CPA PART III SECTION 6
ADVANCED AUDITING AND ASSURANCE

FRIDAY: 1 December 2017. Time Allowed: 3 hours.

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

QUESTION ONE
(a) Distinguish between “forensic accounting” and “forensic audit”. (4 marks)
(b) Describe three challenges that an auditor might encounter in carrying out an audit in an e-commerce environment. (6 marks)
(c) Argue three cases for and two cases against the use of global corporate governance standards. (10 marks)
(Total: 20 marks)

QUESTION TWO
(a) The framework for assurance engagements does not permit an auditor to give an absolute level of assurance. With reference to the above statement, suggest five reasons why it is not possible to give an absolute level of assurance. (10 marks)
(b) The International Standard on Auditing (ISA) 220: Quality Control for an Audit of Financial Statements provides that audits should be conducted in a manner that ensures the correct opinion is arrived at with due regard to time and other resource constraints. The engagement partner should be satisfied that the engagement team has the appropriate competence and capabilities. Required:
Evaluate the importance of each of the following qualities in selecting an effective engagement team:
(i) Independence. (2 marks)
(ii) Scope of the assignment. (2 marks)
(iii) Complexity of the assignment. (2 marks)
(iv) Duration of the assignment. (2 marks)
(v) Client expectations and requests. (2 marks)
(Total: 20 marks)

QUESTION THREE
(a) You are the audit manager responsible for the audit of Kamupni Kubwa (KK) Ltd., a manufacturing company listed on the securities exchange. You are assigning staff to the final audit of KK Ltd. for the year ended 30 September 2017.

You are aware of the following matters:
- Janice Tuli, the assistant manager assigned to the interim audit of KK Ltd., recently discovered that some senior managers in the company have been defrauding the organisation. She has since received some threatening e-mails and calls from the managers.
- Alex Baricho, an audit senior has been auditing KK Ltd. for the last three years. He has confided in you that his father owns 2,000 shares in KK Ltd.

Required:
Analyse the ethical threats raised by the above matters. (4 marks)

(b) You are the audit manager of Tausi Ltd. You are conducting a review of the financial statements and notice some transactions with the pension fund of the employees. There is no disclosure in the accounts about any related party transactions.
Required:
With reference to the above statement, suggest six procedures that an auditor might carry out in order to establish if the pension fund is a related party. (6 marks)

(c) You are the audit manager assigned to the audit of Njema Ltd., the parent company of a group. As part of your work, in relation to the consolidated accounts, you are reviewing the work of the auditors who audit the accounts of the subsidiaries.

Required:
In the context of the above scenario, discuss five matters you should examine before relying on accounts not audited by you. (10 marks)

(Total: 20 marks)

QUESTION FOUR
You are the audit manager in charge of the audit of Vuka Mpaka Ltd., a limited liability company.

On 1 July 2000, Vuka Mpaka obtained the exclusive rights to operate car and passenger ferries across Ziwa Channel, for a period of twenty years. The company refurbished two ferries to service the route. The ferries do not meet the standards of the Environmental Regulation Authority. Each ferry makes an average of ten return crossings every day and has the capacity to carry 2,000 passengers and 400 vehicles per trip.

Vuka Mpaka Ltd. currently receives a subsidy from the local transport authority as an incentive to increase market awareness of the ferry service. The subsidy increases as the number of vehicles carried increases and is based on quarterly returns submitted to the authority.

The company employs fifty full-time crew members who are trained in daily operations, customer service as well as passenger safety in the event of personal accident or breakdown. The management of Vuka Mpaka Ltd. is planning to apply for a safety management certificate at the end of the year. This will require an audit of the ferries including a review of safety documents and evidence that activities are performed in accordance with documented procedures. A safety management certificate, valid for five years, will be issued if no major non-conformities have been found.

Your firm has been asked to provide Vuka Mpaka Ltd. with a business risk assessment as a management assurance service.

Required:
(a) Discuss five business risks that Vuka Mpaka Ltd. might face. (10 marks)
(b) Describe the processes by which the risks identified in (a) above could be managed by Vuka Mpaka Ltd. (10 marks)

(Total: 20 marks)

QUESTION FIVE
(a) You are the engagement partner of Kitabu Ltd. The financial statements for Kitabu Ltd., for the year ended 30 September 2017, show total assets of Sh.749 million and profit before tax of Sh.57.4 million.

Required:
Discuss the potential implications of the following matters on the audit report:

(i) The basis of accounting note states that financial statements have been prepared in compliance with International Financial Reporting Standards (IFRSs). However, the accounting policy note for development costs states that all development costs are expensed as incurred. Results of audit tests showed that of the Sh.25.9 million development costs expensed during the year, Sh.5.8 million should have been recognised as an asset, in accordance with International Accounting Standard (IAS) 38 “Intangible Assets”. (4 marks)

(ii) The management of Kitabu Ltd. has informed you that, for the first time, the company’s annual report is to be published on the company’s website. (2 marks)

(b) You are auditing the financial statements of Zebra Engineering Ltd. for the year ended 30 June 2017. The partner in charge of the audit instructs you to carry out a review of the company’s activities since the financial year end.

Required:
Analyse seven audit procedures which you might carry out in order to identify any material post balance sheet events. (14 marks)

(Total: 20 marks)
ADVANCED AUDITING AND ASSURANCE


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

Time Allowed: 3 hours.

QUESTION ONE

You are the audit manager responsible for the audit of Tamasha Ltd. for the year ended 30 June 2016. The audit fieldwork has been completed and the general manager in charge of finance is seeking to finalise the financial statements.

You are reviewing the audit file and the financial statements and have noted the following issues:

1. An investment held at the year end has since declined by Sh. 1,250,000 in market value.
2. A tangible asset with a net book value of Sh. 800,000 was sold on 29 June 2016. The final selling price was contingent on a valuer’s report which was not received until 15 July 2016. As a result of this report, the profit recorded on this sale should be reduced by Sh. 300,000.
3. A number of minor control points were noted and reported to management by way of a formal management letter.
4. Trade payables include a balance of Sh. 700,000 owing to the parent company of Tamasha Ltd. The parent company has assured the general manager that it will not seek repayment of the amount for two years from the date the audit report is signed. The general manager will confirm this in the letter of representation.
5. A legal case which was ongoing at the year end has just been concluded. The case is disclosed and a provision of Sh. 350,000 included in the draft financial statements. The outcome of the case was that Tamasha Ltd. should pay damages amounting to Sh. 1,450,000 to the other party.

The draft financial statements, which do not contain any adjustments and some relevant disclosures relating to the above matters, show the following:

<table>
<thead>
<tr>
<th>Item</th>
<th>Sh. “000”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Turnover</td>
<td>34,500</td>
</tr>
<tr>
<td>Profit before tax</td>
<td>2,900</td>
</tr>
<tr>
<td>Net current liabilities</td>
<td>(1,400)</td>
</tr>
<tr>
<td>Net assets</td>
<td>2,100</td>
</tr>
</tbody>
</table>

Required:

(a) For each of the issues noted from your review, summarise the potential implications on the audit report. Treat each issue independently. (10 marks)

(b) Explain the overall audit opinion that you would express taking into consideration that no further adjustments or disclosures were made for the issues noted. (4 marks)

(c) Describe one other significant audit issue likely to arise from the above information. (3 marks)

(d) Outline further audit work you would perform arising from the potential audit issue identified in (c) above. (3 marks)

(Total: 20 marks)

QUESTION TWO

(a) Pona Hospital is a referral hospital fully owned by the Government. Two years ago, on recommendation by the hospital’s internal audit department, the management reviewed all aspects of hospital operations and implemented a number of measures aimed at improving overall “value for money” for the users of the facility.

Your audit firm has been requested to perform a review of the following measures which have been implemented so far:

1. Pona Hospital has one centralised purchasing department where all purchase requisitions for medical supplies are forwarded. Upon receipt, the procuring team will research on the lowest price from suppliers and a purchase order is raised. This is then forwarded to the purchasing manager who authorises all orders. The small purchasing team receives in excess of 200 requisition forms per day.
2. The human resource department has experienced difficulties in recruiting suitably trained staff. Overtime rates have been increased to incentivise permanent staff performing extra duties due to staffing gaps. This has been popular and reliance on expensive temporary staff has been reduced. Monitoring of staff hours had been difficult. However, the hospital has implemented time card procedures for clocking in and out. The hours clocked are used to calculate payments.

3. The hospital has invested heavily in new surgical equipment. Although the surgical equipment are very expensive, more surgeries can be performed and patient recovery rates are now faster. However, there is a shortage of appropriately trained medical staff and the equipment is underutilised. A capital expenditure committee has been established, made up of senior managers, to authorise future procurement of any significant capital expenditure items.

Required:
(i) Analyse four strengths within Pona Hospital’s internal control environment. (4 marks)

(ii) For each of the strengths analysed in (a)(i) above, recommend further improvements in order to provide best value for money. (8 marks)

(b) Your firm has been invited by Mr. Abdalia Juma, the Managing Director of Msingi Bora Ltd., to accept appointment as auditors of the company. You establish that the present firm of auditors will not be reappointed when their term of office expires as Msingi Bora Ltd. is dissatisfied with their services.

Mr. Juma has further requested that:
1. An employee of your firm assumes responsibility of preparing monthly management accounts on tight deadlines. The continuation of the overdraft facility by the company’s banker is dependent on the receipt of these accounts by the bank within ten days of each month end.
2. The audit partner in your firm attends the monthly board meetings, mainly to explain the management accounts to the other directors.

Required:
Describe the matters that you would consider in deciding whether to accept the above appointment as auditor and to provide the additional services as requested. (8 marks)

(Total: 20 marks)

QUESTION THREE
(a) Periodically, there arises debate within and outside the accountancy profession on the independence of auditors. One suggestion floated to improve auditor independence is to have compulsory rotation of audit firms after a pre-determined period.

Required:
(i) Discuss four ethical threats created by a long association with an audit client. (8 marks)

(ii) Evaluate three advantages and three disadvantages of compulsory rotation of audit firms. (6 marks)

(b) You are a newly appointed auditor of Shida Ltd. You have recently ascertained the following about your new client:

1. The company has two major customers and a few small-sized customers.
2. The company recently purchased a very large and complex computer system as part of its automation process. The administration staff do not have adequate competence to run the system properly.
3. The Chief Executive Officer of the company, Albert Amingi, has a dominating personality and is overbearing on his subordinates.
4. The company has no formal management accounting system. The new computer system is supposed to remedy this gap.

Required:
Justifying your answer, suggest an appropriate audit strategy for the first audit of Shida Ltd. (6 marks)

(Total: 20 marks)
QUESTION FOUR
Kenya Construction Ltd. (KCL), a company involved in construction of residential houses for sale, has sued their outgoing general manager over matters of financial impropriety. Kelly Limited, which owns 70% of the shares in KCL is also a complainant against the general manager of KCL on the basis that Sh.60 million advanced by the company to KCL was not refunded. The High Court has ordered the lawyers representing the parties in the above case to liaise with their clients and appoint an independent auditor who would scrutinise the documents submitted by the general manager as ordered by the Court. Thereafter, the independent auditor is to file a report to the Court.

The main issues being raised between Kelly Limited and KCL are as follows:
1. All the houses planned to be constructed and sold were actually constructed and sold.
2. All the buyers had paid KCL all monies due.
3. The general manager kept changing contractors and the terms of contract for personal gain.
4. The general manager engaged in excessive overseas travels for personal errands using company resources.
5. The general manager did not maintain proper books of account and did not retain all business vouchers as expected.
6. The general manager did not file VAT, PAYE, corporate tax and social security returns as expected thereby exposing the company to fines and penalties. Failure to file returns was aimed at concealing the general manager’s misfeasance.
7. Although all houses were sold, KCL still owed Kelly Limited Sh.60 million and had a bank overdraft of Sh.80 million secured against some of the houses already disposed of.
8. The present cost was grossly overstated through unexplained and unsupported expenditure. The general manager violated all known principles of good project governance regarding execution, supervision and handing over of a project.

Required:
Assuming you have been appointed the forensic auditor in the above case:
(a) Describe how you would deal with each of the issues numbered 1 to 8 above. (16 marks)
(b) Explain how you would ensure that you are effective in the provision of valuable evidence to the Court. (3 marks)
(Total: 20 marks)

QUESTION FIVE
A newspaper article contains the following:
"The role of statutory auditors is often misunderstood. In particular, there is confusion over the auditor’s responsibilities in respect to fraud and the nature of the assurance provided by an audit. Furthermore, following a number of corporate collapses and the revelation of fraud perpetrated by management, it is the auditors who may be sued for large sums of money. This trend is threatening the future of the auditing profession. The majority of auditors would prefer the current legislation to be changed to enable auditors agree on a contractual cap on liability (that is, a limit on the monetary amount which the auditors could pay out in damages)".

Required:
(a) Compare and contrast the responsibilities of auditors and directors of a company in relation to the prevention and detection of fraud. (6 marks)
(b) Explain why the statutory audit cannot provide absolute assurance that the financial statements are free from misstatement whether caused by fraud, error or other irregularity. (6 marks)
(c) Discuss in each case, four arguments for and against changing the legislation to allow auditors to agree on a contractual cap on liability in respect to the statutory audit. (8 marks)
(Total: 20 marks)
KASNEB
CPA PART III SECTION 6
ADVANCED AUDITING AND ASSURANCE


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

QUESTION ONE
Electronic Solutions Ltd. is a newly incorporated limited liability company. The company provides information technology services to overseas clients. The company relies heavily on information technology for operational activities. Most of the activities are captured online through a monitoring system. The company does not sell any of the systems that it has developed outright but has agreements with clients that permit the company to receive commissions based on the volume of transactions that flow through its system. The rates charged for the transactions vary with the volume of transactions.

The prevailing local taxation laws grant the company an income tax exemption for five years subject to the company complying with specific conditions. One of the conditions is that 90% of the company’s income received during the year should be in foreign currency.

In order to grant exemption for the year ending 31 December 2016, the Revenue Authority has requested for an assurance report from the company auditors that 90% of the company’s income is received in foreign currency.

Required:
(a) Suggest with reasons the quality control objectives which are likely to be particularly relevant in the audit of Electronic Solutions Ltd. (10 marks)

(b) Describe the additional audit procedures you would request the audit staff to perform in order to issue the assurance report. (10 marks)

(Total: 20 marks)

QUESTION TWO
Your audit firm, Makau Kilunda and Associates, are the auditors of Kikomi Manufacturing Group (KMG) Ltd. The group comprises various subsidiaries which were acquired over the last two years.

The subsidiary companies operate diverse businesses including but not limited to mining, agriculture, beauty products and steel manufacturing works. The CEO of KMG Ltd., Mr. Tim Kilonzo is very entrepreneurial and autocratic. KMG Ltd. is highly geared and recently acquired a listed company dealing in information communication technology solutions. A financial analyst had indicated in one of the respected financial magazines that the listed company was acquired at a very high price compared to the value of its assets.

Another large subsidiary which manufactures skin products has been sued by customers over some products which have allegedly adversely affected their skins. Some farmers also allege that the maize seeds supplied by one of the subsidiary companies were faulty and thus the seedlings withered one month after germination.

Required:
(a) Assess the audit risk faced by Makau Kilunda and Associates in the course of the audit of Kikomi Manufacturing Group (KMG) Ltd. (6 marks)

(b) Summarise the advantages of a business risk approach to the audit of KMG Ltd. (6 marks)

(c) (i) Undertake a business risk assessment of KMG Ltd. (4 marks)

(ii) Highlight how the business risk assessment in (c) (i) above might influence the audit process. (4 marks)

(Total: 20 marks)
QUESTION THREE

(a) Your audit client, Informat Solutions Ltd., has requested your audit firm to undertake a forensic investigation related to a suspected payroll fraud at the company.

Analyse how the code of ethics for professional accountants would be applied in undertaking the forensic investigation of the suspected fraud in Informat Solutions Ltd.  (10 marks)

(b) Your audit senior has requested you to undertake a value for money audit during the course of your audit of a public sector organisation:

(i) Explain the importance of a value for money audit in the public sector.  (4 marks)

(ii) Summarise six common areas that an auditor would consider when undertaking a value for money audit in an organisation.  (6 marks)

(Total: 20 marks)

QUESTION FOUR

You are the audit manager responsible for the audit of Ixcel Group, an audit client for several years. All group companies had a financial year that ended on 31 March 2016. You are currently in the final phase of the group audit. The following matters were discussed during your review with their engagement partner:

1. Karen Ltd is a subsidiary of Ixcel Group. During the audit, the audit team observed several issues in relation to the entity's ability to continue as a going concern, as follows:
   • Karen Ltd. will not be able to continue without continuous support from Ixcel Group.
   • Ixcel Group has issued a letter of support also referred to as a "comfort letter" to Karen Ltd.

2. The directors' report for Ixcel Group stated that the group has maintained a gross profit margin of 30%. This percentage did not tally with the income statement. During your review, you observed that some 'other income' items were considered when calculating the gross profit margin in the directors' report. The audit senior ignored this deviation in the directors' report observing that it was not relevant to the financial statements.

3. The audit senior has prepared a draft qualified audit opinion on the going concern issue considering the seriousness of the situation.

Required:

(a) Describe the purpose of support letters (comfort letters) as evidence in the audit of financial statements.  (8 marks)

(b) (i) Critique the draft audit opinion by the audit senior justifying the opinion you would recommend.  (6 marks)

(ii) Suggest with justification the audit opinion you would recommend based on the misstatement of the gross profit margin in the directors' report.  (6 marks)

(Total: 20 marks)

QUESTION FIVE

You are the partner responsible for providing direction to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence. They have also heard that in some countries, it is possible to restrict liability by making a liability limitation agreement with an audit client.

Required:

(a) Discuss the civil liabilities of an auditor under common law.  (12 marks)

(b) Assess the potential implications to the audit profession of audit firms that sign a liability limitation agreement with their audit clients.  (8 marks)

(Total: 20 marks)
KASNEB
CPA PART III SECTION 6
ADVANCED AUDITING AND ASSURANCE

FRIDAY: 27 May 2016.

Time Allowed: 3 hours.

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

QUESTION ONE
You are the audit manager assigned the audit of the financial statements of Himaya Ltd. for the year ended 31 December 2015. You have come across three material items in the course of your audit which need to be concluded in order to form an audit opinion on the financial statements.

Required:
(a) In the context of the above scenario, describe the audit work to be performed on the following matters:

(i) The allowance for doubtful debts for the current financial year is Sh.15 million which represents 2.5% of the accounts receivable as at 31 December 2015. The allowance for doubtful debts for the three previous years was 5% of the accounts receivable. The credit controller has advised that the reduction in allowance was due to the measures undertaken to improve on debt collection and credit check procedures. (5 marks)

(ii) The directors’ emoluments amounting to Sh.70 million during the year have not been disclosed in the financial statements. (4 marks)

(iii) Circularisation of a debtor owing the company Sh.68 million had not been done due to what the financial controller justified as “strained relations with the debtor”. No cash has been received from the debtor and some documents regarding shipment to the customer are missing. (5 marks)

(b) Explain how the three matters outlined in (a)(i), (ii) and (iii) above would impact on the auditors report, assuming that your best estimate of the appropriate allowance for doubtful debts is Sh.30 million and that no adjustments had been made in the financial statements in respect of the matters set out in items (a)(i), (ii) and (iii) above. (6 marks)

(Total: 20 marks)

QUESTION TWO
Apex Ltd. was incorporated in the year 2012. The company deals with the extraction of sand, gravel and stone materials for residential and commercial building construction as well as for road construction projects. The following information relates to the affairs of the company during its few years of operation:

1. Apex Ltd. is currently working closely with sports complexes and golf course architects to develop sand of high quality for use in the construction and top dressing of golf courses and sports complex playing fields.
2. The company’s profit has been declining mainly due to intense price competition from several smaller competitors. The managing director hopes that profits would improve in the year 2017 as a significant amount of the company’s long term debt is payable by the year 2016. Apex Ltd. is currently involved in discussions with the banks on refinancing.
3. In late 2015, a significant theft took place at the company’s quarry facility. Security was lax because it was believed that there was only low risk of these products being stolen given their nature as high volume low value products.

Required:
(a) Discuss the reviews that could be carried out by the internal audit function in Apex Ltd. (12 marks)

(b) Explain the potential obligations that might accrue to Apex Ltd. arising from an environmental audit. (8 marks)

(Total: 20 marks)

QUESTION THREE
Bakari Ltd. acquired 75 per cent of the ordinary shares of Makali Ltd. on 30 June 2015 for Sh.20 million. The reserves of Makali Ltd. at the time of acquisition were Sh.10 million (credit).
The statements of financial position of the two companies as at 31 December 2015 were as follows:

### Statements of financial position as at 31 December 2015:

<table>
<thead>
<tr>
<th></th>
<th>Bakari Ltd.</th>
<th>Makali Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Sundry assets</strong></td>
<td>Sh. “000”</td>
<td>Sh. “000”</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>50,000</td>
</tr>
<tr>
<td><strong>Investments in Makali Ltd.</strong></td>
<td></td>
<td></td>
</tr>
<tr>
<td>75,000 ordinary shares of Sh.100 each</td>
<td>20,000</td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>50,000</td>
</tr>
</tbody>
</table>

**Financed by:**

<table>
<thead>
<tr>
<th></th>
<th>Bakari Ltd.</th>
<th>Makali Ltd.</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Share capital</strong></td>
<td>Sh. “000”</td>
<td>Sh. “000”</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>10,000</td>
</tr>
<tr>
<td><strong>Revenue reserves</strong></td>
<td>Sh. “000”</td>
<td>Sh. “000”</td>
</tr>
<tr>
<td></td>
<td>20,000</td>
<td>40,000</td>
</tr>
<tr>
<td></td>
<td>40,000</td>
<td>50,000</td>
</tr>
</tbody>
</table>

**Additional information:**

The subsidiary company was audited by another auditing firm and the directors of the holding company agreed through a resolution that the audit firm would continue to audit the subsidiary company for the year ended 31 December 2015.

**Required:**

(a) Describe the matters you would consider in the audit of the holding company, Bakari Ltd. (15 marks)

(b) Summarise the information that you would require from the auditors of the subsidiary company, Makali Ltd. (5 marks)

**Total:** 20 marks

**QUESTION FOUR**

You are responsible for the audit of Superior Packaging Ltd. for the year ended 31 March 2016. The principal activity of Superior Packaging Ltd. is the provision of high quality packaging services for manufacturing companies. The company was established 3 years ago and has significantly exceeded its growth targets in each subsequent year. Historically, the packaging process was labour intensive. However in December 2015, in an effort to reduce labour costs and increase efficiency, the company invested in an enhanced automated packing system. The investment was funded by a loan repayable in monthly instalments over 4 years. The loan agreement includes a covenant specifying that the company’s debt equity ratio should not exceed 1:1.

A comparison of the draft financial statements for the year ended 31 March 2016 with the previous year’s financial statements indicates a significant increase in the turnover (revenue) with a small increase in profitability. The company is currently trading in excess of its overdraft limit and is negotiating an increase in its facility with the bank. The management of the company has prepared, in support of its negotiations, profit and cash flow forecasts based on the assumption that the anticipated increase in efficiency and reduction in labour costs will be achieved.

The company has struggled to meet its wage bill obligations and fallen behind with PAYE, NHIF and NSSF remittances. It has also failed to comply with the terms of the lease in respect of the factory premises and has not paid the last three months' instalments.

**Required:**

(a) Explain from the information provided above, factors which could indicate that Superior Packaging Ltd. might not be a going concern. (6 marks)

(b) Describe the duties of the directors in respect of going concern basis of a company. (6 marks)

(c) Where events have been identified which cast doubt on the appropriateness of the going concern basis, management should demonstrate to the auditors that they have identified the problem and have plans to deal with it. Propose the procedures the auditors must carry out on the management plans and the possible impact to the auditors report. (8 marks)

**Total:** 20 marks

**QUESTION FIVE**

(a) Discuss the matters that a professional accountant should consider before accepting an engagement to report on prospective financial information of a company. (10 marks)

(b) Zakayo and Associates were invited to tender for the audit of Premier Enterprises Ltd. for the financial year ended 31 December 2015. The firm was awarded the tender as it was the most competitive. The firm had used a low bailing strategy when submitting their tender. During the course of the audit, the auditors have suspected the company is involved in money laundering activities.
Required:

(i) Explain the term “low balling” citing the potential threat of low balling to the auditor’s independence. (4 marks)

(ii) Define the term “money laundering”. (2 marks)

(iii) With reference to the code of ethics and conduct for professional accountants, advise the action the auditors should take with respect to the suspected money laundering activities by the company. (4 marks)

(Total: 20 marks)
KASNEB
CPA PART III SECTION 6
ADVANCED AUDITING AND ASSURANCE

FRIDAY: 27 November 2015.

Time Allowed: 3 hours.

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

QUESTION ONE

(a) Your firm has been retained as the auditors of Solo Ltd., a retailer of books, music media and computer software. As part of the audit planning for the year ended 30 June 2015, your audit manager has asked you to assist with drafting of the audit programmes.

Required:
For each of the four (4) items listed below, describe the audit procedures that you would undertake in respect of the matters listed to ensure that the financial statements of Solo Ltd. are fairly stated.

(i) On 1 June 2015, Solo Ltd. relocated from its rented warehouse to a larger property in order to accommodate growth in the business. The lease on the old warehouse, which came to an end on 31 May 2015, contains a dilapidation clause which specifies that Solo Ltd. must carry out repairs to the warehouse in order to restore the property to the same condition it was in when the lease commenced. Work on the dilapidations commenced on the day Solo Ltd. vacated the property and it is expected to take three months to complete. The directors of Solo Ltd. have included the estimated cost of these works in the financial statements for the year ended 30 June 2015 at Sh.20 million.

(ii) In order to cope with its recent expansion, Solo Ltd. installed a new computer system during the year. The old computer system, which has now been disposed of, was replaced after three years, despite its initial useful life being assessed as five years. Solo Ltd. has capitalised the new system at a cost of Sh.60 million and is depreciating it at 20% per annum on a straight line basis.

(iii) Solo Ltd. maintains a perpetual inventory system. Monthly inventory reports analyse the age of items in three-month periods for all inventory up to one year old and as a single figure for all inventory older than one year old. Solo Ltd. has historically included a provision in its financial statements to cover both obsolete and damaged inventory equal to 10% of the total inventory cost.

(iv) Solo Ltd. pays a 5% commission to referees in return for them directing business to the company. The 5% commission is calculated using the retail price as advertised by Solo Ltd. The commission is payable at the end of the month following that in which Solo Ltd. receives payment from its customers. Solo Ltd.’s computer system generates a monthly statement of sales made on this basis together with a calculation of the commission due. However, due to a computer virus, the computer system has not calculated or paid any commission since 31 March 2015. A number of the largest referees have since contacted Solo Ltd. demanding payment of their own estimates of commission due. Solo Ltd. has not made provisions in the financial statements for unpaid commission.

(b) With respect to item (a) (iv) above, justify three audit opinions you could issue in respect of the financial statements of Solo Ltd. for the year ended 30 June 2015.

(6 marks)

(Total: 20 marks)

QUESTION TWO

(a) Maxwel Wamalwa is an audit manager in Ambu and Associates Certified Public Accountants. One of the audit clients, Maridadi Ltd., designs and manufactures wooden tables and chairs for the audit firm. The business of Maridadi Ltd. has expanded rapidly in the last two years after the company employed Patrick Tundo, an experienced Sales and Marketing Manager.

The directors of Maridadi Ltd. intend to obtain a loan of Sh.30 million in order to expand its operations. The directors have approached LCT Bank for the loan. The bank’s lending policy requires the loan application to be accompanied by a detailed business plan including an analysis of how the funds will be used. LCT Bank Ltd. must confirm that the loan applied for is adequate for the proposed business purpose.
The business plan must be supported by an assurance opinion on the adequacy of the requested funds. Maridadi Ltd. has projected that the Sh.30 million loan will be used as follows:

<table>
<thead>
<tr>
<th>Description</th>
<th>Sh. “000”</th>
</tr>
</thead>
<tbody>
<tr>
<td>Construction of a new factory</td>
<td>12,500</td>
</tr>
<tr>
<td>Purchase of new machinery</td>
<td>10,000</td>
</tr>
<tr>
<td>Initial supply of timber raw material</td>
<td>2,500</td>
</tr>
<tr>
<td>Advertising and marketing of new products</td>
<td>5,000</td>
</tr>
<tr>
<td></td>
<td>30,000</td>
</tr>
</tbody>
</table>

Your audit firm has agreed to review the business plan and to provide assurance on the completion of the loan application. A meeting is scheduled with Maridadi Ltd. to discuss this assignment.

Required:
(i) Appraise the matters relating to the assurance assignment that should be discussed during the meeting with Maridadi Ltd. (8 marks)

(ii) Summarise the enquiries you would make to the directors of Maridadi Ltd. to ascertain the adequacy of the Sh.30 million loan applied for by the company. (7 marks)

(b) Summarise the role played by the audit committee in enhancing corporate governance in an organisation. (Total: 20 marks)

**QUESTION THREE**

You are a member of the audit team assigned to audit the financial statements of Elite Trading Co. Ltd., a listed company, for the year ended 31 August 2015. The detailed audit work was completed on Friday, 30 October 2015. The audit assignment partner has requested you to consider the auditor’s responsibilities for identifying subsequent events and the audit procedures for examining subsequent events.

With respect to the financial statements of Elite Trading Co. Ltd., it is tentatively proposed as follows:

1. The audit report be signed on Thursday, 12 November 2015.
2. The financial statements be sent to the shareholders on Wednesday, 2 December 2015.
3. The annual general meeting of the company be held on Wednesday, 30 December 2015, at which meeting the shareholders will vote to approve the financial statements.

Required:
(a) Assess the responsibility of the auditors for detecting material subsequent events in the following periods:
   (i) 31 August 2015 to 30 October 2015. (2 marks)
   (ii) 30 October 2015 to 12 November 2015. (1 mark)
   (iii) 12 November 2015 to 2 December 2015. (2 marks)
   (iv) 2 December 2015 to 30 December 2015. (1 mark)

(b) Explain the audit procedures that you could use in the examination of subsequent events. (10 marks)

(c) Describe the work you would carry out for the period listed in (a) (ii) above. (4 marks)

**TOTAL: 20 marks**

**QUESTION FOUR**

(a) Biashara Ltd. has, as a result of technological developments, adopted sophisticated information systems in its business in order to reduce its operational costs. During the year ended 31 March 2015, the company adopted e-commerce to conduct its business in various countries. The directors of Biashara Ltd. have approached you to advise on managing risks associated with e-commerce.

Required:
Advise Biashara Ltd. on the procedures that the company should put in place to mitigate e-commerce risks. (8 marks)

(b) Describe the audit procedures that an auditor could perform to assess whether or not a client entity is a going concern. (8 marks)

(c) Explain the auditor’s responsibilities in relation to the prevention and detection of fraud and error. (4 marks)

**TOTAL: 20 marks**
QUESTION FIVE
You are a manager in an audit firm and double up as the head of the forensic investigation department. Your audit firm has recently been appointed the auditors of Afrokeen Manufacturers Ltd. for the year ending 31 December 2015. The directors of Afrokeen Manufacturers Ltd. have contacted your audit firm regarding a suspected fraud relating to the company’s payroll. You have been assigned to undertake a forensic investigation and have held preliminary discussions with the finance director of the company.

The finance director suspects that the accountant, who had been absent from work after the finance director queried the increasing costs of overtime and casual workers payments, could be involved in some fraudulent activities.

Required:
(a) Describe three objectives of a forensic investigation. (3 marks)

(b) Explain the procedure you would follow to gather evidence on the suspected payroll fraud. (12 marks)

(c) Assess how the code of ethics for professional accountants should be used in the provision of the forensic investigation service to Afrokeen Manufacturers Ltd. (5 marks)

(Total: 20 marks)
KASNEB
CPA PART III SECTION 6
ADVANCED AUDITING AND ASSURANCE
PILOT PAPER

September 2015.

Time Allowed: 3 hours.

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

QUESTION ONE
(a) Your audit firm has tendered for the audit of Hekima Group of Companies.

Required:
Evaluate six matters that should be considered before accepting the audit engagement in the event your firm is successful in the tender. (6 marks)

(b) You are an audit manager in Hasibu and Co. working on the audit of Safari Group (The Group), whose financial year ended on 31 March 2015. This is the first time you have worked on group audit. The draft consolidated financial statements recognise profits before tax of Sh.600 million (2014 - Sh.900 million) and total assets of Sh.900 million (2014 - Sh.820 million). The group manufactures equipment used in telecommunication industry.

Goodwill of Sh.100 million is recognised in the group statement of financial position having arisen on several business combinations over the last few years. An impairment review was conducted in March 2015 by the group finance director, from which an impairment of Sh.5,000,000 is to be recognised in respect of goodwill.

The group finance director has prepared a file documentation to support the results of the impairment review, including notes on the assumptions used, his calculations and conclusions. He made the following comment:

“I don’t think you need any evidence other than that contained in my file. The assumptions used are straightforward, so you need to look into them in detail. The assumptions are consistent with how we conducted impairment reviews in previous years and your firm has always agreed with the assumptions used; so you can check that back to last year’s audit file. All of the calculations have been checked by the head of group internal audit department”.

The group finance director has also informed you that two members of the sales team are suspected of paying bribes in order to secure lucrative customer contracts. The internal audit team were alerted of this when they were auditing cash payments and found significant payments to several new customers being made prior to the contract being signed. The Director has asked if Hasibu & Co. could perform a forensic investigation into the alleged bribery payments.

Required:
(i) Discuss how professional skepticism should be applied to the statement made by the group finance director. (2 marks)

(ii) Explain the principal audit procedures to be performed on the impairment of goodwill. (6 marks)

(iii) Recommend two procedures to be used in performing a forensic investigation on alleged bribery payments. (6 marks)

(Total: 20 marks)

QUESTION TWO
(a) Define the term “environmental matters” and discuss the implication environmental matters have on company’s financial statements. (6 marks)

(b) You are the audit manager of Kilimanjaro Co., a company which designs and manufactures aircraft engine parts. The audit of the financial statements for the year ended 31 December 2015 is nearing completion and you are reviewing the papers addressing the going concern section of the audit file. The draft financial statements recognise a loss of Sh.50 million (2014 - profit Sh.76 million) and total assets of Sh.138 million (2014 - Sh.144 million).
The audit senior has left the following note for your attention:

"I have performed analytical review on Kilimanjaro Co.'s year end financial statements. The current ratio is 0.8 (2014 - 1.2), the quick ratio is 0.5 (2014 - 1.6). The latest management accounts show that ratios have deteriorated further since the year end, and the company now has a cash balance of only Sh.2,500,000. Kilimanjaro Co. has a long-term loan outstanding of Sh.8 million with a covenant attached, which states that if the current ratio falls below 0.75, the loan can be immediately be recalled by the lender.

You are also aware that one of the Kilimanjaro Co.'s best selling product Mofire, has become technically obsolete during 2015 as customers now prefer more environmentally friendly engine parts. Historically the Mofire has generated 45% of the company's revenue. In response to customers preference, Sh.130m has been spent on designing a new product G-fire, due to launch in February 2016 which will be marketed as an environmentally friendly product.

A cash flow forecast has been prepared for the year ending 31 December 2016, indicating that based on certain assumptions, the company cash balance is predicted to increase to Sh.22 million by the end of the forecast period.

Assumptions include:

1. Successful launch of the G-fire product.
2. The sale of plant and machinery which was used to manufacture Mofire generating cash proceeds of Sh.0.5 million, forecast to take place in January 2016.
3. A reduction in payroll costs of 15%, caused by redundancies in the Mofire manufacturing plant.
4. The receipt of grant of Sh.300,000 from a government department which encourages innovation in environmentally friendly products, scheduled to be received in February 2016.

Required:
(a) Explain the matters which cast doubt on the going concern status of Kilimanjaro Co. (6 marks)

(b) Explain the audit evidence you should expect to find in your file review in respect of the cash flow forecast. (8 marks)

(Total: 20 marks)

QUESTION THREE

(a) Kenya Lab Instruments Ltd. is an established manufacturing company producing laboratory instruments. The following extracts are from the company's final draft statement of financial position and income statement for the year ended 30 April 2015.

<table>
<thead>
<tr>
<th>Income statement:</th>
<th>Year 2015 (Sh.000)</th>
<th>Year 2014 (Sh.000)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Sales</td>
<td>351,760</td>
<td>378,845</td>
</tr>
<tr>
<td>Gross profit</td>
<td>243,993</td>
<td>286,505</td>
</tr>
<tr>
<td>Net profit</td>
<td>40,076</td>
<td>38,773</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Statement of financial position:</th>
</tr>
</thead>
<tbody>
<tr>
<td>Fixed Assets:</td>
</tr>
<tr>
<td>Cost</td>
</tr>
<tr>
<td>Accumulated depreciation</td>
</tr>
<tr>
<td></td>
</tr>
</tbody>
</table>

| Current Assets:                 |
| Stock                           | 185,336             | 86,111              |
| Debtors                         | 67,627              | 63,141              |
|                                  | 252,963             | 149,252             |

| Current Liabilities:            |
| Creditors                       | 20,691              | 17,379              |
| Overdraft                       | 95,461              | 37,634              |
|                                  | 116,152             | 55,013              |

| Net Assets                      | 204,878             | 164,799             |
The following issues arose during the audit assignment of which you are the manager:

1. Sales during the second half of the year were 40% below those in the first half.
2. Kenya Lab Instruments Ltd.’s main competitor Focus Instruments Ltd. has launched a new range of specialist equipment causing Kenya Lab Instruments Ltd.’s forward orders to fall significantly.
3. The current overdraft limit is Sh.700 million.
4. Plant and machinery costing of Sh.40 million, is fully depreciated and the production director advises that new machinery must be acquired within one year to avoid incurring excessive repair costs.

**Required:**
A file memorandum reviewing the above results and information and raising any issues which need to be resolved prior to the signing of the audit report. 

(b) There are specific regulatory obligations imposed on accountants and auditors in relation to detecting and reporting money laundering activities.

You have been asked to provide a training session to the new audit juniors on the auditor’s responsibilities in relation to money laundering.

**Required:**
(i) Explain the term “money laundering”. Illustrate your explanation with examples of money laundering offences including those which could be committed by an accountant.

(ii) Explain the policies and procedures that a firm of Certified Public Accountants should establish in order to meet its responsibilities in relation to money laundering.

**QUESTION FOUR**

(a) Your firm audits H-Pound Ltd., a recognised East Africa’s premier engineering construction and infrastructure company that undertakes construction contracts which include roads, bridges, warehouses, factories and offices. H-Pound Ltd. customers include governments and businesses. Recent cut-backs in local government expenditure have resulted in fewer contracts being started this year than budgeted.

The statement of accounting policy for construction contracts in H-Pound financial statements provides as follows:

“Revenue is recognised using the percentage of completion method, calculated on the basis of costs incurred as a percentage of expected costs.

“Anticipated losses are provided for in full as soon as the possibility of loss is forecast”.

Direct costs attributed to specific contracts include:

- Architect’s design costs, legal fees and engineering assistance.
- Material issued to site.
- Site supervision (apportioned foreman’s salaries).
- Site labour costs (allocated from the payroll and subcontractors invoices).
- Costs of hiring suitable building and leasing plant and equipment.
- Depreciation of plant, equipment and vehicles.
- Transportation costs of resources such as materials between sites.
- Insurance and telephone.

Indirect expenses incurred by H-Pound Ltd.’s head office which relates to construction activities are attributed to the project at 70% of direct costs.
Last year, your firm qualified the auditor’s report due to lack of evidence to support the client’s schedule of estimated costs to completion.

During the year, a quantity surveyor joined the client’s management team to undertake the following:

1. Supervise monthly physical counts at the major construction sites.
2. Monitor costs to date against the monthly rolling budget.
3. Prepare year-end schedules by contract of total cost of completion (that is direct costs incurred to the balance sheet date, attributable overheads and estimated costs to completion).

You are satisfied that the quantity surveyor is appropriately qualified and experienced.

Required:

(i) Explain the principal audit risks to be considered when placing the approach to the final audit for the year ending 30 September 2015. (10 marks)

(ii) Explain the nature and extent of reliance which you should seek to place on the work of the quantity surveyor. (5 marks)

(b) Explain the factors which have contributed to the increased number of lawsuits against auditors from third parties in recent years. (5 marks)

(Total: 20 marks)

QUESTION FIVE

Public sector auditing refers to the examination of and control of government receipts and payments with a view of assessing the benefits derived from the use of public property, utility or service and evaluate level of responsibility and accountability of government officers to the electorate.

The audit exercise is governed by professional norms of independence, competence and due care and it draws its mandate from the constitution. The client is in principle the government comprising the executive office, ministries, the treasury, county governments, independent departments and government executed projects.

Required:

(a) Describe the comprehensive process in public sector audits. (4 marks)

(b) Briefly describe two main elements of public sector audits. (4 marks)

(c) Outline the status, functions and powers of the Controller and Auditor General. (12 marks)

(Total: 20 marks)