:

"I have performed analytical review on Kilimanjaro Co's year end financial statements. The current ratio is 0.8 (2014 - 1.2), the quick ratio is 0.5 (2014 - 1.6). The latest management accounts show that ratios have deteriorated further since the year end, and the company now has a cash balance of only Sh.2,500,000. Kilimanjaro Co. has a long-term loan outstanding of Sh.8 million with a covenant attached, which states that if the current ratio falls below 0.75, the loan can be immediately be recalled by the lender.

You are also aware that one of the Kilimanjaro Co.'s best selling product Mofire, has become technically obsolete during 2015 as customers now prefer more environmentally friendly engine parts. Historically the Mofire has generated 45% of the company's revenue. In response to customers preference, Sh.130m has been spent on designing a new product G-fire, due to launch in February 2016 which will be marketed as an environmentally friendly product.

A cash flow forecast has been prepared for the year ending 31 December 2016, indicating that based on certain assumptions, the company cash balance is predicted to increase to Sh.22 million by the end of the forecast period.

Assumptions include:

1. Successful launch of the G-fire product.
2. The sale of plant and machinery which was used to manufacture Mofire generating cash proceeds of Sh.0.5 million, forecast to take place in January 2016.
3. A reduction in payroll costs of 15%, caused by redundancies in the Mofire manufacturing plant.
4. The receipt of grant of Sh.300,000 from a government department which encourages innovation in environmentally friendly products, scheduled to be received in February 2016.

Required:

(a) Explain the matters which cast doubt on the going concern status of Kilimanjaro Co. (6 marks)

(b) Explain the audit evidence you should expect to find in your file review in respect of the cash flow forecast. (8 marks)

(Total: 20 marks)

QUESTION THREE

- (a) Kenya Lab Instruments Ltd. is an established manufacturing company producing laboratory instruments. The following extracts are from the company's final draft statement of financial position and income statement for the year ended 30 April 2015.

Income statement:

| | Year 2015 (Sh.000) | Year 2014 (Sh.000) |
|--------------|-----------------------|-----------------------|
| Sales | 351,760 | 378,845 |
| Gross profit | <u>243,993</u> | <u>286,505</u> |
| Net profit | <u>40,076</u> | <u>38,773</u> |

Statement of financial position:

| | | |
|-----------------------------|------------------|------------------|
| Fixed Assets: | | |
| Cost | 183,060 | 176,400 |
| Accumulated depreciation | <u>(114,993)</u> | <u>(105,840)</u> |
| | <u>68,067</u> | <u>70,560</u> |
| Current Assets: | | |
| Stock | 185,336 | 86,111 |
| Debtors | <u>67,627</u> | <u>63,141</u> |
| | <u>252,963</u> | <u>149,252</u> |
| Current Liabilities: | | |
| Creditors | 20,691 | 17,379 |
| Overdraft | <u>95,461</u> | <u>37,634</u> |
| | <u>116,152</u> | <u>55,013</u> |
| Net Assets | <u>204,878</u> | <u>164,799</u> |

The following issues arose during the audit assignment of which you are the manager:

1. Sales during the second half of the year were 40% below those in the first half.
2. Kenya Lab Instruments Ltd.'s main competitor Focus Instruments Ltd. has launched a new range of specialist equipment causing Kenya Lab Instruments Ltd.'s forward orders to fall significantly.
3. The current overdraft limit is Sh.700 million.
4. Plant and machinery costing of Sh.40 million, is fully depreciated and the production director advises that new machinery must be acquired within one year to avoid incurring excessive repair costs.

Required:

A file memorandum reviewing the above results and information and raising any issues which need to be resolved prior to the signing of the audit report. (10 marks)

- (b) There are specific regulatory obligations imposed on accountants and auditors in relation to detecting and reporting money laundering activities.

You have been asked to provide a training session to the new audit juniors on the auditor's responsibilities in relation to money laundering.

Required:

- (i) Explain the term "money laundering". Illustrate your explanation with examples of money laundering offences including those which could be committed by an accountant. (5 marks)
- (ii) Explain the policies and procedures that a firm of Certified Public Accountants should establish in order to meet its responsibilities in relation to money laundering. (5 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) Your firm audits H-Pound Ltd., a recognised East Africa's premier engineering construction and infrastructure company that undertakes construction contracts which include roads, bridges, warehouses, factories and offices. H-Pound Ltd. customers include governments and businesses. Recent cut-backs in local government expenditure have resulted in fewer contracts being started this year than budgeted.

The statement of accounting policy for construction contracts in H-Pound financial statements provides as follows:

"Revenue is recognised using the percentage of completion method, calculated on the basis of costs incurred as a percentage of expected costs.

"Anticipated losses are provided for in full as soon as the possibility of loss is forecast".

Direct costs attributed to specific contracts include:

- Architect's design costs, legal fees and engineering assistance.
- Material issued to site.
- Site supervision (apportioned foreman's salaries).
- Site labour costs (allocated from the payroll and subcontractors invoices).
- Costs of hiring suitable building and leasing plant and equipment.
- Depreciation of plant, equipment and vehicles.
- Transportation costs of resources such as materials between sites.
- Insurance and telephone.

Indirect expenses incurred by H-Pound Ltd.'s head office which relates to construction activities are attributed to the project at 70% of direct costs.

Last year, your firm qualified the auditor's report due to lack of evidence to support the client's schedule of estimated costs to completion.

During the year, a quantity surveyor joined the client's management team to undertake the following:

1. Supervise monthly physical counts at the major construction sites.
2. Monitor costs to date against the monthly rolling budget.
3. Prepare year-end schedules by contract of total cost of completion (that is direct costs incurred to the balance sheet date, attributable overheads and estimated costs to completion).

You are satisfied that the quantity surveyor is appropriately qualified and experienced.

Required:

- (i) Explain the principal audit risks to be considered when placing the approach to the final audit for the year ending 30 September 2015. (10 marks)
 - (ii) Explain the nature and extent of reliance which you should seek to place on the work of the quantity surveyor. (5 marks)
- (b) Explain the factors which have contributed to the increased number of lawsuits against auditors from third parties in recent years. (5 marks)
- (Total: 20 marks)**

QUESTION FIVE

Public sector auditing refers to the examination of and control of government receipts and payments with a view of assessing the benefits derived from the use of public property, utility or service and evaluate level of responsibility and accountability of government officers to the electorate.

The audit exercise is governed by professional norms of independence, competence and due care and it draws its mandate from the constitution. The client is in principle the government comprising the executive office, ministries, the treasury, county governments, independent departments and government executed projects.

Required:

- (a) Describe the comprehensive process in public sector audits. (4 marks)
 - (b) Briefly describe two main elements of public sector audits. (4 marks)
 - (c) Outline the status, functions and powers of the Controller and Auditor General. (12 marks)
- (Total: 20 marks)**
-