



COLLEGE OF BUSINESS, PEACE, LEADERSHIP AND GOVERNANCE

NMAC207: AUDITING PROCESS

END OF SEMESTER EXAMINATION

MAY 2021

LECTURER: DR J MUZURURA

TIME: 7 HOURS

INSTRUCTIONS

Answer **ONE** question

The marks allocated to each question are shown at the end of the question.

Show all your workings where it is required.

Credit will be given for presentations that are neat, logical and grammatically well constructed.

Question 1

1(a)

“The objective of the auditor is to design and perform audit procedures in such a way as to enable the auditor to obtain sufficient appropriate audit evidence to be able to draw reasonable conclusions on which to base the auditor's opinion. (ISA 500.4) “

Required

Discuss the extent to which each of the following sources of audit evidence is sufficient and appropriate.

- (a) Oral representation by management in respect of the completeness of sales where the majority of transactions are conducted on a cash basis (5 marks)
- (b) Flowcharts of the accounting and control system prepared by a company's internal audit department (5 marks)
- (c) Year-end suppliers' statements (5 marks)
- d) Physical inspection of a non-current asset by an auditor (5marks)
- (e) Comparison of statement of profit or loss items for the current period with corresponding information for earlier periods. (5 marks)

1(b)

You are an audit manager in Petters & Co, and you are in the process of planning the upcoming audit of Work Co, a large private company. In your initial conversation with Greatermans Co's finance director, you discovered that there is a small internal audit team, under the supervision of Ruthie Rosaro, a recently qualified accountant. Before heading up the internal audit department at Greatermans Co, Ruthie worked for the business advisory department of a major firm of professional accountants. The internal audit department has a manual of procedures that was created by Ruthie's predecessor. Internal audit work that is done each year includes observing the inventory count, as well as extensive testing of financial controls over the sales, purchases and

wages systems. Ruthie reports directly to Gretermans Co's finance director, who has overall responsibility for the department. In the course of the year the finance director instructed the team to work on the implementation of cost cutting measures being introduced across the company. This is in addition to the team's responsibilities for testing the existing financial and operational controls. The internal audit team has three members, including Ruthie. The remaining team members are in the process of studying for professional accountancy qualifications. One team member left the company during the year, citing 'overwork' as their reason for leaving. As a result of financial pressures, Gretermans Co is currently operating under a recruitment freeze and the team member has not been replaced. In addition, team members currently qualifying have been told that Gretermans Co will no longer be able to offer them support in their professional studies.

Required

Identify and explain the matters that should be considered in respect of the extent to which reliance can be placed on the work of the internal audit function of Gretermans Co. (20 marks)

1(c)

You have been informed by the senior partner of your firm that you are to be in charge of the audit of a new client, Nhamo Pvt Ltd, for the year ended 31 December 2021. She tells you that the company is engaged in the manufacture and wholesaling of sweets and confectionery, with revenue of approximately \$10,000,000 and a workforce of about 150. The company has one manufacturing location, sells mainly to the retail trade but also operates ten shops of its own. The senior partner asks you to draw up an outline audit plan for the assignment showing when you anticipate visits to the client will be made and what kind of work will be carried out during each visit. The deadline for your audit report is 28 February 2020.

Required

Draw up an outline plan for the audit of Nhamo Pvt Ltd for the year ended 31 December 2021, including:

- (a) Approximate timing in the company's year of each stage of the audit of this new client. State why you have selected the approximate timing (5marks)
- (b) The objective of each stage (5 marks)
- (c) The kind of work that will be carried out at each stage. (5 marks)

Question 2

2 (a)

As audit senior, you have recently attended a meeting with the managing director of Gatora Stow Co (audit client) and the new audit partner assigned to the audit, Michael Judah, who has recently joined your firm, Eastlake and Pond. The audit partner is familiarising himself with the client. Go Stow Co is a large limited liability building company set up by Joe Sithole, who has been managing director since incorporation. It operates in the south of the country, purchasing land outside of major towns and building retail parks, which the company then manages. You are familiar with

the client, as you have taken part in the audit for the last three years. The other key member of the board is Kathleen Hafa, who set up the business with Joe Sithole and is finance director. Kathleen is a qualified accountant, and the accounting systems and procedures at Go Stow Co have always appeared sound. You took minutes of the meeting, which are given below.

Minutes of a meeting between Michael Judah and Joe Sithole, 30 March 20X2 MJ introduced himself to JS and asked for a brief history of the business, which was given. Currently, the majority of income is from the property management side, as the building market is becoming saturated. With interest rates set to rise, JS is less keen to borrow and build in the current climate. MJ asked JS whether a recent spate of terrorist bomb attacks had had any effect on business. JS commented that he had been given the impression that retail was down and that customers were staying away from the retail centres – but he felt that some of that could be attributed to a rise in interest rates and was likely to be temporary. The first months of the year are always poor for retail ...

MS asked whether there had been a rise in empty units in the retail centres. JS said there had been a small rise. MS asked JS about his views in relation to the current proposed legislation before the Government concerning quality standards in the building trade. JS commented that it seemed like a 'load of nonsense' to him, and expressed some dissatisfaction with the current political situation ... MS pressed the matter, enquiring as to JS's opinion on the likely effects on his business were more stringent standards to be required in the future. JS is of the firm belief that it would not be passed. MS expressed his fear that the legislation was more than likely to be passed, and would have far-reaching and expensive effects on most builders in the country. JS repeated some of his previous comments about politicians. MS enquired as to whether there were any anticipated developments in the business that he should know about. JS made reference to KH's plans to retire from full-time work in the business. MS asked how JS was going to replace her. JS commented that he was hoping to persuade her to stay on as she deals with all the financial side, and he'd be lost without her. MS tried to enquire how firm her retirement plans were, but JS was not forthcoming. After the meeting, Michael Judah asked you to ring Kathleen and discuss her plans. She confirmed that she does plan to retire. She informed you that she plans to emigrate to Australia, and is not keen to put back her plans. She asked about the possibility of Eastlake and Pond assisting in the recruitment process for her replacement, as she does not feel that Joe Sithole has the technical ability to recruit someone without her, and has not accepted her plans enough to recruit before her retirement. She said that she has even wondered about the possibility of someone being seconded to the company from Eastlake and Pond to cover her position after she has left and before her replacement is found. Mike is keen to reappraise the audit strategy taken towards the audit of Go Stow, as he feels the audit could be conducted more efficiently than it has been in the past. Historically the audit has been highly substantive.

Required

- (a) Identify and explain the key business risks that exist at Gotora Stow (10 marks).
- (b) Explain what is meant by the 'business risk approach' to an audit. (10 marks)
- (c) Propose and justify a strategy for the audit of Gotora Stow. (10 marks)
- (d) Discuss the ethical implications for the audit of the two suggestions made by Kathleen (10 marks)

2(b)

You are the Ethics Partner at Studza Briannne & Co, a firm of Chartered Certified Accountants. The following situations exist. Teresa is the audit manager assigned to the audit of Recreater, a large quoted company. The audit has been ongoing for one week. Yesterday, Teresa's husband inherited 1,000 shares in Recreater. Teresa's husband wants to hold on to the shares as an investment. The Stewart Brian & Co pension scheme, which is administered by Friends Benevolent, an unconnected company, owns shares in Tadhura Group, a listed company with a number of subsidiaries. Stewart Brian & Co has recently been invited to tender for the audit of one of the subsidiary companies; Kermit Co. Studza Briannne has been the auditor of Kripps Sisters, a limited liability company, for a number of years. It is a requirement of Kripps Sisters' constitution that the auditor owns a token \$1 share in the company.

Required

- (ii). Comment on the ethical and other professional issues raised by the above matters. (5 marks)
- (ii) Analyse the extent to which the risk of litigation against the audit firm is affected by the firm's knowledge of the impending need by Recreater to raise finance in the coming year. (5 marks)

Scenario

You are a partner in a firm of Certified Public Accountants. The following issues have emerged in relation to three of your clients. (a) Easter is a major client. It is listed on a major Stock Exchange. The audit team consists of eight members, of whom Paul is the most junior. Paul has just invested in a personal pension plan that invests in all the listed companies on the exchange. (b) You are at the head of a team carrying out due diligence work at Electrar, a limited company which your client, Powerful, is considering taking over. Your second in command on the team, Peter, has confided in you that in the course of his work he has met the daughter of the managing director of Electrar, and he is keen to invite her on a date. (c) Your longest standing audit client is Tedius, which you have been involved in for ten years, four as engagement partner. You recently went on an extended cruise with the managing director on their yacht.

Required

Comment on the ethical and other professional issues raised by the above matters. Your answer should outline the threat arising, the significance of the threat, any factors you have taken into account and, if relevant, any safeguards you could apply to eliminate or mitigate the threat.

(10 marks)

Question 3**Case study: Hollidayy INN Hotel Group Ltd.**

You are an audit manager in Munombodeyi & Co. Certified Public Accountants and Registered Auditors. The audit engagement partner, John Munombodeyi, has called you into his office to discuss a new audit client. You have been assigned as the audit manager of Hollidayy INN Hotel Group Ltd. (Hollidayy INN Group) for the year ended 31 December 2019. The Group operates a chain of luxury hotels across Ireland. However, as part of a continuing growth strategy, it has acquired a new hotel in Paris. You are very excited about auditing this luxury group of hotels, and are hoping that you may get to stay in one of the hotels during the audit. It is now January 2020,

and you have recently had a planning meeting with John Munombodeyi, Paul Wilson, the managing director of Hollidayy INN Group, and Lisa Tapfuma, the finance director of Hollidayy INN Group. From detailed discussions with them, you note the following information: Background information: Hollidayy INN Group owns five hotels in Ireland (Dublin, Cork, Kerry, Monaghan and Belfast) and one hotel in Paris, which was acquired in September 2019. Each hotel operates through a separate legal entity, and Hollidayy INN Group owns 100% of each entity. The Group prepares consolidated financial statements on an annual basis. The Head Office is located in Dublin. In 2019, the Hollidayy INN Group had total revenues of \$90 million (2018: \$80 million), and operating profits of \$8,500,000 (2018: \$11,000,000). Lisa Tapfuma explained that all the hotels have been performing well over the last year, with the exception of the hotel in Belfast (see Appendix 1).

Information Technology (IT) Lisa Tapfuma highlighted that the Hollidayy INN Group relies heavily on the use of information technology (IT) and noted that approximately 96% of bookings are made online via its website. The Group invested significantly in IT over the last six months, which resulted in an extensive upgrade of its website and the development of a user-friendly app. Paul Wilson said, “We have spent a significant amount of money developing our IT systems and ensuring they are secure, as the rapid increase in cybercrime in Ireland is frightening.”

Finance team

Each hotel has a finance team, including a financial controller. At the end of every month, a reporting pack is prepared by the financial controller, including a copy of the management accounts, key completed reconciliations and detailed commentary on how the hotel has met key performance indicators for that particular month. Each reporting pack is submitted to the head office in Dublin, and the group financial controller reviews them and performs additional reconciliations. The group financial controller also prepares the year-end consolidated financial statements. Lisa has, however, informed you that the group financial controller resigned in November 2019 because he could not cope with the pressure of the job. She has not yet been able to find a suitable replacement. Lisa has asked if your firm would be able to help with the finalisation of the consolidated financial statements for the year ended 31 December 2019, as her team is currently struggling to find the time needed.

New acquisition

The hotel in Paris (Paris Ltd.) was acquired in September 2019 for \$8,500,000, and will be included in the consolidated financial statements at 31 December 2019. The purchase of the hotel was financed by a bank loan. Paul Wilson explained this was a significant investment for the Hollidayy INN Group and that a further \$2 million has since been spent on capital expenditure to ensure it meets the exceptionally high standards of the Group. Paul Wilson has invited the entire audit team to travel to Paris for the opening of the hotel in March 2020 as his guests. He has also assured the team will be treated very well while there.

Valuation of the hotel properties

The group policy is to value Land and Buildings at fair value. The calculation of fair value and the allocation of fair value to Land and Buildings requires significant judgement. Paul Wilson confirmed professional valuation experts were appointed to value Land and Buildings at 31

December 2019. Land and Buildings at that date were valued at \$110 million, representing a revaluation increase of \$12 million.

Loans and Borrowings During the financial year to 31 December 2019, the Group borrowed \$10,500,000 in order to finance the purchase of the new hotel in Paris, and to complete the renovation work required. The loan is repayable over 10 years and the Group must adhere to strict loan covenants. The bank requires the Group to provide management accounts on a quarterly basis: if a loan covenant is breached, the loan may be due for repayment immediately. Lisa Tapfuma has informed you that the group is also struggling to ensure management accounts for the quarter ended 31 December 2019 will be submitted within the allocated timeframe. Appendix 1: Hotel in

Belfast Overview:

The hotel in Belfast is one of the biggest in the Group, and contributes 25% of total revenue. Although revenue has increased in 2019, profit has fallen significantly due to a number of “special offers” in both accommodation rates and the restaurant. Paul Wilson believes the main causes for this fall are reduced gross margins (due to the successful uptake of the various special offer promotions during the year) and increasing costs (mainly driven by payroll). The number of special offers were approved by management in a bid to counter the tough economic environment within which the hotel operates and thereby increase revenue.

During the year, a new bonus scheme was introduced for both managers and directors in order to increase revenue. The bonus is directly linked to revenue.

The hotel has four main revenue streams, as outlined below.

1. Accommodation income: The hotel has 350 rooms, with average room rates of \$225. Paul Wilson informed you that occupancy rates average 75% throughout the year, with almost 100% occupancy during the summer months. In the latter six months of 2019, it was difficult to achieve occupancy targets, as three new hotels were opened in the city centre in May 2019. A further two hotels are expected to open next month.

2. Restaurant income: The hotel has one restaurant which is open daily for breakfast, lunch and dinner. Paul Wilson explained the restaurant incurred significant losses during 2019, due to increased competitor offerings.

3. Bar income: There are two bars in the hotel and a wide range of drinks is available to both residents and non-residents. In April 2019, the hotel opened a wine bar, which has proven to be very profitable. **4. Function room income:** The hotel has a large function room which is ideal for weddings, small conferences and business meetings. The function room was renovated in March 2019, and the hotel hosted a wedding fair in April 2019. Due to the success of the wedding fair, supplemented with advertising in various media outlets, almost all Fridays and Saturdays in 2020 and 2021 have been booked. The average cost of a wedding in the hotel is \$15,500 and a deposit of \$2,000 is required for each booking.

Requirement:

(a) Draft a memo to the audit partner that outlines FIVE key audit risks in respect of Hollidayy INN Group, and recommend an appropriate approach to test each highlighted risk. **(30 marks)**

(b) In accordance with ISA 315 - *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and its Environment*, discuss the key procedures which should be performed to assess the risk of cybercrime to the Hollidayy INN Group. **(30 marks)**

END OF EXAMINATION
