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CPA PART II SECTION 4

AUDITING AND ASSURANCE

WEDNESDAY: 27 November 2019.

Time Allowed: 3 hours.

Answer ALL questions. Marks allocated to each question are shown at the end of the question.

QUESTION ONE

- (a) Lingo Ltd. was recently incorporated. It will be operating in the retail sector. The company has five directors and is currently in the process of setting-up in order to commence business on 1 January 2020. The directors of the company are considering outsourcing the internal audit function in the interim period instead of recruiting their own staff.

Required:

Analyse six advantages to Lingo Ltd. of outsourcing the internal audit function. (6 marks)

- (b) In relation to audit investigations:

(i) Highlight six characteristics of audit investigations. (6 marks)

(ii) Evaluate eight reasons why audit investigations might be conducted. (8 marks)

(Total: 20 marks)

QUESTION TWO

- (a) The completeness assertion is always the most difficult for the auditor to assess, particularly in relation to provisions and contingent liabilities.

Required:

Describe six steps that might be undertaken by the auditor to confirm unrecorded liabilities. (6 marks)

- (b) You work as an audit senior for Kamau Mengo and Associates. You have been appointed to be the lead auditor of Tamu Tamu Ltd. for the financial year ended 31 October 2019. Tamu Tamu Ltd. specialises in the production of biscuits and cakes.

During preliminary audit work, you noted that the profitability of the company declined, costs increased and prices charged were higher than those of competitors. This was due to low levels of output. In recent years, Tamu Tamu Ltd. has been financing its operations using a bank overdraft facility. This issue was raised during a meeting between the auditors and Tamu Tamu Ltd.'s management.

During this meeting, a discussion took place which focused on actions that could be taken by the management to improve the liquidity of the company. The management team informed you of a plan to expand facilities for producing biscuits, as this line of production had maintained its market share. Tamu Tamu Ltd. has applied for a bank loan to finance this expansion and also maintain the present level of working capital.

To support its request for a loan, the company has prepared a cash flow forecast for the two years from the end of the reporting period. The internal audit department has submitted a report on this forecast to the board of directors. However, the bank has said it would like a report from the external auditors, to confirm the reasonableness of the forecast.

Following this request, the company has requested you to examine the cash flow forecast and write a report to the bank.

Required:

(i) Describe three levels of assurance that could be included in your response to the bank's request. (6 marks)

(ii) Assess eight procedures that could be adopted to examine the cash flow forecast. (8 marks)

(Total: 20 marks)

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QUESTION THREE

- (a) Your firm, JM and Associates, has just concluded an external audit on Familia Medical Services Ltd. Based on the audit findings, JM and Associates issued an unqualified report to the company.

Required:

- (i) Explain the term “unqualified opinion”. (2 marks)
- (ii) Suggest five matters that could be included in your unqualified report to the company. (5 marks)
- (b) In relation to auditing in a computerised environment:
- (i) Explain the term “test data”. (2 marks)
- (ii) Analyse two uses of test data when auditing a computerised environment. (2 marks)
- (c) Distinguish between “tolerable error” and “expected error”. (4 marks)
- (d) (i) Explain the term “inherent risk”. (1 mark)
- (ii) Highlight four factors that could result in an increase in inherent risk of a business. (4 marks)

(Total: 20 marks)

QUESTION FOUR

- (a) In the context of International Standard on Auditing (ISA) 560 – Subsequent Events:

- (i) Distinguish between “adjusting events” and “non-adjusting events” giving an example in each case. (4 marks)
- (ii) Analyse the relationship between “going concern” and “non-adjusting event”. (2 marks)

- (b) The financial reporting year of Kipengo Ltd., ends on 31 October. The financial statements of the company for the year ended 31 October 2019 are due to be approved on 15 December 2019. You were appointed to carry out the audit assignment and arising from your audit work, the following events have come to your attention:

1. On 5 November 2019, Kipengo Ltd. sold inventory for a price which was less than its cost price. (The inventory had been recorded in the financial statements as closing inventory).
2. Kipengo Ltd. issued new shares on 7 November 2019.
3. A fire in the warehouse destroyed all of Kipengo Ltd.’s inventory on 10 November 2019.
4. A major customer who owed Kipengo Ltd. Sh.3,000,000 as at 31 October 2019 was declared bankrupt on 12 November 2019.
5. On 23 November 2019, Kipengo Ltd. Purchased an asset worth Sh.1,600,000.

Required:

Review each of the events above. Advise, with reasons, if the event is an adjusting or non-adjusting event and the action to be taken (if any) on Kipengo Ltd.’s financial statements. (10 marks)

- (c) Describe four objectives of public sector auditing. (4 marks)

(Total: 20 marks)

QUESTION FIVE

- (a) You have recently been appointed as the auditor of Sugo Ltd. for the financial year ended 30 June 2019.

Required:

Examine eight reasons why it is important for your audit firm to review Sugo Ltd.’s internal control system prior to undertaking verifications of transactions. (8 marks)

(b) Kaka Kimenju & Co. is an international audit firm with a number of clients listed on the securities exchange. Recently, the firm held a staff training session on quality control. During the meeting, the members of staff were invited to raise matters from their past experiences relating to the ethical code on independence. Some of the matters raised are outlined below:

1. Shortly before commencing the final audit of AKZ Ltd., a listed company, a junior staff member on the audit team inherited a substantial number of shares in that company. No action was taken because, although representing a large investment for the staff member concerned, the number of shares were totally immaterial with respect to the company. Moreover, the partner knew that when the company's results would be announced, the share price would rise and he did not think it was fair to require the staff member to sell them before hand.
2. The management accountant of ABC Ltd., a listed client, had an accident and was away from work for three months. At the time of the accident, the audit senior was winding up the prior year's audit. Given his familiarity with the company's management accounting system, it was agreed that he would take over as the management accountant for the three months.
3. Kaka Kimenju & Co. warned its client, MKN Ltd., that its computer system lacked essential controls. Subsequently, MKN Ltd., decided to install a totally new system and Kaka Kimenju and Co.'s management consultancy department was appointed to design the new system.

Required:

Evaluate whether Kaka Kimenju & Co. had complied with the ethical code on independence or had acted unprofessionally in any other way with respect to each of the above scenarios.

(12 marks)

(Total: 20 marks)

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