STRICTLY CONFIDENTIAL

THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2010 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

(DECEMBER 2010)

TIME ALLOWED : 3 HOURS

SUGGESTED SOLUTIONS

1. (a) Internal controls over computer based accounting systems may be considered under the following two main headings:

(i) Application controls – these relate to the transactions and standing data appertaining to each computer based accounting system and therefore specific to each application. The objectives of application controls, which may be manual or programmed, are to ensure the completeness and accuracy of the accounting records and the validity of the entries made therein resulting from both manual and programmed processing.

Examples include:

- Controls over completeness, accuracy and authorization of input;
- Controls over completeness and accuracy of processing;
- Controls over the maintenance of master files and standing data contained therein;

(ii) General controls – controls other than application controls, which relate to the environment within which computer based accounting systems are developed, maintained and operated, and which are therefore applicable to all applications. The objectives of general controls are to ensure the proper development and implementation of applications and integrity of programs and data files and of computer operations. General controls may also be manual or programmed.

Examples may include:

- Controls over application development
- Controls to prevent or detect unauthorized changes to programs
- Controls to ensure that all programs changes are adequately tested and documented
- Controls to prevent or detect errors during program execution
- Controls to prevent unauthorized amendments to data files
- Controls to ensure that the systems software is properly installed and maintained
- Controls to ensure that proper documentation is kept
- Controls to ensure continuity of operations.

(b) The microcomputer may be used by the auditor to assist him in the following ways:

(i) Preparation of working papers – computers can be used to prepare working papers. They are particularly helpful when standardized formats are used and where there are extensive calculations. For example, debtors circularization control procedures, fixed assets summaries;

(ii) Analytical review procedures are greatly helped by the computer. Most special use software programs offer analytical review procedures as part of the product;

(iii) Audit programme preparation – they may be typed onto a word processing package and saved from year to year. A more sophisticated use is to have programmes which assist the auditor at the planning stage in his assessment of audit risk;

(iv) Evaluation of internal control – the internal control system can be documented on the word processor and internal control questionnaires can be automated so as to document and evaluate the system. Additionally, flowcharting software may be used;

(v) Audit sampling – software is available which designs, selects and evaluates samples using a variety of statistical and non-statistical techniques;

(vi) Time budgeting – spreadsheets may be used to prepare time budgets and monitor time spent in relation to budget;

(vii) Trial balance and lead schedules preparation – the microcomputers can be used to develop a working trial balance and lead schedules for the various statements;

(c) Controls over computers used by the auditor may include the following:

(i) Data stored on the computer must be protected against corruption and unauthorized access. Thus copies of disks must be kept by the auditor, printouts must regularly be made of the data on the disks and a system of passwords should be used to prevent unauthorized access;

(ii) Much of the information about the data on the computer may not be visible to the audit manager, for example the basis of selection of a statistical sample. It is important therefore for the auditor to properly document input data and computational routines. This essentially means that the auditor must prepare working papers manually in order to supplement the working schedules set up on the computer;

(iii) Programmes utilized by the auditor to assist his work must be properly evaluated and tested before use. It is also important that the auditor has been properly trained in the use of the software and computers, for if this is not the case, the auditor may come to invalid conclusions on the information produced by the computer

2. (a) This question examines how internal controls work within accounting systems. Payroll systems are often classified as either wages or salary systems. Wages systems usually remunerate manual workers for work performed on a weekly basis, while salary systems usually reimburse staff for time worked on a monthly basis. Internal controls and compliance tests for control objectives identified in the question are analyzed as below:

(i) **Control objective**:

To ensure payment is made for actual services rendered

Internal Controls

- Clock cards must be authorized by the foreman
- Time sheets are authorized by Department Manager
- Nobody calculates their own pay especially the wages clerks

Compliance tests that the auditor can carry out in respect of above

- Select a sample of clock cards and time sheets and examine for signature of foreman and manager as evidence of authorization
- Ascertain the system to ensure that nobody calculates their own pay and if they do then check relevant employees pay in total

(ii) **Control objective**

To ensure only bona-fide employees are paid

Internal Controls

- Payroll is reviewed by responsible official to ensure no abnormal amounts are paid and no bogus employees included;
- Starters and leavers are authorized by the Human resource department or senior executive;

Compliance tests:

- Select a sample of payrolls and examine signature of reviewer. Discuss procedures with relevant official;
- Select a sample of starters and leavers from personnel records and check they appear/disappear in the correct weeks from the payroll;

(iii) **Control Objective**

Ensure pay is properly calculated

Internal Controls:

- Authorized rates of pay are used;
- Calculations checked by independent employee;

Compliance Tests

- Agree a sample of pay rates from payroll to authorized list. Discuss procedure with payroll clerks – see authorized list;
- Examine payroll for evidence of this check;

(iv) **Control Objective**

Wages and salaries are accurately recorded

Internal Controls

- System ensures all payments get properly recorded into records;
- Deductions (i.e. tax, pension, union fees etc) are properly calculated and accounted for;

Compliance Tests

- Select sample of payments and agree to payroll, cash book and nominal ledger;
- Select sample of deductions and test calculations and agree to relevant ledger account.

(v) **Control Objective**

Payments are adequately controlled

Internal Controls

- Cheque signatories review payroll. At least two signatories;
- Employees sign for their pay packet;
- More than one employee makes up pay packets;
- Returned pay packets put in safe and banked soon after if not collected;
- Bank account details of employees up to date;
- Adequate insurance cover obtained.

Compliance Tests

- Examine payroll for evidence of their review. Discuss procedure with cheque signatories;
- Attend a payroll payout. Examine records of employee signatures;
- Attend a pay packet make up. Discuss procedure with officials;
- Discuss procedure of returned cheques with responsible employee;
- See insurance certificates. Compare sum insured with the highest payroll total to ensure it is adequate;

- Discuss the procedure of updating employee bank details with relevant official;

(b) Internal control can be conveniently broken down into five components and some of them are:

(i) Control environment

Control environment forms the foundation for all other components of control. Control environment is largely concerned with the awareness and attitude of management to controls. The company's organizational structure, the existence of budgetary system, and the existence of an internal audit department would also be factors relevant to a consideration of the control environment. It will generally set the tone of the organisation since commitment to control must start at the apex of the organisation. The management's philosophy and management style will reflect the effectiveness of the control environment. Other factors of a control environment are:

- Integrity and ethical values
- Organization's commitment to competence
- Existence of an independent Board of Directors or audit committee
- Management's philosophy and operating style
- Assignment of auditing
    - Human resource policies and practices

(ii) Control activities

Control activities are one facet of an effective control process. They refer to the policies and procedures throughout the organisation that help ensure management's directives are carried out and that necessary actions are taken to address risks. They relate to the risk-assessment process and must be appropriate to ensure that management's directives are carried out.

3. (a) (i) Audit planning is one of the critical tasks the auditor has to do before embarking on any audit assignment. It helps the auditor identify any critical areas to which particular attention must be paid. The auditor will perform planning for audit assignments in order to:

(1) Establish the intended means of achieving the objectives of the audit;

(2) Assist in the direction and control of work;

(3) Help to ensure that attention is devoted to the critical aspects of the audit;

(4) Help to ensure that the work is completed expeditiously (will allocate adequate staff to assignments).

(ii) The preparatory procedures which the auditor should consider include the following:

(1) Reviewing matters raised in the audit of the previous year which may have continuing relevance to the current year;

(2) Assessing the effect of any changes in legislation or accounting practice affecting the financial statements of the enterprise;

(3) Reviewing interim or management accounts where these are available and consulting with the management and staff of the enterprise. Matters of consideration should include current trading circumstances and significant changes in

- The business carried on
- The enterprise management

(4) Identifying any significant changes in the enterprise's accounting procedures such as a new computer based system;

(5) The timing of significant phases of the preparation of financial statements;

(6) The extent to which analyses and summaries can be prepared by the enterprise's employees;

(7) The relevance of any work to be carried out by the enterprise's internal auditors.

(b) The concept of materiality appears in both company law and accounting standards. A matter is considered to be material if its non-disclosure, misstatement or omission is likely to distort the view given by the financial statements to their users. Materiality should be considered in relative terms.

(c) In applying the term material to any item, the auditor should take the following into considerations:

(i) The amount itself in relation to

- The overall view of the accounts;
- The total of which it forms or should form part of it;
- The associated items;

- The corresponding figures in previous years.

(ii) The description, including questions of emphasis;

(iii) The presentation and context;

(iv) Any statutory requirements for disclosures.

4. (a) Firms adopting a risk approach to audit do so to minimize the risk of giving the wrong opinion or audit risk. Audit risk is defined in SAS 300 Accounting and internal controls Systems and Audit risk assessment as the risk that auditors may give an inappropriate opinion on the financial statements, usually meaning that the auditor will fail to qualify his opinion when necessary. This may happen for various reasons and therefore there are several component parts of the audit risks.

(b) (i) SAS 300 states that there are three components of audit risk:

Inherent risk – is defined in SAS 300 as the susceptibility of an account balance or class of transactions to material misstatements….. irrespective of related internal controls. Inherent risk can be looked at from the entity and account balance levels.

(iii) Control risk - Given that it is possible that errors of misstatements will occur in the financial statements, the auditor would expect to see some controls in place to prevent this happening. SAS 300 defined control risk as "the risk that could occur in an account balance or class of transactions…… which would not be prevented or detected and corrected on a timely basis by the accounting and internal control systems. Control risks can also be considered at two levels, general level-control environment and at specific level-control procedures.

(iii) Detection risk – SAS 300 defines detection risk as the risk that auditor's substantive procedures (tests of details of transactions and balances or analytical procedures) do not detect a misstatement that exists in an account balance or class of transactions.

Examples:

- Carrying out substantive tests in the form of analytical review;
- Detailed tests of transactions and balances.

Examples of inherent risks include:

- The state of the economy and of the industry in which the enterprise operates;

- Legislation;

- Regulations and accounting practices affecting the industry;
- The nature of the company's business and its products;
- The size and number of locations of the company;
- The experience and integrity of the management and personnel.

Examples of control risk include:

- Organizational structures
- Existence of a budgetary system
- Existence of an internal audit department
- Existence of an independent board of directors or audit committee
- Existence of procedures to detect errors and misstatements
    - Approval and control of documents
    - Arithmetical controls including control accounts and reconciliations
    - Monthly sales and purchase ledger control accounts and bank reconciliations
    - Regular cash, security and stock count and comparisons to accounting records, and physical controls over both the assets and records of the company.

5. (a) From the facts given, there seems to be no objection to accepting the appointment, because:

(i) There is no legal requirement regarding the auditing of the books and accounts of a partnership, and the appointment of an auditor is purely a matter of agreement;

(ii) As the audit is thus a matter of agreement with partners, its scope will depend on the terms of agreement which may limit or extend the scope of the audit. It would be advisable for the auditor to have the precise scope of the work set down in writing.

(iii) If partners of the firm are able to supervise and control the recording of transactions to their satisfaction, there seems little object in appointing an auditor for the complete audit, and the limitation of the auditor's duty to the checking of debtors and the private ledger may give the partners all the aid which they may require from services of the auditor.

(iv) Any provision in the partnership agreement regarding the appointment of auditors should, however, be taken into account before arriving at a decision to accept the appointment;

(v) As the Companies Act 1984, requires that an audit must have been carried out free of any restriction before an auditor can give an unqualified opinion, the auditor's opinion in this particular case should be qualified.

(b) If the request, as indicated, comes from the directors of a company, the auditor can certainly not accept the appointment, since the minimum rights, duties, and responsibilities of an auditor are specifically laid down in the Companies Act, and, by inference these may not be curtailed. The duties etc. may be extended, but never limited. It is not certain from the given facts that the auditor should actually decline the appointment, but he should nevertheless point out the legal position to the directors, making it clear to them that he is willing to accept the appointment, but then without any limitations whatsoever.

(c) A letter of engagement defines the extent of the respective responsibilities of auditors and the directors of the company in order to minimize the possibility of misunderstanding between the client and the auditor. It also serves as a written confirmation of the auditor's acceptance of the appointment, the scope of the audit, the form of the opinion and the scope of non-audit services.

Items to be found in an engagement letter include paragraphs on:

- Responsibilities and scope of the audit
- Representations by management
- Irregularities and fraud
- Accounting and other services
- Fees
- Agreement of terms
- Non-audit engagements

6. (a) The statement regarding the meaning of vouching is definitely incorrect and unsatisfactory, since it does not do good justice to the important concept of vouching.

It must be criticized with particular reference to the **three** basic principles of vouching:

(i) Checking the origin and the authenticity of the entry;

(ii) Checking the amount of the entry; and

(iii) Checking the method of entry and its correctness.

In the statement no reference is made to points (i) and (iii), but only partly to point(ii).

Point (i) includes checking of all vouchers, correspondence, etc. which may possibly refer to the entry and establishing whether all the requirements for a sound voucher have been satisfied.

Point (ii) includes not only checking whether the amount shown on the vouchers has been entered correctly in the books but also whether the calculation of the amount is correct.

Point (iii) embraces the checking of the entry itself, i.e. whether the correct amounts have been debited and credited;

(b) Verification of vans and fuel would cover the following:

(i) Delivery vans K45,560,000

- Checking the existence of the asset through physical inspection, in such a way each vehicle mentioned in the vehicle register identified. The vehicle register must be thoroughly checked as regards the number of vehicles on hand at the beginning of the year, vehicles bought and sold during the year and the number on hand at balance sheet date. All entries in the books in respect of vehicle purchased and sold must already have been vouched;

- Checking the ownership by referring to the registration certificates, licenses, insurance policies etc.;

- Checking the value of the delivery vans and the method of showing the asset on the balance sheet, i.e. at cost less accumulated depreciation. The auditor must check that adequate provision for depreciation so as to show the asset at a true and fair valuation.

(ii) Fuel at own pump K7,516,217

- If the auditor was present at the yearend stock-taking exercise then he could verify the existence of fuel on hand by making a note of the quantity of fuel on hand in the storage tanks when the dipstick reading was taken at the end of the day;

- If he was not present at stock taking, then he could take a dipstick reading at a later date and with due regard to purchases and consumption could calculate the quantity of fuel that should be on hand on the last day of the financial year. The calculated figure should agree more or less with the dipstick reading on the last day of the financial year – taking into account the allowance for spillage and evaporation.

- Ownership could be deduced from the fact that the fuel is in the possession of the bakery together with the vouching of purchases (invoices made out in the name of the bakery).

- The value of fuel on hand could be calculated by multiplying the number of litres of petrol and diesel with the respective price per litre according to the recent purchase invoice

7. (a) The auditor or professional accountant cannot perform professional work in connection of any matter which is subject of dispute or litigation on condition that payment for such work shall be made only if such dispute or litigation ends favourably for the party for whom such work is performed.

The terms and scope of such work must be clearly spelt out in the letter of engagement as part of other services to avoid getting strange conditions like the one the management of Shoe and Boots Limited put to their auditors.

The rules of professional ethics provide clear guidance on the remuneration and determination of fees for the work done by the auditor. Fees should be computed based on time spent by the partners and staff of the firm in the particular work. The auditor will also consider the skill and responsibilities of the staff involved in the particular assignment. The fees should be charged separately for each class of work done and the firm should not derive too great a part of its professional income from one client or group of connected clients.

(b) Under professional ethics an auditor may not divulge to any third party any confidential information which he may have obtained in the course of his professional relations with any client or employer, unless such client has expressly consented to such information being so divulged. Information acquired in the course of the auditor’s duties should not be used for the advantage of a third party.

Confidentiality should be preserved both within and outside the auditor’s organisation. Disclosure should be made only with proper authority or where there is a professional obligation, a right, a legal requirement or public duty to disclose.

In the case stated, the auditor has no professional obligation or a right or a legal or a public duty to disclose the information regarding the financial position of Grain Processors Limited. This will be tantamount to breach of confidentiality and could also influence a conflict of interest and impair his professional independence.

(c) Audit firms may provide other services to their clients in addition to the audit of their books. The auditor should however be wary that the provision of other services does not impinge upon his professional independence. Other services that the auditor can provide include:

- Accounting services – these may include the preparation of financial statements based on accounting records maintained by the client. The auditor may also prepare books of the accounts but the client must accept that the records remain his.

- Taxation services – this may involve the preparation of tax computations based on the accounts provided by the client. He may also provide advisory services for the clients with regard to corporation tax matters and other taxes like VAT, PAYE etc.

- Special investigations – the auditor, upon request from the client, may carry out investigations into the client's fraud and irregularities. It must be emphasized that the responsibility for detection and prevention of fraud and irregularities rests with the management of the client.

- Company secretarial services – this could involve the preparation and lodging of annual returns with the Registrar of Companies.

- Recruitment services – the auditor may be involved in recruitment of senior management staff. The auditors must be involved in the advertisement, arranging and interviewing candidates, short listing and making recommendations to the client. The final decision on who to hire should be left with the client.

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