

# KASNEB

## CPA PART II SECTION 4

### 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

You are an audit manager in Ujima & Co. One of the your audit clients, Shangilia Africa Ltd. is a specialist supplier of African literature books with over 120,000 customers. The company owns one large warehouse which holds about 1 million books of up to 80,000 different titles. Customers place orders for books either over the internet or by mail order. Books are dispatched on the day of receipt of the order.

Returns are allowed up to 30 days from the dispatch date provided the books look neat and unread.

Due to high inventory turnover, Shangilia Africa Ltd. maintains a perpetual inventory system using standard purchased software. Ujima Co. has audited the system for the last five years and has found no error within the software.

Continuous inventory checking is carried out by Shangilia Africa Ltd.'s internal audit department.

You are currently reviewing the continuous inventory checking system with an audit junior. The audit junior needs experience in auditing continuous inventory checking systems and some basic knowledge on the code of ethics for professional accountants.

#### Required:

- (a) Explain four advantages of using a perpetual inventory system. (4 marks)
- (b) Summarise the audit procedures you would perform to confirm the accuracy of the continuous inventory checking at Shangilia Africa Ltd. Justify each of the procedures. (7 marks)
- (c) Explain five fundamental principles set out in the Code of Ethics for professional accountants. (5 marks)
- (d) During preliminary audit planning you note that the engagement letter has been returned unsigned by the directors of Shangilia Africa Ltd. When asked to explain their action, the directors indicate that they cannot allow you access to information on the company's new website development as this contains various trade secrets. You would not, therefore, be able to perform audit procedures on the research and development expenditure incurred on the website and included in non-current assets.  
Briefly explain four actions you would take as a result of directors not signing the engagement letter. (4 marks)

(Total: 20 marks)

#### QUESTION TWO

- (a) Outline the meaning of the following terms:
  - (i) Audit risk. (1 mark)
  - (ii) Inherent risk. (1 mark)
  - (iii) Control risk. (1 mark)
  - (iv) Detection risk. (1 mark)
- (b) My-family Car Hire Limited has a large fleet of cars for hire. The firm operates from twelve separate depots providing national car hire services around the country. It offers car hire services to corporate customers on credit payment terms, including payment by cash.

In addition to the car hire revenue, the company categorises income from the sales of excess damage waiver insurance premiums, the hire of child seats and satellite navigation systems as car hire income.

**Required:**

Explain three factors that would contribute to the assessment of high inherent risks applying to car hire income as reported in the financial statements of My-family Car Hire Limited. (6 marks)

- (c) (i) A Junior colleague working at your firm is uncertain as to why on every audit all of the work carried out by the audit team is regularly reviewed by the audit manager.

**Required:**

Explain the purpose of the review carried out by the audit manager. (5 marks)

- (ii) List two examples of subsequent events that may provide confirming evidence when auditing the financial statements of a large manufacturing company. (2 marks)

- (iii) State the auditor's responsibility for reporting on the going concern assumptions of a company. (3 marks)

**(Total: 20 marks)**

**QUESTION THREE**

- (a) Smiling Windows Co. (SW) is a window cleaning company. Customers windows are cleaned monthly. The window cleaner then posts a stamped addressed envelope for payment through the customer's front door.

SW has a large number of receivables balances. These customers pay by cheque or cash which is received in the stamped addressed envelopes through the post. The following procedures are applied to the cash received cycle:

1. A junior clerk from the accounts department opens the posts and if any cheques or cash have been sent, she records the receipts in the cash received log and then places all the monies into the locked small cash box.
2. The content of the cash box are counted each day and every few days these sums are banked by whichever member of the finance team is available.
3. The cashier records the details of the cash received log into the cash received day books and also updates the sales ledger.
4. Usually on a monthly basis the cashier performs bank reconciliation which he then files. If he misses a month then he catches this up in the following months' reconciliation.

**Required:**

- (i) Explain three deficiencies in the system. (3 marks)

- (ii) Suggest controls to address each of these deficiencies. (3 marks)

- (b) Describe the steps an audit firm should perform prior to accepting a new audit engagement. (5 marks)

- (c) Explain the term "International Standards on Auditing". (4 marks)

- (d) Outline how an audit committee may be of assistance in the relationship between the internal auditor and external auditor. (5 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

- (a) XYZ Ltd.'s directors have expressed an interest in your audit firm Tato & Co. to perform other review engagements in addition to the external audit. However, they are unsure how much assurance would be gained via these engagements and how these differ compared to the assurance provided by an external audit.

**Required:**

Identify and explain the level of assurance provided by an external audit and other review engagements. (4 marks)

- (b) Discuss the legal responsibilities of an auditor to shareholders and third parties during the course of their normal professional engagement and the mitigation measures that auditors may institute. (8 marks)

- (c) Knowledge of the business is crucial in determining the most effective and efficient audit strategy of an entity using the internet for electronic commerce. Any auditor needs to have an indepth understanding of the related risks and the measures to minimise them.

**Required:**

Discuss the impact of e-commerce on the audit process.

(8 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

Fitness Ltd. (fitness) is a client of your firm and runs both fitness and leisure centres all over your country. You are the audit senior on assignment and the audit field work for the year ended 31 December 2015 has just been completed. The following figures have been extracted from the draft financial statements:

	Year ended 31 December	
	2014	2013
	Sh. "000"	Sh. "000"
Revenue	5,000	5,300
Profit before tax	300	320
Taxation	(96)	(102)
Profit after tax	<u>204</u>	<u>213</u>

1. Fitness received fees from customers in November 2014 as they ran a special gym offer for the four months period from 1 November 2014 to 28 February 2015. The fees collected amounted to Sh.20,000 and the full amount had been recorded in revenue for the year ended 31 December 2014.
2. One of the directors is unwilling to disclose her interests in the shares of the company and currently this amount is not shown in the draft financial statements. The director holds 400 ordinary shares of the 200,000 issued ordinary shares of the company.
3. During the audit test of control performed on the revenue cycle, it was noted that the monthly prepared bank reconciliation had not been reviewed on a consistent basis by management.

**Required:**

- (a) Set an appropriate materialist level for fitness, showing your calculation. (4 marks)
- (b) Outline the testing you should perform on the revenue figure which arises from the gym membership fees. (4 marks)
- (c) Draft a memorandum to the audit partner in which you evaluate the potential implications for the audit report of fitness for the year ended 31 December 2014 arising from each of the three issues (1) to (3) described above. (12 marks)

**(Total: 20 marks)**

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