**EGERTON UNIVERSITY**

**(NAKURU TOWN CAMPUS COLLEGE)**

**BCOM 412: AUDITING 2**

**EXAM FOR APRIL 2012 TIME: 2 HRS**

**INSTRUCTIONS:** ATTEMPT **QUESTION ONE** AND **TWO** OTHER QUESTIONS

1.

a. The following are examples of documentation typically obtained by auditors:

* Suppliers’ invoices
* General ledger files
* Bank statements
* Cancelled payroll checks
* Payroll time records
* Purchase requisitions
* Receiving reports (documents prepared when merchandise is received)
* Minutes of the board of directors
* Remittance advices
* Signed lease agreements
* Duplicate copies of bills of lading
* Subsidiary accounts receivable records
* Cancelled notes payable
* Duplicate sales invoices
* Articles of incorporation
* Title insurance policies for real estate
* Notes receivable

1. Classify each of the preceding items according to type of documentation:

* Internal or
* External. (9 mks)

ii. Explain why external evidence is more reliable than internal evidence. (3 mks)

b. The national stock exchanges require listed companies to have an independent audit committee.

i. Describe an audit committee. (2 mks)

ii. What are the typical functions performed by an audit committee? Highlight THREE. (3 mks)

1. Explain how an audit committee can help an auditor be more independent. (3 mks)

c. Discuss any FIVE internal controls expected in the revenue process. (10 mks)

2.

a. Nelly Nekesa, CPA, is auditing the financial statements of a manufacturing company with a significant amount of trade accounts receivable. Nelly Nekesa is satisfied that the accounts are correctly summarized and classified and that allocations, reclassifications, and valuations are made in accordance with GAAP. Nelly Nekesa is planning to use accounts receivable confirmation requests to obtain sufficient appropriate evidence as to trade accounts receivable.

i. Identify and describe the two forms of accounts receivable confirmation requests and indicate when each is appropriate. (6 mks)

ii. Under what circumstances would confirmations not be appropriate means of gathering audit evidence? (4 mks)

iii. What are the implications to a CPA if during an audit of accounts receivable some of a client’s trade customers do not respond to a request for positive confirmation of their accounts? (2 mks)

iv. Describe FOUR analytical procedures that you would conduct over the revenue process. (4 mks)

3. The following are various potential frauds in the sales and collection cycle:

i. The company engaged in channel stuffing by shipping goods to customers that had not been ordered.

ii. The allowance for doubtful accounts was understated because the company altered the aging of accounts receivable to reduce the number of days outstanding for delinquent receivables.

iii. A cashier stole cash receipts that had been recorded in the cash register.

iv. The company recorded “bill-and-hold sales” at year-end. Although the invoices were recorded as sales before year-end, the goods were stored in the warehouse and shipped after year-end.

v. The company did not record credit memos for returns received in the last month of the year. The goods received were counted as part of the company’s year-end physical inventory procedures.

vi. The accounts receivable clerk stole checks received in the mail and deposited them in an account that he controlled. He issued credit memos to the customers in the amount of the diverted cash receipts.

vii. The company contacted a major customer and asked them to accept a major shipment of goods before year end. The customer was told that they could return the goods without penalty if they were unable to sell the goods.

viii. A cashier stole cash receipts by failing to record the sales in the cash register.

a. Indicate whether the fraud involves misappropriation of assets or fraudulent financial reporting (Management fraud). (10 mks)

b. For those frauds that involve misappropriation of assets, state a control that would be effective in preventing or detecting the misappropriation. (6 mks).

c. For those frauds that involve fraudulent financial reporting, state an audit procedure that would be effective in detecting the fraud. (4 mks)

4.

a. Explain three hypotheses that explain why users of accounting information demand audits. (9 mks).

b. Distinguish auditing from accounting. (2 mks).

b. Explain each of the following classes of audits; (9 mks)

* Operational audits.
* Forensic audits.
* Information systems audits.

5.

Lew Otieno and Vera Wanjiku are friends who are employed by different CPA firms. One day during lunch they are discussing the importance of internal control in determining the amount of audit evidence required for an engagement. Otieno expresses the view that internal control must be evaluated carefully in all companies, regardless of their size or whether they are publicly held, in a similar manner. His CPA firm requires a standard internal control questionnaire on every audit as well as a flowchart of every transaction area. In addition, he says the firm requires a careful evaluation of the system and a modification in the evidence accumulated based on the controls and deficiencies in the system.

Wanjiku responds by saying she believes that internal control cannot be adequate in many of the small companies she audits; therefore, she simply ignores internal control and acts under the assumption of inadequate controls. She goes on to say, “Why should I spend a lot of time obtaining an understanding of internal control and assessing control risk when I know it has all kinds of weaknesses before I start? I would rather spend the time it takes to fill out all those forms in testing whether the statements are correct.”

a. Express in general terms the most important difference between the nature of the potential controls available for large and small companies. (2 mks)

b. Criticize the positions taken by Otieno and Wanjiku, and express your own opinion about the similarities and differences that should exist in understanding internal control and assessing control risk for different-sized companies. (10 mks)

c. Discuss whether Wanjiku’s approach is acceptable under existing auditing standards for either public or non-public companies. (6 mks)

d. Describe what additional procedures Otieno must perform if auditing the financial statements of a public company. (2 mks).