**EGERTON UNIVERSITY**

**NAKURU TOWN CAMPUS COLLEGE**

BCOM 412: AUDITING II TIME: 2 HOURS

ATTEMPT QUESTION ONE AND CHOOSE TWO OTHER QUESTIONS

**QUESTION ONE (30 mks)**

1. As auditor of the Star Manufacturing Company, you have obtained:
2. a trial balance taken from the books of STAR one month before year-end:

Cash in bank 87,000

Trade accounts receivable 345,000

Notes receivable 125,000

Inventories 317,000

Land 66,000

Buildings, net 350,000

Furniture, fixtures, and equipment, net 325,000

Trade accounts payable (235,000)

Mortgages payable (400,000)

Capital stock (300,000)

Retained earnings (510,000)

Sales (3,130,000)

Cost of sales 2,300,000

General and administrative expenses 622,000

Legal and professional fees 3,000

Interest expense 35,000

1. There are no inventories consigned either in or out.
2. All notes receivable are due from outsiders and held by STAR.

**REQUIRED;**

Which accounts should be confirmed with outside sources? Briefly describe from whom they should be confirmed and the information that should be confirmed. (12 mks)

Organize your answer in the following format:

|  |  |  |
| --- | --- | --- |
| Account name | From whom confirmed | Information to be confirmed |
|  |  |  |

1. During audit planning, an auditor obtained the following information:
2. Management has a strong interest in employing inappropriate means to minimize reported earnings for tax-motivated reasons.
3. The company’s board of directors includes a majority of directors who are independent of management.
4. Assets and revenues are based on significant estimates that involve subjective judgments and uncertainties that are hard to corroborate.
5. The company is marginally able to meet exchange listing and debt covenant requirements.
6. New accounting pronouncements have resulted in explanatory paragraphs for consistency for the company and other firms in the industry.
7. The company has experienced low turnover in management and its internal audit function.
8. Significant operations are located and conducted across international borders in jurisdictions where differing business environments and cultures exist.
9. There are recurring attempts by management to justify marginal or inappropriate accounting on the basis of materiality.
10. The company’s financial performance is threatened by a high degree of competition and market saturation.

**REQUIRED**

a. Indicate whether the information indicates an increased risk for fraud (Write YES/NO Against each statement). (4.5 mks)

b. If the information indicates an increased risk of fraud, indicate which fraud condition (that is incentives/pressures, opportunities, or attitudes/rationalization, or concealment) is indicated (4.5 mks).

1. Assessing the risk of fraud in a financial statement audit is a difficult audit judgment. Auditing standards require the auditor to perform several audit procedures to accumulate information to assess the risk of fraud. You are the in-charge auditor responsible for planning the financial statement audit of Spencer, Inc. Two new staff auditors are assisting you with the initial audit planning and have asked you the following questions. Briefly summarize your response to these staff auditor questions:

**REQUIRED**

1. What is the purpose of the audit team’s brainstorming session? (2 mks)
2. Who should attend the brainstorming session and when should the session be held? (2 mks)
3. What is the role of the two staff auditors in the brainstorming session? (2 mks)
4. What is the auditor’s responsibility under auditing standards for detecting fraud? (3 mks)

**QUESTION 2 (20 MKS)**

Items i through x present various internal control strengths or internal control deficiencies.

1. Credit is granted by a credit department.
2. Once shipment occurs and is recorded in the sales journal, all shipping documents are marked “recorded” by the accounting staff.
3. Sales returns are presented to a sales department clerk who prepares a written, pre-numbered receiving report.
4. Cash receipts received in the mail are received by a secretary with no recordkeeping responsibility.
5. Cash receipts received in the mail are forwarded unopened with remittance advices to accounting.
6. The cash receipts journal is prepared by the treasurer’s department.
7. Cash is deposited weekly.
8. Statements are sent monthly to customers.
9. Write-offs of accounts receivable are approved by the controller.
10. The bank reconciliation is prepared by individuals independent of cash receipts record keeping.

a. For each of the preceding i–x items, indicate whether the item represents an:

1. Internal control strength for the sales and collection cycle.
2. Internal control deficiency for the sales and collection cycle. (10 mks)

b. For each item that you answered (1), indicate the transaction-related audit objective(s) to which the control relates (4 mks).

c. For each item that you answered (2), indicate the nature of the deficiency and recommend way(s) to remedy the deficiency (6 mks).

**QUESTION 3 (20 MKS)**

NAKURU Company has an internal audit department consisting of a manager and three staff auditors. The manager of internal audits, in turn, reports to the corporate controller. Copies of audit reports are routinely sent to the audit committee of the board of directors as well as to the corporate controller and the individual responsible for the area or activity being audited. The manager of internal audits is aware that the external auditors have relied on the internal audit function to a substantial degree in the past. However, in recent months, the external auditors have suggested there may be a problem related to the objectivity of the internal audit function. This objectivity problem may result in more extensive testing and analysis by the external auditors.

The external auditors are concerned about the amount of non-audit work performed by the internal audit department. The percentage of non-audit work performed by the internal auditors in recent years has increased to about 25% of their total hours worked. A sample of five recent non-audit activities is as follows:

1. One of the internal auditors assisted in the preparation of policy statements on internal control. These statements included such things as policies regarding sensitive payments and standards of control for internal controls.

2. The bank statements of the corporation are reconciled each month as a regular assignment for one of the internal auditors. The corporate controller believes this strengthens internal controls because the internal auditor is not involved in the receipt and disbursement of cash.

3. The internal auditors are asked to review the budget data in every area each year for relevance and reasonableness before the budget is approved. In addition, an internal auditor examines the variances each month, along with the associated explanations.

These variance analyses are prepared by the corporate controller’s staff after consultation with the individuals involved.

4. One of the internal auditors has recently been involved in the design, installation, and initial operation of a new computer system. The auditor was primarily concerned with the design and implementation of internal accounting controls and the computer application controls for the new system. The auditor also conducted the testing of the controls during the test runs.

5. The internal auditors are often asked to make accounting entries for complex transactions before the transactions are recorded. The employees in the accounting department are not adequately trained to handle such transactions. In addition, this serves as a means of maintaining internal control over complex transactions. The manager of internal audits has always made an effort to remain independent of the corporate controller’s office and believes that the internal auditors are objective and independent in their audit and non-audit activities.

a. Define *objectivity* as it relates to the internal audit function. (4 mks)

b. For each of the five situations outlined, explain whether the objectivity of NAKURU

Company’s internal audit department has been materially impaired. Consider each situation independently. (10 mks)

c. The manager of audits reports to the corporate controller.

1. Does this reporting relationship result in a problem of objectivity? Explain your answer. (2 mks)
2. Would your answer to any of the five situations in requirement b have changed if the manager of internal audits reported to the audit committee of the board of directors? Explain your answer. (4 mks)

**QUESTION 4**

Following are six situations that involve the audit risk model as it is used for planning audit evidence requirements. Numbers are used only to help you understand the relationships among factors in the risk model.

|  |  |  |  |  |  |  |
| --- | --- | --- | --- | --- | --- | --- |
| Risk | Situation | | | | | |
|  | 1 | 2 | 3 | 4 | 5 | 6 |
| Acceptable audit risk | 5% | 5% | 5% | 5% | 1% | 1% |
| Inherent risk | 100% | 40% | 60% | 20% | 100% | 40% |
| Control risk | 100% | 60% | 40% | 30% | 100% | 60% |
| Planned detection risk | - | - | - | - | - | - |

a. Explain what each of the four risks means. (8 mks)

b. Calculate planned detection risk for each situation. (6 mks)

c. Which situation requires the greatest amount of evidence and which requires the least? (2 mks)

d. Using your knowledge of the relationships among the foregoing factors, state the effect on planned detection risk (increase or decrease) of changing each of the following factors while the other two remain constant:

1. An increase in control risk. (1 mk)
2. A decrease in inherent risk. (1 mk)
3. An increase in control risk and a decrease in inherent risk of the same amount (2 mk)

**QUESTION 5**

In the normal course of performing their responsibilities, auditors often conduct audits or reviews of the following:

* 1. Income tax returns of an officer of the corporation to determine whether he or she has included all taxable income in his or her return.
  2. Disbursements of a branch of the government for a special research project to determine whether it would have been possible to accomplish the same research results at a lower cost to the taxpayers.
  3. Computer operations of a corporation to evaluate whether the computer center is being operated as efficiently as possible.
  4. Annual statements for the use of management.
  5. Operations of the Kenya Revenue Authority (KRA) to determine whether the revenue agents are using their time efficiently in conducting audits.
  6. Statements for bankers and other creditors when the client is too small to have an audit staff.
  7. Financial statements of a branch of the government to make sure that the statements present fairly the actual disbursements made during a period of time.
  8. Income tax returns of a corporation to determine whether the tax laws have been followed.
  9. Financial statements for use by stockholders when there is an internal audit staff.
  10. A bond indenture agreement to make sure a company is following all requirements of the contract.
  11. The computer operations of a large corporation to evaluate whether the internal controls are likely to prevent misstatements in accounting and operating data.
  12. Disbursements of a branch of the government for a special research project to determine whether the expenditures were consistent with the legislative bill that authorized the project.

**REQUIRED**

1. For these 12 examples, state the most likely type of auditor (Internal auditor, External auditor, Information System auditor, Government/ Public sector auditor) to perform each. Note that some tasks may be performed by more than one type of auditor. (12 mks)
2. In each example, state the type of audit (financial statement audit, operational audit, or compliance audit). (8 mks)