STRICTLY CONFIDENTIAL

THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2011 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

(JUNE 2011)

TIME ALLOWED : 3 HOURS

SUGGESTED SOLUTIONS

1. Advantages of the computerized accounting systems include the following:

(i) Computers' processing of data is uniform and totally accurate. IT reduces clerical errors.

(ii) A computer will go on processing for as long as it is given information to process.

(iii) With appropriate software, it is possible to generate reports and analysis for management. It can also provide much more information than is feasible under a purely manual system.

(iv) Auditors can use Computer Assisted Audit Techniques (CAATs) to interrogate the system and carry out comparative and analytical tests.

(v) Managers can obtain data and use analytical techniques which may enhance control.

(b) There are two approaches to the audit of computerized accounting systems. One of that approaches is "auditing around the computer". Auditing around the computer is one method that auditors use to evaluate a client's computer controls. It involves picking a source document at random and verifying the corresponding outputs with inputs.

Auditing around the computer is appropriate in situations where significant computer controls are not required.

This approach will usually be used:

(i) To examine the standing of master file data e.g. rates, prices, VAT rate, interest rate which the computer uses as a basis of making calculations, to ensure it is properly authorized and is used currently by the computer.

(ii) Examine the output and relate it to the input so that, say, a selection of sales invoices can be traced directly to customers accounts in sales ledger.

(iii) Examine the output with external verification, for example, the purchase ledger balances with supplier statements.

(iv) To examine controls around data input to ensure that the day to day input of transactions information e.g. invoices and orders is properly controlled.

(c) The controls for computerized systems will be almost the same as the manual systems. These can be summarized as:

- Segregation of duties
- Authorization levels
- Access to information
- Arithmetical and reconciliation checks

The following procedures must be found in a computerized accounting system environment including that of Elite Suppliers Limited:

(i) It must establish a strong control environment and all the staff of the company should be aware of the need for internal controls and procedures to be followed.

(ii) The company must have documented procedures which all staff should be aware of by means of documentation and training.

(iii) The suppliers of the software should provide to Elite Suppliers Limited full documentation for the programs in use.

(iv) The access to applications software e.g. programs which control how data is processed should be restricted.

(v) Access to data should be restricted to staff that use it in the course of their work and no one else.

(vi) Access to system should be controlled by passwords and authorized log ons. Passwords must be changed regularly and not disclosed or shared.

(vii) The company must put into place application controls such as:

- Batch controls
- Sequential numbering systems
- Controls over coding data
- Manual authorization of input data
- Arithmetical controls
- Range checks
- Logging of when and who performed document processing.

2. (a) (i) The companies Act (1984) requires the directors of a company to prepare the financial statements for each financial period which give a true and fair view of the financial position of the company and its operating results for that period. In preparing the financial statements directors accept responsibility for the following:

- Maintenance of proper accounting records
- Selection of suitable accounting policies and consistent application thereof

- Making judgments and estimates that are reasonable and consistently applied
- Compliance with all applicable accounting standards when preparing financial statements
- Preparation of financial statements on a going concern basis unless it is inappropriate to presume that the company will continue in business in the foreseeable future.

The auditor's responsibility is to express opinion on the financial statements, as prepared by directors, based on their audit. The audit will be conducted in accordance with International Auditing standards which require that the auditor comply with ethical requirements and plan and perform the audit to obtain reasonable assurance whether the financial statements are free from material misstatements. They must obtain sufficient and appropriate evidence to provide a basis for the audit opinion.

(ii) Auditors responsibility to fraud not given.

(b) The auditor should be aware that there are limitations of an audit to detect fraud due to:

- The primary objective of the auditor is to form an opinion on the financial statements and not to detect fraud.
- Auditing is based on testing samples of transactions and evaluating of controls.
- Management, particularly senior management, have capacity to hide fraud from auditors and deliberately manipulate accounting records.
- Where misrepresentation involves exercise of judgment, it is difficult to decide whether these were caused by fraud.
- Fraud may involve sophisticated and carefully organized schemes designed to conceal it.

(c) The primary responsibility for the prevention and detection of fraud and error rests with management. Some of the ways the directors can discharge their duty towards prevention and detection of fraud and error are:

- Complying with combined code on corporate governance.
- Developing the code of conduct, monitoring compliance and taking action against breaches.

- Emplacing a strong commitment of fraud prevention. This involves establishing a culture of honesty and ethical behavior within the organization with clearly communicated policies on corporate attitude to fraud.
- Establishing a strong control environment, monitoring its effectiveness and taking corrective action.
- Establishing internal audit department

- Establishing a compliance function that is a separate department of the enterprise specifically charged with ensuring compliance with regulations.

  - Having an audit committee.

3. (a) (i) The Guideline "Internal Controls" defines internal control system as, "the whole system of control, financial or otherwise established by the management in order to carry on the business of the enterprise in an orderly and effective manner.
Ensure the adherence to management policies.
Safeguard the assets and secure as far as possible the completeness and accuracy of the records".
The individual components of an internal control system are known as controls or internal controls.

(ii) Segregation of duties

This is the most important single control activity and is key to good system and procedure design. Segregation of duties means that no one person should be responsible for recording and processing of a complete transaction. The involvement of several people reduces the risk of intentional manipulation or accidental error and increases the element of checking of work.

Example:

Initiation – works foreman decides the company needs more weldings gas
Authorization – works manager approves the purchase

Execution – the purchasing department order the product

Receipt – on arrival of gas it is received and passed with appropriate documentation to the stores department

Recording – the arrival of gas is documented by stores and invoice is compared with original order and goods received note by the accounts department and recorded by them in the books
(Different examples may be given by candidates as long as they cover the 5 steps above)

(b) Control objectives in the payroll department of Zalewa Precious Stones Limited should include the following:

(i) Ensure that wages and salaries are paid to actual employees at authorized rates of pay.
(ii) To ensure that wages and salaries are computed in accordance with records of work performed whether in respect of time, output, sales made or other criteria.

(iii) Ensure payroll are correctly calculated.
(iv) Ensure that payments are only made to correct employees.
(v) Ensure payroll deductions are correctly accounted for and paid over to the appropriate third parties.
(vi) Ensure all transactions are correctly recorded in the books of account.

(c) Control procedures would include the following:

(i) There should be separate records for each employee like date of birth' date of employment, next of kin, agreed deductions, skills, department and specimen signature.
(ii) Procedures for employment, retirement, dismissals, fixing, changing rates of pay.
(iii) Time records should be approved before preparation of salaries and wages. All overtime should be approved.
(iv) Output or piecework records should be properly controlled and authorized.
(v) Procedures should be established for dealing with advances, holiday pay, lay-off pay, new employees etc.
(vi) Starters and leavers should be dealt with by the Human Resources department and details passed to payroll separately.
(vii) Payroll must be approved by senior official prior to wages being paid.
(viii) Deductions such as PAYE pension contribution and other authorized must be paid over in time.
(ix) Regular independent comparisons should be made between personnel records and payroll records.
(x) Regular independent comparisons of payroll at different dates and reconciliations of numbers should be done.
(xi) Surprise investigation of wages records and records by internal audit or senior official.

4. (a) The auditor's report as presented by the auditors of Soche Hill Traders Limited is subject to criticism considering the provisions of the Companies Act (1984). Some of these are:

- The report is addressed to the directors instead of the members of the company. The Companies Act specifically states that audit reports must be addressed to the members of the company.

- It does not contain statements of fact and opinion as required by the companies Act e.g. obtaining audit evidence about amounts and disclosures in financial statements.

- It certifies the correctness of the statement of the financial position and the comprehensive income statement instead of expressing an opinion of the fairness thereof.
- The report contains no reference to the period it covers nor does it mention the name of the company on affairs the auditor is reporting.

(b) (Candidates are unlikely to remember the precise wording, but they should be familiar with what is included in an auditor's report)

The auditor's report should contain matters under the following headings:

- A clear heading including the word "independent" e.g. independent auditors report
- It should be addressed to the shareholders or members of the company e.g. to the members of Michiru Limited
- It should set out what is comprised in the financial statements i.e. what has been audited
- It should explain the basis on which the accounts have been prepared
- It should set out the responsibilities of the directors of the company
- It should set out the responsibilities of the auditors
- It must explain what the primary and secondary purposes of the report are

- It sets out the basis of the audit opinion i.e. how the work was carried out in order to provide evidence for the opinion
- It includes a statement about the level of evidence required i.e. enough to give "reasonable assurance"
- It must give the auditors opinion
- It makes reference to the directors report
- It needs a name and date of the report e.g. ABC & Co. Registered Auditors, 30 September 2010
- It comments on parts of the financial report not covered by the audit and also a clear statement of where the auditors responsibilities end.

5. (a) (i) **Five** advantages for small companies to have an audit are:

(1) The provider of finance e.g. banks requires audited accounts.

(2) Audits can help protect creditors which is important because of limited liability.

(3) An audit helps establish the credibility of the company at the time when fraudsters are committing 'long-firm' frauds i.e. building trust over a period of time and then disappearing with substantial amounts of goods or money having created a false picture of the activities of the company.

(4) There may be shareholders who are not involved in the business and their interest need to be protected by an independent audit.

(5) It provides reassurance for directors that the figures they are using are reliable and reinforces financial discipline.

(ii) **Three** advantages for small companies to have audit are:

(1) It is argued that an audit is only for compliance and does not assist management running the business.
(2) The costs of the audit represent a non productive expense and the money could be better used elsewhere.
(3) Banks and other lenders, including suppliers can make their own conditions for lending and do not really need historical audited accounts.
(4) Historical accounts taking advantage of limited disclosure requirements are of little value.

(b) The international Auditing Practice Statement (IAPS), "Special Considerations in the Audit of small Entities", highlights some issues which the auditor must take into consideration in the audit of small companies:

(i) <u>Independence issues</u>

(1) Small businesses present problems because of the professional relationship between auditors and the directors of a small business. Auditors are often seen as advisors and tend to become involved with their clients at a much deeper level than auditors of larger companies.

(2) Auditors of small companies often prepare the accounts and usually perform other tasks for the business and this acquaintance with the client can constitute audit evidence. There would be a "self – review" threat.

(3) Smallness and unsophisticated activities and the close personal relationship with auditors make a thorough knowledge of the business much easier but can make it difficult for the auditors to raise contentious issues with management.

(4) Auditors of small companies must always stay objective and should not take over the management role. There is a danger that advice can evolve into active management.

(ii) <u>Internal controls</u>

(1) Internal control or more likely lack of it is the biggest problem the auditors face.

(2) Small businesses tend to have a concentration of management and ownership, few sources of income and uncomplicated activities, relatively uncomplicated record keeping and limited management information.

(3) Segregation of duties is often a major problem as there are usually limited number of staff.

(4) Book-keeping might fairly be informal without much in ways of systems. Whilst some level of basic controls might be instituted the auditor is generally not able to rely on them for audit purposes to any significant extent.

(5) Owner- managers generally have unlimited opportunities for overriding what controls there are.

(iii) Going concern and uncertainty

(1) Small businesses have more going concern uncertainty than larger businesses as they are often vulnerable to cash flow problems, limited number of customers, vulnerability to bad debts, and competition.

(2) Lack of proper management information and limited financial expertise can compound the problems. Auditors can be drawn into acting as quasi financial directors if they are not careful.

(3) In some occasions the uncertainty surrounding small businesses can be so pervasive that the business is unauditable. In such case it may be better to decline to accept or to resign the post of auditor. There is no point in disclaiming an opinion as this really negates the purpose of carrying out any audit work and incur costs the client will be reluctant to pay.

(4) Completeness is a major problem for small companies' audits due to lack of internal controls and the possible danger of owner-manager manipulating the business for their own purpose. It is not always possible for auditors to ensure that all the business transacted is reflected in the records.

6. Auditors should first consider whether or not they can take on the audit engagements from an ethical, legal and practical point of view. This process must be done before accepting audit assignments.

(a) Before accepting the appointment as auditor of Tidye restaurant and bars, Pambalipe should:

(i) Request the clients permission to communicate with the previous auditor.
(ii) If this permission is refused, the firm must refuse the appointment as auditor.
(iv) If the appointment is granted, the firm should request in writing:

- Confirmation that there is no professional reasons why the appointment may not be accepted.
- Any information required to enable them to decide whether or not they are prepared to accept the appointment.

(v) In case the old auditor receives permission then he should
- Confirm there is no professional reasons why the appointment cannot be accepted.
- Disclose to the proposed auditor all information which they will need to decide whether or not to accept appointment.
- Discuss freely with the new auditor all matters relevant to the appointment which the auditor will need.

(b) Matters which should be discussed with new clients include:

(i) Establish the client's business, its products and customer base.
(ii) Consideration of the potential client's position in its industry and its reputation – is it a reputable company or dubious?
(iii) Consideration of the potential client's management and their ability.

(iv) Review the clients financing and capital structure.
(v) Consideration of any particular legal or special reporting requirements.

(vi) Discussing with the potential client any detailed information provided by the client in response to enquiries.
(vii) Consideration of the strength of the finance function.

(c) The purpose of the engagement letter is:

(i) To define clearly the extent of the auditor's responsibility and those of directors.
(ii) To minimize misunderstanding between auditor firm and the client.

(iii) To confirm in writing verbal arrangements.
(iv) To confirm acceptance by the auditor of his appointment.
(v) To inform and educate the client.
(vi) To set out details of any other services the audit firm is to carry out.

(vii) To set out the basis on which the fees will be charged.
(viii) To set out which legal jurisdiction the agreement is made under and the process of arbitration of any disputes.

(d) Omissions of the letter of engagement may result in:

(i) Disagreements with the client on matters of fees and work to be performed.
(ii) Increase in the expectation gap between the auditor and the client.

(iii) The auditor may be exposed to potential liability in terms of litigation.

7. (a) Stock-take procedures should cover the following characteristics:

(i) Good planning so that work is carried out carefully and systematically.

(ii) Division of stock-take into manageable areas for control purposes.

(iii) Identification of stocks and especially of high value items.
(iv) Nomination of people responsible for each aspect of count. These people should be independent from those charged with custody of stocks.
(v) Written instructions to counters for counting, weighing, measuring and checking should be issued and all counters must ensure they are familiar with them.
(vi) Controls to ensure all stocks are counted and once only.
(vii) Proper control over blank stock sheets by numbering them and the control over the return of completed and unused stock sheets.
(viii) Control of stock movement during the count – no goods in or out.

(ix) Cut off arrangements must be done.
(x) Arrangement for identification of defective, damaged, obsolete and slow-moving stock.
(xi) Identification of stock on premises owned by third parties and clients stock held by outside parties.
(xii) Appropriate treatment of sealed containers. Dangerous good and goods with specific problems.

(b) Duties of auditors at the planning stage as regards stock-taking include:

(i) Review the previous year's working papers and discuss with management any significant changes from last year.
(ii) Discuss stock-taking arrangements with management.
(iii) Familiarize themselves with the nature and volume of stocks and especially high value items.
(iv) Consider location of stocks and the problems this caused for client and auditors.
(v) Consider likely points of difficulty like cut off.
(vi) Consider internal audit involvement and reliance to be placed upon it.
(vii) Arrangements to obtain from third parties confirmation of stocks held by them.
(viii) Establish whether expert help will be needed from third parties.
(ix) Evaluate client's stock-taking instructions.
(x) Ensure all audit teams have a copy of the client's stock-take instructions.
(xi) Review surrounding system of internal control to identify areas of potential difficulty.
(xii) Plan usage of audit staff as to their availability to cover all required locations.

(c) Cost and net realisable value is a method of valuation of stocks, and stock is valued at lower of cost or net realizable value.

Cost includes cost of actual item plus costs related to bring it to its present location and condition. Cost can include import duties, transport costs, handling costs and net of rebates or discounts.

Net realizable value is the selling price of those goods in the course of ordinary business. This can be calculated after deduction of a proportion to cover selling and distribution costs if appropriate.

(d) Procedures the auditor would take to establish the existence of slow moving stocks are:

(i) By personal observation during stock-taking or even afterwards. He must note such items in his working papers.

(ii) Slow moving items may be ascertained by scrutinizing catalogue numbers in the stock sheets by examining stock records for particulars of dates of purchase and sale.

(iii) It would be revealing to have a discussion on this topic with officials, who, by the nature of their work, are in constant touch with stocks.

(iv) Compare quantities of individual items in this year's stock sheets with those of the previous year. An increase or even static number may suggest a decrease in demand for these items.

(v) Calculate the rate of turnover of stock both total and on departmental basis. A decrease in the rate of turnover in relation to the immediately preceding years may indicate an accumulation of slow moving stock.

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