

# KASNEB

## CPA PART III SECTION 6

### ADVANCED AUDITING AND ASSURANCE

FRIDAY: 25 November 2016.

Time Allowed: 3 hours.

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

#### QUESTION ONE

Electronic Solutions Ltd. is a newly incorporated limited liability company. The company provides information technology services to overseas clients. The company relies heavily on information technology for operational activities. Most of the activities are captured online through a monitoring system. The company does not sell any of the systems that it has developed outright but has agreements with clients that permit the company to receive commissions based on the volume of transactions that flows through its system. The rates charged for the transactions vary with the volume of transactions.

The prevailing local taxation laws grant the company an income tax exemption for five years subject to the company complying with specific conditions. One of the conditions is that 90% of the company's income received during the year should be in foreign currency.

In order to grant exemption for the year ending 31 December 2016, the Revenue Authority has requested for an assurance report from the company auditors that 90% of the company's income is received in foreign currency.

#### Required:

- (a) Suggest with reasons the quality control objectives which are likely to be particularly relevant in the audit of Electronic Solutions Ltd. (10 marks)
- (b) Describe the additional audit procedures you would request the audit staff to perform in order to issue the assurance report. (10 marks)

(Total: 20 marks)

#### QUESTION TWO

Your audit firm, Makau Kilunda and Associates, are the auditors of Kikomi Manufacturing Group (KMG) Ltd. The group comprises various subsidiaries which were acquired over the last two years.

The subsidiary companies operate diverse businesses including but not limited to mining, agriculture, beauty products and steel manufacturing works. The CEO of KMG Ltd., Mr. Tim Kilonzo is very entrepreneurial and autocratic. KMG Ltd. is highly geared and recently acquired a listed company dealing in information communication technology solutions. A financial analyst had indicated in one of the respected financial magazines that the listed company was acquired at a very high price compared to the value of its assets.

Another large subsidiary which manufactures skin products has been sued by customers over some products which have allegedly adversely affected their skins. Some farmers also allege that the maize seeds supplied by one of the subsidiary companies were faulty and thus the seedlings withered one month after germination.

#### Required:

- (a) Assess the audit risk faced by Makau Kilunda and Associates in the course of the audit of Kikomi Manufacturing Group (KMG) Ltd. (6 marks)
- (b) Summarise the advantages of a business risk approach to the audit of KMG Ltd. (6 marks)
- (c)
  - (i) Undertake a business risk assessment of KMG Ltd. (4 marks)
  - (ii) Highlight how the business risk assessment in (c) (i) above might influence the audit process. (4 marks)

(Total: 20 marks)

**QUESTION THREE**

- (a) Your audit client, Informat Solutions Ltd., has requested your audit firm to undertake a forensic investigation related to a suspected payroll fraud at the company.

Analyse how the code of ethics for professional accountants would be applied in undertaking the forensic investigation of the suspected fraud in Informat Solutions Ltd. (10 marks)

- (b) Your audit senior has requested you to undertake a value for money audit during the course of your audit of a public sector organisation:

(i) Explain the importance of a value for money audit in the public sector. (4 marks)

(ii) Summarise six common areas that an auditor would consider when undertaking a value for money audit in an organisation. (6 marks)

**(Total: 20 marks)**

**QUESTION FOUR**

You are the audit manager responsible for the audit of Ixcel Group, an audit client for several years. All group companies had a financial year that ended on 31 March 2016. You are currently in the final phase of the group audit. The following matters were discussed during your review with their engagement partner:

1. Karen Ltd is a subsidiary of Ixcel Group. During the audit, the audit team observed several issues in relation to the entity's ability to continue as a going concern, as follows:
  - Karen Ltd. will not be able to continue without continuous support from Ixcel Group.
  - Ixcel Group has issued a letter of support also referred to as a "comfort letter" to Karen Ltd.
2. The directors' report for Ixcel Group stated that the group has maintained a gross profit margin of 30%. This percentage did not tally with the income statement. During your review, you observed that some "other income" items were considered when calculating the gross profit margin in the directors' report. The audit senior ignored this deviation in the directors' report observing that it was not relevant to the financial statements.
3. The audit senior has prepared a draft qualified audit opinion on the going concern issue considering the seriousness of the situation.

**Required:**

(a) Describe the purpose of support letters (comfort letters) as evidence in the audit of financial statements. (8 marks)

(b) (i) Critique the draft audit opinion by the audit senior justifying the opinion you would recommend. (6 marks)

(ii) Suggest with justification the audit opinion you would recommend based on the misstatement of the gross profit margin in the directors' report. (6 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

You are the partner responsible for providing direction to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence. They have also heard that in some countries, it is possible to restrict liability by making a liability limitation agreement with an audit client.

**Required:**

(a) Discuss the civil liabilities of an auditor under common law. (12 marks)

(b) Assess the potential implications to the audit profession of audit firms that sign a liability limitation agreement with their audit clients. (8 marks)

**(Total: 20 marks)**

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