



The Institute of  
Chartered Accountants  
of Nigeria (ICAN)

**SKILLS LEVEL EXAMINATION**

**2014**

**Mock Exam 2**

**(3 hours)**

# **Audit and Assurance**

1. This paper consists of **SEVEN** written test questions of which you must answer **FIVE** questions in total.
  - Section A (30 marks) consists of **one compulsory** question
  - Section B (40 marks) consists of three 20-mark questions.  
You must **answer two questions only**.
  - Section C (30 marks) consists of three 15-mark questions.  
You must **answer two questions only**.
2. Ensure your candidate details are on the front of your answer booklet.
3. Answer each question in black ballpoint pen only.
4. Answers to each question must begin on a new page and must be clearly numbered. Use both sides of the paper in your answer booklet.
5. The examiner will take account of the way in which answers are presented.

## **IMPORTANT**

Question papers contain confidential information and must **NOT** be removed from the examination hall.

**DO NOT OPEN THE QUESTION PAPER UNTIL INSTRUCTED**

Enter your candidate number in this box

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## Section A: 30 marks (compulsory)

### Question 1

You are an employee of McGraw & Co, a firm of Chartered Accountants. One of the firm's clients is Trotters, a car rental company whose shares are not traded on a stock exchange. The company has a large fleet of vehicles which it hires out on a contract basis.

The duration of a contract varies from one day to three months. Anybody wishing to hire a car must possess a valid driving licence. In addition, they must take out insurance with Trotters.

You are involved in the audit of non-current assets for the year ended 31 December 20X4.

The company's main non-current assets are:

- ☐ Freehold land and buildings
- ☐ Office equipment (mainly computers for office staff)
- ☐ Motor vehicles

The company was formed ten years ago and all non-current assets (except for land and buildings) are maintained on a non-current asset register. The company depreciates non-current assets at the following rates:

- ☐ Freehold land and buildings – 2% on cost
- ☐ Office equipment – 20% on cost
- ☐ Motor vehicles – 50% on cost

The company has recently revalued its buildings upwards by ₦200 million. The directors believe that they have fallen victim to a fraudster who has disappeared with a number of the company's vehicles.

#### Required:

- (a) What is the difference between the responsibilities of management and the auditor for the prevention and the detection of fraud? Explain how these responsibilities are carried out. **(6 marks)**
  - (b) Describe how you would verify the ownership of:
    - (i) Freehold land and buildings
    - (ii) Computers
    - (iii) Motor vehicles. **(6 marks)**
  - (c) Comment on the appropriateness of the depreciation rates of the non-current assets and their respective effect on the income statement. **(6 marks)**
  - (d) List the contents of a non-current asset register and describe its usefulness for Trotters **(6 marks)**
  - (e) Explain the accounting effect of the revaluation of the buildings to the financial statements and the audit work you would perform in this matter. **(6 marks)**
- (Total: 30 marks)**

## Section B: 40 marks – answer two out of three questions

### Question 2

Dreamers, a limited liability company, is a new audit client and you are at the planning meeting for the forthcoming audit. The company has grown rapidly and has a 30 June year-end. The financial statements have not been audited in previous years since the organisation has only just converted from a partnership to a company.

The company's bankers have requested that an audit is undertaken on the financial statements for the year ending 30 June 20X4. Higher levels of inventory required to meet the increasing demand for its products have necessitated a request for an increase in the bank's overdraft facility.

The company makes beds. It buys in the materials direct and manufactures the beds. At the year-end, inventory comprises raw materials, work-in-progress and finished goods. The company does not undertake continuous inventory counting but does intend to perform a full inventory count on 30<sup>th</sup> June 20X4. The company uses a standard costing system to value finished products and work-in-progress.

#### Required

- (a) What are the objectives of the planning stage, with particular attention being paid to those areas that will assist the auditor in obtaining a sound knowledge of the business? **(10 marks)**

- (b) What are the audit risks of Dreamers and how would you address those risks? **(10 marks)**

**(Total: 20 marks)**

### Question 3

You have recently been appointed to be the auditor of Spider plc, a company whose shares are traded on a stock exchange. The directors of Spider plc have recommended that you perform the following services:

- ☐ the statutory audit of the annual accounts;
- ☐ taxation services; and
- ☐ consultancy services in respect of the implementation of a new information technology system.

Your firm has not acted for Spider plc before but does act as auditor for one of its major competitors.

#### Required:

- (a) Identify and explain the professional and ethical issues that should have been identified by your firm in relation to the provision of the services, outlined above, to Tetra and describe the safeguards that should be in place in order to address these issues. **(11 marks)**

- (b) What are the five fundamental principles of ethics? Briefly explain their meaning. **(5 marks)**

- (c) A client's affairs should not be disclosed to third parties. However where a client has been guilty of an unlawful act, to whom should the auditor disclose this information, and in what order? **(4 marks)**

**(Total: 20 marks)**

**Question 4**

You are carrying out the audit of the sales system of Chinchai, a company that manufactures office furniture. The company has annual sales revenue of ₦150 million. All the shares are owned by Yang Lau and her husband Petr. Neither is involved in the running of the business. The chairman is responsible for running the business, but does not own any of the company's shares.

The bookkeeper maintains all the accounting records and prepares the annual financial statements.

A stand-alone computer is used to maintain the accounting records including those of the sales system. Standard accounting software is used, which was purchased from an independent supplier. For the sales system, a sales ledger is maintained to which sales invoices, credit notes, cash and discounts are posted. When sales invoices are posted and credit notes are input to the computer, the value of the invoice or credit note is posted to both the sales ledger and the nominal ledger.

You have determined that the documents and personnel involved in the sales ledger are as follows:

- ☐ When an order is received by telephone it is recorded by the sales clerk in the sales department. This is usually done on a note pad.
- ☐ The sales clerk will then pass the sales order to the stores, to the goods outwards department where the office furniture is kept.
- ☐ If the goods ordered are in inventory, then the goods will be loaded onto one of the vehicle delivery trucks. A two-part despatch note will be prepared to accompany the sales order. This is usually done before the stores have received the sales order from the sales department.
- ☐ The goods are delivered to the customer together with the top copy of the goods despatch note.
- ☐ The driver on his return will inform the sales department that the delivery has been a success and will maintain the bottom copy of the goods despatch note in the stores.
- ☐ At the end of the week, the sales department prepare a sales invoice for the customer.
- ☐ When the post is received, it is opened by one of the sales department. The person opening the post will both make a list of all the cheques received and that same person will then go to the bank and bank the cheques. Upon return, the remittances and cheque paying-in book are passed to the bookkeeper for updating the receivables ledger.
- ☐ The receivables ledger is reviewed by the bookkeeper on a monthly basis to see which customers are over their credit terms and will inform the sales staff who to telephone and chase up about their debt.

**Required:**

- (a) Identify the weaknesses in the internal control in the sales system in Chinchai. Propose one control to address each weaknesses you identify **(12 marks)**
  - (b) It has been suspected that Petr and Yang Lau are looking to manipulate the financial statements. In which case, which assertion would you pay more attention to in the audit of receivables – completeness or existence? **(1 mark)**
  - (c) Explain your answer to part (b) and give a substantive test that would test your suspicion. **(3 marks)**
  - (d) A receivables' circularisation frequently doesn't produce the same quality of audit evidence as a supplier statement reconciliation. Why do you think this is? **(4 marks)**
- (Total: 20 marks)**

## Section C: 30 marks – answer two out of three questions

### Question 5

Jim Harley is the managing director of Gramps, a private company. Gramps is currently audited by Leggit and Co. Jim has informed you that the directors of Gramps wish to appoint your firm, Knight and Co as auditors in place of Leggit and Co, but they consider that Leggit and Co will not be willing to resign.

#### Required

- (a) Assuming that Leggit and Co are not willing to resign, set out the statutory and other procedures which will have to be followed by Gramps, your firm and which may be adopted by Leggit and Co in connection with this proposed appointment. You should assume that Knight and Co have adequate resources to take on the audit of Gramps, and that there are no issues surrounding independence or client integrity. **(6 marks)**
- (b) Assuming that Leggit and Co are willing to resign part way through their term of office, set out the procedures to be followed by Leggit and Co and Gramps in order to effect the resignation. **(4 marks)**

Your office has recently taken on a new student, John. You have been asked to explain to John what information is recorded in the audit process and where.

#### Required

- (c) Set out a brief explanation for John. **(5 marks)**
- (Total: 15 marks)**

### Question 6

Control activities may be defined as policies, procedures and operations that help to enable management directives to be carried out. These activities are detailed procedures designed to prevent, or to detect and correct, errors that may arise in processing information.

#### Required

- (a) Set out the five types of control activities and illustrate each one in the context of the purchases or trade payables system. **(10 marks)**
  - (b) Explain why, even where tests of controls prove satisfactory, substantive procedures can never be completely eliminated. **(5 marks)**
- (Total: 15 marks)**

**Question 7**

Magical Mist has been in existence, importing perfume, for a number of years. The managing director had built up the business using contacts he already had in the industry. The company imports only one brand of perfume which is manufactured exclusively by one company. The perfume is distributed via 'shops within shops' at 20 branches of a well-known store. Under this agreement, Magical Mist pays a percentage of its takings to the store, with a minimum annual payment of ₦100,000 per store.

The audit is nearing completion but you have just heard that the Egyptian manufacturer is facing serious financial difficulties and that supplies have ceased.

**Required**

- (a) Set out the further information the auditor would require before reaching his audit opinion. **(6 marks)**

You are the internal auditor of Desmond's Disks, which runs a chain of video rental stores.

The company guarantees that if a video is not available for rental, the customer will get free rental when that video comes back into inventory. It is not possible for customers to pre-book videos.

The company purchases a number of copies of each video, taking the above policy into account, but has no way of monitoring whether their procurement strategy is effective. Procurement decisions are made and actioned locally and no central budgets are produced.

You have been asked by the directors to review the above procurement and other strategies.

**Required**

- (b) Identify and explain the potential business risks arising from the above procurement and other strategies. Suggest controls and strategies that management could instigate to mitigate those business risks. **(9 marks)**

**(Total: 15 marks)**

*< End of exam paper >*