**EGERTON UNIVERSITY**

**NAKURU TOWN CAMPUS COLLEGE**

**BCOM 412: AUDITING II**

**INSTRUCTIONS: ATTEMPT QUESTION 1 AND CHOOSE 2 OTHER QUESTIONS**

1. Read the passage below and use it, together with your knowledge of auditing II to answer the questions that follow.

**Auditor rotation**

**Regulators are considering forcing companies to change their auditors**

IT WAS the year of the first X-ray, the first fatal car accident and the premiere of “La Bohème”. And 1896 was also the year that Barclays, a British bank, chose an ancestor of PriceWaterhouseCoopers (PwC) as its auditor, a relationship unbroken to this day. Fidelity is the norm in auditing. GE, Procter & Gamble and Dow Chemical have also clocked up centuries with their auditors. The average tenure for an auditor of a British FTSE 100 company is 48 years. Two-thirds of Germany’s DAX 30 have had their auditors for over 20 years.

Auditors say it helps to know their clients’ business intimately. But companies that ran into trouble in the financial crisis—Lehman Brothers, AIG and GM, for example—were with their auditors for decades without obvious benefit to investors. And regulators are increasingly worried that chumminess with clients erodes auditors’ independence. In August James Doty, the head of America’s Public Company Accounting Oversight Board, floated an old idea, forcing firms to rotate audit firms after a set (and as yet undefined) period. Michel Barnier, the European Union’s commissioner for the internal market, also raised mandatory rotation in a “green paper” last year and it is likely to feature in formal proposals this November.

The Big Four accounting firms—PwC, Deloitte, Ernst & Young and KPMG—say forced rotation will erode audit quality. There is some evidence for this. Audit problems can be gauged by factors like the size of the discretionary accruals that firms are allowed to make and the frequency with which accounts are restated. According to Billy Soo of Boston College, such red flags tend to pop up at the beginning of auditors’ tenures, when accountants are too green to spot potential problems, and again well into the relationship—after about 14 years, he and colleagues calculate. But he says that the problems at the beginning are two to three times more common, and is sceptical about forced rotation.

Italy has had mandatory rotation since 1974; an auditor’s term with a client is limited to nine years. A 2002 study found that 69% of Italian bosses were happy enough with this arrangement. But that’s like polling foxes on which chicken coops they prefer. One of the authors, Mara Cameran of Bocconi University, found that mandatory rotation tends to worsen audit quality. Other experiments have been too brief to produce firm conclusions.

Proposals abound for improving audit performance. Some are modest—greater use of explanatory paragraphs in audit reports, for example. Some are more dramatic: having auditors appointed by regulators, or stripping out audit firms from the multidisciplinary monsters (conducting audits, accounting, IT, Human resources, e.t.c.) the Big Four have become. Mandatory rotation would probably not do much harm; but it might well not do much good, either.

(**Source:** *The Economist, Sep 3rd 2011* | *NEW YORK* | from the print edition)

1. From the above passage, cite and critically analyze the advantages and disadvantages of having external auditors reigning for long with one organization. (6 mks).
2. In your own opinion, would you advocate for or against the mandatory rotation of auditors? Discuss. (4 mks).
3. Discuss FOUR factors that may erode the independence of an auditor, and explain in what ways the reign (number of years auditing one business firm) of an auditor can affect independence. (8 mks).
4. From the passage above, cite and critically analyze the proposals put forward to improve audit performance. (6 mks)
5. List and discuss THREE measures you would implement at your place of work to improve the independence of the internal audit function bearing in mind that most internal auditors are employees of the organization. (6 mks).
6. ‘Computer emergency readiness team (CERT) shows that 80% of all malicious activity comes from current or former employees, yet most organizations spend over 75% of their IT security budgets to protect against outsiders.’ (**Source:** ISACA JOURNAL, Vol. III, 2010)
7. Discuss three **entity level** controls and two **general controls** that should be put in place to protect against this insider threat. (10 mks).
8. What five **access controls** would you recommend to minimize the threat from employees and other insiders? Discuss.
9. Highlight four major functions of the revenue process. (4 mks)
10. Explain two areas in the revenue process where segregation of duties should be put in place. (4 mks).
11. Distinguish between positive and negative confirmation. When is each type of confirmation appropriate? (4 mks).
12. Expound on any two substantive analytical procedures, and two tests of details that you would conduct in an audit of the revenue process. (8 mks)

Explain audit tests that you would conduct for the following items in the light of manufacturing organization. (20 mks)

1. Remuneration of employees (Salaries and wages).
2. Purchases.
3. Stock/ Inventory.
4. Investments.
5. Share capital.
6. List and explain FOUR different classifications of audit. (4 mks)
7. Distinguish between internal and external audit. (6 mks)
8. Critically evaluate the relationship between internal audit and external audit in the light of a commercial organization. (10 mks).