

# KASNEB

## CPA PART III SECTION 6

### ADVANCED AUDITING AND ASSURANCE

FRIDAY: 26 May 2017.

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 responsible for the audit of Tamasha Ltd. for the year ended 30 June 2016. The audit fieldwork has been completed and the general manager in charge of finance is seeking to finalise the financial statements.

You are reviewing the audit file and the financial statements and have noted the following issues:

1. An investment held at the year end has since declined by Sh.1,250,000 in market value.
2. A tangible asset with a net book value of Sh.800,000 was sold on 29 June 2016. The final selling price was contingent on a valuer's report which was not received until 15 July 2016. As a result of this report, the profit recorded on this sale should be reduced by Sh.300,000.
3. A number of minor control points were noted and reported to management by way of a formal management letter.
4. Trade payables include a balance of Sh.700,000 owing to the parent company of Tamasha Ltd. The parent company has assured the general manager that it will not seek repayment of the amount for two years from the date the audit report is signed. The general manager will confirm this in the letter of representation.
5. A legal case which was ongoing at the year end has just been concluded. The case is disclosed and a provision of Sh.350,000 included in the draft financial statements. The outcome of the case was that Tamasha Ltd. should pay damages amounting to Sh.1,450,000 to the other party.

The draft financial statements, which do not contain any adjustments and some relevant disclosures relating to the above matters, show the following:

	Sh. "000"
Turnover	34,500
Profit before tax	2,900
Net current liabilities	(1,400)
Net assets	2,100

#### Required:

- (a) For each of the issues noted from your review, summarise the potential implications on the audit report. Treat each issue independently. (10 marks)
  - (b) Explain the overall audit opinion that you would express taking into consideration that no further adjustments or disclosures were made for the issues noted. (4 marks)
  - (c) Describe one other significant audit issue likely to arise from the above information. (3 marks)
  - (d) Outline further audit work you would perform arising from the potential audit issue identified in (c) above. (3 marks)
- (Total: 20 marks)**

#### QUESTION TWO

- (a) Pona Hospital is a referral hospital fully owned by the Government. Two years ago, on recommendation by the hospital's internal audit department, the management reviewed all aspects of hospital operations and implemented a number of measures aimed at improving overall "value for money" for the users of the facility.

Your audit firm has been requested to perform a review of the following measures which have been implemented so far:

1. Pona Hospital has one centralised purchasing department where all purchase requisitions for medical supplies are forwarded. Upon receipt, the procuring team will research on the lowest price from suppliers and a purchase order is raised. This is then forwarded to the purchasing manager who authorises all orders. The small purchasing team receives in excess of 200 requisition forms per day.

2. The human resource department has experienced difficulties in recruiting suitably trained staff. Overtime rates have been increased to incentivise permanent staff performing extra duties due to staffing gaps. This has been popular and reliance on expensive temporary staff has been reduced. Monitoring of staff hours had been difficult. However, the hospital has implemented time card procedures for clocking in and out. The hours clocked are used to calculate payments.
3. The hospital has invested heavily in new surgical equipment. Although the surgical equipment are very expensive, more surgeries can be performed and patient recovery rates are now faster. However, there is a shortage of appropriately trained medical staff and the equipment is underutilised. A capital expenditure committee has been established, made up of senior managers, to authorise future procurement of any significant capital expenditure items.

**Required:**

- (i) Analyse four strengths within Pona Hospital's internal control environment. (4 marks)
  - (ii) For each of the strengths analysed in (a)(i) above, recommend further improvements in order to provide best value for money. (8 marks)
- (b) Your firm has been invited by Mr. Abdalla Juma, the Managing Director of Msingi Bora Ltd., to accept appointment as auditors of the company. You establish that the present firm of auditors will not be reappointed when their term of office expires as Msingi Bora Ltd. is dissatisfied with their services.

Mr. Juma has further requested that:

1. An employee of your firm assumes responsibility of preparing monthly management accounts on tight deadlines. The continuation of the overdraft facility by the company's banker is dependent on the receipt of these accounts by the bank within ten days of each month end.
2. The audit partner in your firm attends the monthly board meetings, mainly to explain the management accounts to the other directors.

**Required:**

Describe the matters that you would consider in deciding whether to accept the above appointment as auditor and to provide the additional services as requested. (8 marks)

**(Total: 20 marks)**

**QUESTION THREE**

- (a) Periodically, there arises debate within and outside the accountancy profession on the independence of auditors. One suggestion floated to improve auditor independence is to have compulsory rotation of audit firms after a pre-determined period.

**Required:**

- (i) Discuss four ethical threats created by a long association with an audit client. (8 marks)
  - (ii) Evaluate three advantages and three disadvantages of compulsory rotation of audit firms. (6 marks)
- (b) You are a newly appointed auditor of Shida Ltd. You have recently ascertained the following about your new client:

1. The company has two major customers and a few small-sized customers.
2. The company recently purchased a very large and complex computer system as part of its automation process. The administration staff do not have adequate competence to run the system properly.
3. The Chief Executive Officer of the company, Albert Amingi, has a dominating personality and is overbearing on his subordinates.
4. The company has no formal management accounting system. The new computer system is supposed to remedy this gap.

**Required:**

Justifying your answer, suggest an appropriate audit strategy for the first audit of Shida Ltd.

(6 marks)

**(Total: 20 marks)**

#### QUESTION FOUR

Kenya Construction Ltd. (KCL), a company involved in construction of residential houses for sale, has sued their outgoing general manager over matters of financial impropriety. Kelly Limited, which owns 70% of the shares in KCL is also a complainant against the general manager of KCL on the basis that Sh.60 million advanced by the company to KCL was not refunded. The High Court has ordered the lawyers representing the parties in the above case to liaise with their clients and appoint an independent auditor who would scrutinise the documents submitted by the general manager as ordered by the Court. Thereafter, the independent auditor is to file a report to the Court.

The main issues being raised between Kelly Limited and KCL are as follows:

1. All the houses planned to be constructed and sold were actually constructed and sold.
2. All the buyers had paid KCL all monies due.
3. The general manager kept changing contractors and the terms of contract for personal gain.
4. The general manager engaged in excessive overseas travels for personal errands using company resources.
5. The general manager did not maintain proper books of account and did not retain all business vouchers as expected.
6. The general manager did not file VAT, PAYE, corporate tax and social security returns as expected thereby exposing the company to fines and penalties. Failure to file returns was aimed at concealing the general manager's malfeasance.
7. Although all houses were sold, KCL still owed Kelly Limited Sh.60 million and had a bank overdraft of Sh.80 million secured against some of the houses already disposed of.
8. The present cost was grossly overstated through unexplained and unsupported expenditure. The general manager violated all known principles of good project governance regarding execution, supervision and handing over of a project.

#### Required:

Assuming you have been appointed the forensic auditor in the above case:

- (a) Describe how you would deal with each of the issues numbered 1 to 8 above. (16 marks)
  - (b) Explain how you would ensure that you are effective in the provision of valuable evidence to the Court. (4 marks)
- (Total: 20 marks)**

#### QUESTION FIVE

A newspaper article contains the following:

"The role of statutory auditors is often misunderstood. In particular, there is confusion over the auditor's responsibilities in respect to fraud and the nature of the assurance provided by an audit. Furthermore, following a number of corporate collapses and the revelation of fraud perpetrated by management, it is the auditors who may be sued for large sums of money. This trend is threatening the future of the auditing profession. The majority of auditors would prefer the current legislation to be changed to enable auditors agree on a contractual cap on liability (that is, a limit on the monetary amount which the auditors could pay out in damages)".

#### Required:

- (a) Compare and contrast the responsibilities of auditors and directors of a company in relation to the prevention and detection of fraud. (6 marks)
  - (b) Explain why the statutory audit cannot provide absolute assurance that the financial statements are free from misstatement whether caused by fraud, error or other irregularity. (6 marks)
  - (c) Discuss in each case, four arguments for and against changing the legislation to allow auditors to agree on a contractual cap on liability in respect to the statutory audit. (8 marks)
- (Total: 20 marks)**
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