

# KASNEB

## CPA PART III SECTION 6

### ADVANCED AUDITING AND ASSURANCE

FRIDAY: 27 May 2016.

Time Allowed: 3 hours.

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

#### QUESTION ONE

You are the audit manager assigned the audit of the financial statements of Himaya Ltd. for the year ended 31 December 2015. You have come across three material items in the course of your audit which need to be concluded in order to form an audit opinion on the financial statements.

#### Required:

- (a) In the context of the above scenario, describe the audit work to be performed on the following matters:
- (i) The allowance for doubtful debts for the current financial year is Sh.15 million which represents 2.5% of the accounts receivable as at 31 December 2015. The allowance for doubtful debts for the three previous years was 5% of the accounts receivable. The credit controller has advised that the reduction in allowance was due to the measures undertaken to improve on debt collection and credit check procedures. (5 marks)
  - (ii) The directors' emoluments amounting to Sh.70 million during the year have not been disclosed in the financial statements. (4 marks)
  - (iii) Circularisation of a debtor owing the company Sh.68 million had not been done due to what the financial controller justified as "strained relations with the debtor". No cash has been received from the debtor and some documents regarding shipment to the customer are missing. (5 marks)
- (b) Explain how the three matters outlined in (a)(i), (ii) and (iii) above would impact on the auditors report, assuming that your best estimate of the appropriate allowance for doubtful debts is Sh.30 million and that no adjustments had been made in the financial statements in respect of the matters set out in items (a)(i), (ii) and (iii) above. (6 marks)
- (Total: 20 marks)

#### QUESTION TWO

Apex Ltd. was incorporated in the year 2012. The company deals with the extraction of sand, gravel and stone materials for residential and commercial building construction as well as for road construction projects. The following information relates to the affairs of the company during its few years of operation:

1. Apex Ltd. is currently working closely with sports complexes and golf course architects to develop sand of high quality for use in the construction and top dressing of golf courses and sports complex playing fields.
2. The company's profit has been declining mainly due to intense price competition from several smaller competitors. The managing director hopes that profits would improve in the year 2017 as a significant amount of the company's long term debt is payable by the year 2016. Apex Ltd. is currently involved in discussions with the banks on refinancing.
3. In late 2015, a significant theft took place at the company's quarry facility. Security was lax because it was believed that there was only low risk of these products being stolen given their nature as high volume low value products.

#### Required:

- (a) Discuss the reviews that could be carried out by the internal audit function in Apex Ltd. (12 marks)
- (b) Explain the potential obligations that might accrue to Apex Ltd. arising from an environmental audit. (8 marks)
- (Total: 20 marks)

#### QUESTION THREE

Bakari Ltd. acquired 75 per cent of the ordinary shares of Makali Ltd. on 30 June 2015 for Sh.20 million. The reserves of Makali Ltd. at the time of acquisition were Sh.10 million (credit).



The statements of financial position of the two companies as at 31 December 2015 were as follows:

**Statements of financial position as at 31 December 2015:**

	<b>Bakari Ltd.</b> Sh. "000"	<b>Makali Ltd.</b> Sh. "000"
Sundry assets	20,000	50,000
Investments in Makali Ltd.		
75,000 ordinary shares of Sh.100 each	<u>20,000</u>	-
	<u>40,000</u>	<u>50,000</u>
<b>Financed by:</b>		
Share capital	20,000	10,000
Revenue reserves	<u>20,000</u>	<u>40,000</u>
	<u>40,000</u>	<u>50,000</u>

**Additional information:**

The subsidiary company was audited by another auditing firm and the directors of the holding company agreed through a resolution that the audit firm would continue to audit the subsidiary company for the year ended 31 December 2015.

**Required:**

- (a) Describe the matters you would consider in the audit of the holding company, Bakari Ltd. (15 marks)
  - (b) Summarise the information that you would require from the auditors of the subsidiary company, Makali Ltd. (5 marks)
- (Total: 20 marks)**

**QUESTION FOUR**

You are responsible for the audit of Superior Packaging Ltd. for the year ended 31 March 2016. The principal activity of Superior Packaging Ltd. is the provision of high quality packaging services for manufacturing companies. The company was established 3 years ago and has significantly exceeded its growth targets in each subsequent year. Historically, the packaging process was labour intensive. However in December 2015, in an effort to reduce labour costs and increase efficiency, the company invested in an enhanced automated packing system. The investment was funded by a loan repayable in monthly instalments over 4 years. The loan agreement includes a covenant specifying that the company's debt equity ratio should not exceed 1:1.

A comparison of the draft financial statements for the year ended 31 March 2016 with the previous year's financial statements indicates a significant increase in the turnover (revenue) with a small increase in profitability. The company is currently trading in excess of its overdraft limit and is negotiating an increase in its facility with the bank. The management of the company has prepared, in support of its negotiations, profit and cash flow forecasts based on the assumption that the anticipated increase in efficiency and reduction in labour costs will be achieved.

The company has struggled to meet its wage bill obligations and fallen behind with PAYE, NHIF and NSSF remittances. It has also failed to comply with the terms of the lease in respect of the factory premises and has not paid the last three months' instalments.

**Required;**

- (a) Explain from the information provided above, factors which could indicate that Superior Packaging Ltd. might not be a going concern. (6 marks)
- (b) Describe the duties of the directors in respect of going concern basis of a company. (6 marks)
- (c) Where events have been identified which cast doubt on the appropriateness of the going concern basis, management should demonstrate to the auditors that they have identified the problem and have plans to deal with it.

Propose the procedures the auditors must carry out on the management plans and the possible impact to the auditors report. (8 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

- (a) Discuss the matters that a professional accountant should consider before accepting an engagement to report on prospective financial information of a company. (10 marks)
- (b) Zakayo and Associates were invited to tender for the audit of Premier Enterprises Ltd. for the financial year ended 31 December 2015. The firm was awarded the tender as it was the most competitive. The firm had used a low balling strategy when submitting their tender. During the course of the audit, the auditors have suspected the company is involved in money laundering activities.



**Required:**

- (i) Explain the term “low balling” citing the potential threat of low balling to the auditor’s independence. (4 marks)
- (ii) Define the term “money laundering”. (2 marks)
- (iii) With reference to the code of ethics and conduct for professional accountants, advise the action the auditors should take with respect to the suspected money laundering activities by the company. (4 marks)

**(Total: 20 marks)**

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