**EGERTON UNIVERSITY**

**NAKURU TOWN CAMPUS COLLEGE**

**BCOM 412: AUDITING 2**

**TIME: 2 HRS**

**ATTEMPT QUESTION ONE AND CHOOSE TWO OTHER QUESTIONS**

1. The following are examples of audit procedures:
2. Review the accounts receivable with the credit manager to evaluate their collectability.
3. Compare a duplicate sales invoice with the sales journal for customer name and amount.
4. Add the sales journal entries to determine whether they were correctly totaled.
5. Count inventory items and record the amount in the audit files.
6. Obtain a letter from the client’s attorney addressed to the CPA firm stating that the attorney is not aware of any existing lawsuits.
7. Extend the cost of inventory times the quantity on an inventory listing to test whether it is accurate.
8. Obtain a letter from an insurance company to the CPA firm stating the amount of the fire insurance coverage on buildings and equipment.
9. Examine an insurance policy stating the amount of the fire insurance coverage on buildings and equipment.
10. Calculate the ratio of cost of goods sold to sales as a test of overall reasonableness of gross margin relative to the preceding year.
11. Obtain information about internal control by requesting the client to fill out a questionnaire.
12. Trace the total in the cash disbursements journal to the general ledger.
13. Watch employees count inventory to determine whether company procedures are being followed.
14. Examine a piece of equipment to make sure that a major acquisition was actually received and is in operation.
15. Calculate the ratio of sales commission expense to sales as a test of sales commissions.
16. Examine corporate minutes to determine the authorization of the issue of bonds.
17. Obtain a letter from management stating that there are no unrecorded liabilities.
18. Review the total of repairs and maintenance for each month to determine whether any month’s total was unusually large.
19. Obtain a written statement from a bank stating that the client has Ksh.15, 671 on deposit and liabilities of Ksh.500, 000 on a demand note.

Classify each of the preceding items according to the eight types of audit evidence: (18 mks)

b. Below are six independent risk factors:

1. The client lacks sufficient working capital to continue operations.
2. The client fails to detect employee theft of inventory from the warehouse because there are no restrictions on warehouse access and the client does not reconcile inventory on hand to recorded amounts on a timely basis.
3. The company is publicly traded.
4. The auditor has identified numerous material misstatements during prior year audit engagements.
5. The assigned staffs on the audit engagement lack the necessary skills to identify actual errors in an account balance when examining audit evidence accumulated.
6. The client is one of the industry’s largest based on its size and market share.

Identify and explain which of the following audit risk model components relates most directly to each of the six risk factors: (12 mks)

• Acceptable audit risk.

• Inherent risk.

• Control risk.

• Planned detection risk.

2.

The following are commonly performed tests of controls and substantive tests of transactions audit procedures in the sales and collection cycle:

1. Account for a sequence of shipping documents and examine each one to make sure that a duplicate sales invoice is attached.
2. Account for a sequence of sales invoices and examine each one to make sure that a duplicate copy of the shipping document is attached.
3. Compare the quantity and description of items on shipping documents with the related duplicate sales invoices.
4. Trace recorded sales in the sales journal to the related accounts receivable master file and compare the customer name, date, and amount for each one.
5. Examine sales returns for approval by an authorized official.
6. Review the prelisting of cash receipts to determine whether cash is prelisted daily.
7. Reconcile the recorded cash receipts on the prelisting with the cash receipts journal and the bank statement for a 1-month period.

a. Identify whether each audit procedure is a test of control or a substantive test of transactions (14 mks).

b. State which of the six transaction-related audit objectives each of the audit procedures fulfills (3 mks).

c. Identify the type of evidence used for each audit procedure, such as documentation and observation (3 mks).

3.

a. Describe what is meant by an operational audit. (2 mks)

b. Identify the three major differences between financial and operational auditing. (4 mks)

c. Distinguish efficiency and effectiveness in operational audits. Give an example of an operational audit explaining efficiency and another explaining effectiveness. (4 mks)

d. Explain the difference between the independence of internal auditors and external auditors in the audit of historical financial statements. How can internal auditors’ best achieve independence? (4 mks).

e. Distinguish between a test of control and a substantive test of transactions. Give three examples of each. (6 mks).

4.

a. List four things an auditor must consider when establishing professional fees. What is meant by “lowballing?” (4 mks)

b. Define a contingency fee. Why should a contingency fee not be used? What are the two exceptions for using contingency fees? (4 mks)

c. Briefly list the four items found in a continuing client audit proposal. List and define the items that may be found in an audit proposal for a new client. (4 mks)

d. What should be included in an engagement letter? What are some reasons a client might change the terms of the engagement? (4 mks)

e. Under what circumstances will an auditor send a new engagement letter each year to a continuing client? (4 mks)

5.

Auditors must not only appear to be independent; they must also be independent in fact.

*Required*:

A. Explain the concept of auditor’s independence as it applies to third-party reliance upon financial statements. (8 mks)

B. Explain how an auditor may be independent in fact but not appear to be independent. (2 mks)

C. Would an accountant in public practice be considered independent for a review of the financial statement of:

* + A church in which the accountant is serving as treasurer? (2 mks)
  + A club for which the accountant’s spouse is serving as a treasurer-bookkeeper if the accountant. (2 mks)
  + Discuss the six ways in which independence of an auditor may be increased. (6 mks).