



**MASINDE MULIRO UNIVERSITY OF
SCIENCE AND TECHNOLOGY
(MMUST)**

MAIN CAMPUS

**UNIVERSITY EXAMINATIONS
2022/2023 ACADEMIC YEAR**

FOURTH YEAR SECOND SEMESTER EXAMINATIONS

**FOR THE DEGREE
OF
BACHELOR OF COMMERCE/SCIENCE (ACCOUNTING)**

COURSE CODE: BCA 450

COURSE TITLE: AUDITING AND INVESTIGATION

DATE: Monday 17th April 2023

TIME: 12.00-2.00pm .

INSTRUCTIONS TO CANDIDATES

Question ONE (1) is compulsory
Answer THREE (3) questions

TIME: 2 Hours

MMUST observes ZERO tolerance to examination cheating

This Paper Consists of 3 Printed Pages. Please Turn Over. ►

QUESTION ONE (30 MARKS)

Read the passage below and attempt the questions that follow

Enron Badly in need of repair

The primary purpose of financial statements is to show the underlying economic performance of a company. The balance sheet provides a snapshot, at a moment in time, of the assets, liabilities and capital of the business; and the income statement, or profit-and-loss account, shows the difference between total revenues and total expenses. The auditors vouchsafe that these present a fair view, acknowledging the subjective nature of some of the measures behind the accounts. The independence of the auditors guarantees, in theory that 'fair' is just that. Somewhere along the line, though, things seem to have gone wrong.

Enron and others have shown how easy it is to manipulate companies' financial statements. Can it be made more difficult? Bodo Schnabel, the boss of Comroad, a navigation technology company listed on Germany's Neuer

Market, treated his accounts with wild abandon. In 1998 the company invented two-thirds of its total revenues and backed them up with the name of a non-existent client in Hong Kong. By 2000, 97% of Comroad's revenues came from the imaginary company, the existence of which its auditor, KPMG, did not bother to verify.

Comroad is just one of a series of accounting scandals that have badly damaged investors' confidence in financial statements. Companies such as Waste Management, Cendant, Xerox and, of course, Enron, have lied wholesale to investors who have now become suspicious of all accounts. The share price of General Electric (GE), the world's biggest company by market capitalization, has fallen by some 23% this year, due in part to concerns about its accounting methods. Blacklists have circulated round the City of London and Wall Street. One listed all companies whose chief financial officers had been recruited from one of the Big Five accounting firms. Many investors now believe that companies can manipulate their accounts more or less at will, with the aim of producing profits that increase steadily over time. Provisions are bumped up in good years and later released, or the value of an acquisition is slashed; there are plenty of tricks. In the dotcom years, finance directors resorted to so-called pro-forma numbers, which strip out negative items from the income statement.

'Our financial reporting model is broken,' said Joseph Berardino, former head of Andersen, Enron's auditor, last year. Designed in the 1930s for an industrial age, financial statements, he argued, look backwards to historic costs; they give investors little clue about the future. Companies cannot include internally produced software, drugs or brands in their balance sheets because they are intangible assets. That has led to an increasing gap between the value of companies as measured by the stockmarket and the value measured by their accounts (their book value), although the difference has contracted of late along with the market values of technology companies.

- (a) From this passage what is the role of a professional accountant in financial reporting by public companies. (2 marks)
- (b) Fraud in a company may be perpetrated by employees or by management.
 - (i) Briefly explain the difference between the two types of fraud (4 marks)
 - (ii) With reasons, identify the type of fraud perpetrated in this passage and the possible motives. (3 marks)
- (c) In all the cases of fraud in this passage, the independent auditor appears to have agreed with the directors that the financial statements presented a true and fair view while in reality they did not. Since the auditor technical competence and professional due care are not doubtful, their independence must be.
 - (i) Identify and briefly explain five natural classes of threats to auditor independence (10 marks)

- (ii) In instances where threat to auditor independence is too great to mitigate or there are no available counter measures, the auditor's only recourse is refusal to act. Identify and explain four(4) general counter measures available to an audit firm. (6 marks)
- (d) From the passage, corporate finance officers recruited from audit firms is a sign of potential fraudulent reporting.
- (i) Briefly explain how recruitment of senior management by audit clients from their auditors facilitate fraudulent reporting (3 marks)
- (ii) Briefly explain a counter measure that may be applied to mitigate this risk. (2 marks)

QUESTION TWO (20 MARKS)

For an audit to be of high value to target users it must be performed independently, competently, and must cover the appropriate scope: alternatively it must fit within the current auditing and financial reporting framework.

- (a) Briefly state and explain the parameters that constitute the auditing and financial reporting framework in Kenya today. (10marks)
- (b) Identify and Briefly explain three(3) matters which although desirable are not within the scope of current auditing and financial reporting framework (5marks)

QUESTION THREE (20 MARKS)

You are the partner in charge of the audit of Mkombero Limited, a private company which intends to seek a stock exchange placement of its shares. The company is required to prepare a prospectus which must incorporate a report by the auditors of the company. The directors intend to include a profit forecast in the prospects and you, as the company auditor, will therefore be required by the Stock Exchange to report on the base and calculations for the forecast.

Required:

- (a) What are the preliminary considerations to be borne in mind before you would accept responsibility for reporting on the profit forecast? (5 marks)
- (b) In your staff briefing as to the method of approach to be adopted in the profit forecast review, list six pertinent issues which staff should consider in their examination of procedures followed by the company in preparing the forecast. (10 marks)
- (c) If you do not consider that certain assumptions in the forecast appear to be realistic, what action should you take? (5 marks)

QUESTION FOUR (20 MARKS)

- (a) The auditor's primary duty is to obtain sufficient audit evidence for the conclusions upon which to base his audit opinion. This he must do, not only effectively but also efficiently. The concepts of risk and materiality are essential to an auditor in achieving this objective.
- i. Explain the three levels of risk an auditor needs to identify and assess for each audit client and how the assessed risk level is applied in designing audit procedures (5marks)
- ii. state the types of materiality an auditor needs to identify and how the materiality are assessed and applied in planning and executing audit procedures and evaluating the results (5marks)
- (b) Distinguish between statistical and non-statistical sampling techniques. (3marks)
- (c) Under what circumstances will the following sampling methods be used in auditing
- (i) Attribute sampling (3marks)
- (ii) monetary unit sampling (4marks)