STRICTLY CONFIDENTIAL

THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2011 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

WEDNESDAY 30 NOVEMBER 2011 **TIME ALLOWED : 3 HOURS**
2.00 PM - 5.00 PM

SUGGESTED SOLUTIONS

1. (a) Application controls are manual or automated procedures that typically operate at a business process level and apply to the processing of transactions by individual applications. Application controls can be preventative or detective in nature and are designed to ensure the integrity of the accounting records.

Application controls relate to procedures used to initiate, record, process and report transactions or other financial data. These controls help ensure that transactions occurred, are authorized and are completely and accurately recorded and processed. They apply to data processing tasks such as sales, purchases and wages procedures and are normally divided into the following categories:

(i) Input Controls

- Examples include batch control totals and document counts as well as manual scrutiny of documents to ensure they have been authorized;
- An example of the operation of batch controls using accounting software would be the checking of a manually produced figure for the total gross value of purchase invoices against that produced on the screen when batch processing option is used to input the invoices.
- A common example of programmed controls over accuracy and completeness of input are edit check (data validation) when the software checks that data fields included on transactions by checking.

(1) Reasonableness check
(2) Existence check e.g. supplier account exists
(3) Character check
(4) Range check
(5) Check light

(ii) Processing controls
An example of a programmed control over processing is a run to run control. The totals from one processing run plus the input totals from second processing should equal the result from second processing run.

(iii) Output controls
Batch processing matches input to output and is therefore also a control over processing and output.

(iv) Master files and standing data controls
Example includes one for checking of changes in master files e.g. customer price changes are checked to an authorized list.

(b) An audit test data normally comprises of a series of dummy data transactions initiated by the auditor for processing through a computer based accounting system. It should include every type of entry including erroneous entries. For example, dummy sales transactions entries should include sales invoices with

authentic errors and invoices with value in excess of parameters set for inclusion in an exception report. The auditor may choose to input the dummy data in the normal production run whereby the dummy transactions are processed with live data. However caution must be exercised to ensure that dummy data does not affect the live data being processed. Alternatively the dummy data transactions can be processed separately from live data but in such circumstance the auditor needs to ensure that all programs used and processing conditions are identified to that for the live running data. By comparing outputs after processing of the audit test data with predetermined expected results, the auditor can assess the extent in which the necessary controls exists and so determine the level of substantive testing to be carried out.

(c) Computer based accounting systems normally facilitate for an audit trail to be printed out. Consequently users can expect to print out a complete audit trail for any number and type of transactions including sales and debtors.

However, many managers prefer to exercise control over computer processing by relying on exception reports. For example a print out of all trade debtors balances in excess of 120 days could be obtained. The tendency to depend on exception reports as a means of control rather than routine printing of audit trail processing has been influenced by various factors including the cost of stationery, relatively slow printing speeds, storage requirements and existence of visible display units which management may occasionally obtain a hard copy of audit trail due to specific problem arising, the consequence of the above is that a full audit trail for a period subject to audit is not available, thus there is a loss visible audit trail.

2. (a) Management report

(i) Procedures
Timeliness

Communication of control weaknesses is normally made shortly after the completion of the audit. On the engagements where control; risk was assessed during an interim visit, a letter should normally be sent after that visit as well as on completion of the audit.

Occasionally the matter may be sufficiently serious as to warrant more timely communication, such as where the exposure to risk is great or where there is reason to suspect that fraud or failure to comply with laws or regulations may have occurred as a result of the weakness.

Method
As implied in the title commonly given, the communications formally made in the form of a letter. Often, however, a preliminary meeting is held with management directly responsible in order to confirm the understanding and to discuss the most appropriate form of changes to the system. The letter is, therefore, more likely to be accepted and its recommendations acted upon.

Oral combination may also be appropriate for weaknesses that are in urgent need of correction followed up by a written communication.

Level of management
As mentioned above, it is common to discuss the detailed recommendations with management before issuing the letter. The letter would normally be addressed to the finance director; the letter may refer to minor matters in brief with more detailed recommendations being sent to financial officers of divisions or subsidiaries. More serious matters may be communicated directly to the Board of Directors or if the entity has one, the audit committee. These would include such matters as previous recommendations that have been implemented where the auditors believe the risks to the entity are material.

(ii) **Auditors responsibility**:

The auditors are not primarily responsible for evaluating the effectiveness of all internal controls and reporting all weaknesses. In the letter of weaknesses and in the engagement letter the auditor should make it clear that the assessment of control effectiveness is restricted to those controls on which reliance is intended to be placed for audit purposes. If auditors intend to place reliance for particular financial statement assertions wholly on substantive procedures, they have no responsibility for controls over these assertions.

Where the auditors do become aware of internal control weaknesses, however, there is an expectation that they will warn management where there is the risk of loss or misstatement is considered material. Awareness of control weaknesses may come about from procedures other than those directed specifically at testing controls. For example in obtaining understanding of the system the auditor may become aware of major control weaknesses. Also in performing substantive procedures investigation or errors may alert the auditor to the presence of control weaknesses.

The auditor's duty to report on the effectiveness of internal controls under auditing standards is confined to the management of the entity. They have no responsibility to report to other parties. The letter of weaknesses normally carries a declaimed of responsibility to any other person to whom the letter might be shown.

Auditors may accept engagement to report on control weaknesses either to managers to regulators or to third parties. However such engagements are not part of the audit of the financial statements.

(b) The auditor has a statutory right to receive information and explanations for the client in relation to the audit. These rights of access give the auditor a position of considerable power and privilege which must not be abused.

Confidential data regarding the client business must not be divulged to a third party without the consent of the client unless there is a public interest duty to make the disclosure. Other matters relating to confidentiality issues are as follows:

- Data obtained during audit regarding the client's affairs must not be used for personal gain of the auditor,
- The auditor can only effectively perform the audit where the client accepts the duty to make all necessary disclosures to the auditor. The statutory responsibilities of the auditor and the client are set out in the letter of engagement at the commencement of the audit to avoid misunderstandings. Where the client does not accept this duty, then the audit appointment should be terminated or declined;
- Confidential information obtained regarding one client during the audit of another client must not be disclosed or misused. Such conflict of interest may mean that the auditor would have to resign from the appointment to resolve the situation;
- Conflict of interest could arise where an auditor or accountant accepts commission's payments from a third party, perhaps as a result of providing advice. The receipt of commission should always be disclosed to the client and the accountant/auditor must ensure that the advice given in the clients best interest. For certain clients the Financial Services Act now gives additional statutory backing and responsibilities in this area to supplement the rules of professional conduct;
- A conflict of interest could also arise when a professional acts for two clients who are in competition. Remember that the rules of confidentiality apply to both clients' affairs and the auditor must be very careful to ensure that neither client is disadvantage as a result of acting for both. When possible, different staff should be employed on the two assignments with strict instructions not to discuss either clients' affairs.

(c) The main issue here is that the audits of Soche Construction Limited and Kanjedza Building Contractors are confidential. Under no circumstances may information gained during one of the audit be disclosed to another client without express permission being granted. The request for information regarding financial stability of an audit client clearly raises a potential conflict of interest and if the firm wishes to retain both audit clients then this type of work should perhaps be declined.

Another issue raised by this case is that the information is requested for a specific purpose and therefore in the event that Kanjedza Building Contractors subsequently suffered financial difficulties, Soche Construction may find it easier to succeed in an action for damages if the financial appraisal was negligently performed. A commercial judgment may have to be made between the amount of the consultancy fee as a one off item of additional fee income and the necessity to withdraw from the audit of Kanjedza Building Contractors Limited (with loss of the audit fee on recurrent basis) if it is decided to go ahead with the financial appraisal work.

3. (a) The first standard in both ISA 520 and SAS 410 states that auditors "should

apply analytical procedures at the planning and overall review stages of the audit". Analytical procedures at these stages are therefore essential and are mandatory in the conduct of the audit. Both of these standards state that analytical procedures may be performed as substantive procedures i.e. optional. The purposes of analytical procedures are:

(i) to assist in planning the nature, timing and extent of other audit procedures;

(ii) used as substantive procedures when their use is more effective or efficient than tests of detail;

(iii) used as overall review to conclude whether the financial statements as a whole are consistent with auditors' knowledge of the business.

(b) (i) The gross profit margin increased due to a number of factors and we shall consider the following:

- Since the sales and cost of sales both increased in line with inflation it would mean that if sales increased the cost of sales must have fallen. The components of the cost of sales are opening inventory + cost of production (raw materials + conversion costs) – closing inventory.
- Cost of sales will have fallen if a cheaper unit cost of production has been achieved. This could have resulted from – more efficient production methods and or cost savings on materials, direct labour wage rates, production overheads.
- As auditor you expect QuickGrowth Supplies Limited management to be aware if cost reductions have been achieved during the year. You can substantiate this from by reference to costing records. If management are not aware of cost reductions during the year, then the possibility of error needs to be considered for example:
  Sales may be overstated
  Opening inventory may be overstated
  Purchases may be understated
  Closing inventory may be overstated.

(ii) Sales overstatement:

Check cut off of sales to ensure January sales are not invoiced in December 2010. Check bank reconciliation statement to see if there are any fictitious receipts from cash sales. Check for overcharging to customers. This should come to light by direct confirmation of customer.

(iii) Opening inventory understatement.

Opening inventory was audited as last year's closing inventory. It was materially understated last year that last year's gross profit percentage would have been understated also. This would seem unlikely as the

scenario does not suggest that last year's auditor's report was qualified in respect of the inventory valuation.

(iv) Purchases understatement
Purchases could be understated if materials or components received before the yearend have not been recorded until after the year end. Such an error might indicate a general lack of control over cut off. If purchase invoices are unrecorded liabilities as well as expenses will be understated. This would be brought to light by an examination of suppliers' statement reconciliations.

(v) Closing inventory overstatement
Closing inventory could be overstated due to:

- An error in the physical count
- Errors in pricing.

(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) Factors that would determine the extent of reliance on substantive analytical procedures include:

- The risk that analytical procedures fail to identify a material misstatement. This is interlinked with materiality of items involved. The less significant an account balance or class of transactions the more reliance may be placed on analytical procedures;

- Other audit procedures directed to the same financial statement assertion. For example, a reduction in the extent of tests of detail will be justified where significant fluctuations and inconsistencies have been corroborated;

- The accuracy of predictions – income and expenditure accounts tend to be more predictable than balance sheet accounts because they are composed of large numbers of like transactions. Non recurring accounting entries and discretionary expenses do not lend themselves to effective analytical procedures;

- Risk assessment – if internal control over processing of sales orders, for example is weak (i.e. control risk is high) more reliance on tests of details for drawing conclusions on receivables may be required;

- The effectiveness of controls, if any, over the preparation of information used for analytical procedures;

- The type of analytical procedure used – the more appropriate the analytical procedure the more reliance can be placed on them.

4. (a) The following are briefly the principal needs for working papers in the office of a practicing accountant:

(i) They provide a historical record showing all work done. They also enable the principal and seniors to review and evaluate the work done by those under their supervision.

(ii) They provide a permanent record of work done, compilation of certain figures in the accounts, and the amount of uncompleted work, can be seen at a glance.

(iii) They must also be very useful in connection with subsequent audits and may prove invaluable in the event of a legal action for negligent or unskillful work.

(iv) They contain the basic information on which the auditor bases his final audit opinion as embodied in his report.

(v) The preparation of working papers encourages the auditor to adopt a methodical approach to audit.

(b) List of working papers one would normally expect to find in an audit file:

(i) Extracts from the memorandum and articles of association, partnership agreements, contracts of a continuing nature, minutes etc.
(ii) A description and analysis of the system of internal control.
(iii) A list of books of accounts in use and the names of persons responsible for keeping them.
(iv) An audit programme.
(v) Schedule of investments.
(vi) Trial balance with supporting adjustment entries.
(vii) Draft accounts and attached schedules.
(viii) Schedules supporting the balance sheet figures such as debtors, creditors and stock, consisting of detailed breakdown of the amounts.
(ix) Schedule of fixed property.
(x) Notes of queries or questions raised and explanations given and action taken.
(xi) Outstanding audit notes.
(xii) Previous years' statement of financial position and the comprehensive income statements.
(xiii) Stock and other certificates such as bank balance confirmations.
(xiv) Audit planning information.

5. (a) The auditor in the course of his work may need specialist evidence from valuers, architects, engineers, geologists, lawyers, stockbrokers and quantity surveyors. The evidence that they would need include:

(i) Valuation of fixed assets, including freehold and leasehold property, plant and equipment, works of art and antiques;

(ii) The measurement of work done on long term contracts;

(iii) Valuation of certain types of stocks and consumable materials, including the determination of their quantity and composition;

(iv) Geological determination of mineral reserves and characteristics;

(v) The legal opinion on the outcome of disputes and litigation;

(vi) Legal opinion on the outcome of disputes and litigation;

(vii) Actuarial advice for the purpose of assessing the cost of pension provision and in disclosure in the employer's financial statements.

(b) The auditor's detailed examination of the specialist's evidence will include the following, whether:

(i) The data provided by management to the specialist is compatible with that used in the preparation of financial statements.

(ii) The assumptions and bases used by the specialist are compatible with those used in the preparation of the financial statements.

(iii) The information supplied by the specialist has been prepared and presented in accordance with his terms of reference.

(iv) The specialist has qualified his opinion or expressed any reservations.

(v) The effective date of the specialist findings is acceptable.

(vi) The details of the specialist's findings are fairly reflected in the financial statements.

(c) The auditor would carry out the following procedures in the verification of plant, equipment and motor vehicles:

(i) Examine the fixed assets register to and ensure that all additions and disposals have been entered therein. Confirm that major items in the register do exist, are in use and in good condition. Prepare schedule of items inspected and file on the current audit file;

(ii) Check reconciliation of the fixed asset register to the trial balance and draft accounts.

(iii) Examine documents of title for assets purchased during the year including hire purchase agreements and operating lease agreements if applicable.

(iv) Confirm the company physically inspects all the items in the fixed assets register each year.

(v) Inspect vehicle registration books or verify the proceeds of sale if sold since last balance sheet date and reconcile opening and closing balances by number of items as well as value. Confirm that all vehicles are used for the purpose of company business.

(vi) If the fixed assets register is not kept, obtain a schedule for permanent file of the major items of the fixed assets showing original cost and accumulated depreciation; reconcile both the total cost and depreciation to the trial balances and financial statements. Confirm the major items on the schedule exist, are in use and in good condition. Prepare a schedule of the items inspected and file on the current audit file.

(vii) Obtain confirmation from the responsible official that all movements on the fixed assets have been included in the financial statements.

(viii) Review depreciation rates in relation to useful lives, replacement policy, consistency with prior years and replacement policy.

(ix) For revalued asset ensure that depreciation is charged on the revalued amount.

(x) Compare the depreciation rates applied in each category of fixed asset with prior years and the depreciation rates laid down.

(xi) Ensure that no further depreciation is charged on fully depreciated assets.

6. (a) The wording of the auditor's report would be dependent on the various circumstances. Examples of situations leading to the following wording could include:

(i) 'Except for' – issues are material but not pervasive – examples could include:

- Inadequate provision for doubtful debts
- Disagreement over the value of some part of stocks e.g. obsolete stocks will be valued at cost instead of scrap value
- Non-disclosure in the accounts of going concern problems

(ii) 'Except for' – limitation of scope – examples as follows:

- Limited evidence available for cash purchases
- Some cash sales records lost due to accidental flooding

- Cash flow statements only prepared for nine months after the year end so full consideration of going concern issues not possible

(iii) Dislaimer of opinion – limitation of scope – examples as follows:

- Appointed as auditors after the year end and unable to attend stock taking where stock is a material item
- Directors deny access to information regarding significant claims against the company
- No cash flow forecasts or cash budgets prepared so the going concern situation cannot be considered

(iv) Adverse opinion – examples include:

- Failure to comply with Companies Act 1984, accounting standards without an acceptable reason
- Significant uncertainly regarding the existence, ownership valuation or recording of assets and liabilities to a material extent e.g. failure to provide for material losses on long-term contracts
- Significant concern about the company's ability to continue as a going concern and the accounts have been prepared on a going concern basis

(b) Differences between internal and external audit can be best explained by contrasting the roles that are carried out.

(i) Objectives

Internal Audit

- To evaluate the organization's risk, management processes and systems control
- To make recommendations for the achievements of organizational objectives.

External audit

- To provide an opinion on whether the financial statements show a true and fair view
- Confirm whether proper accounting records have been maintained.

(ii) Responsibility

Internal audit

- Responsibility is to the management of the organization
- Is part of quality system and corporate procedures on an ongoing basis

External audit

- Responsibility of shareholders
- Report on financial statements on an annual basis

(iii) Scope

Internal audit
- All aspects of the organization's activities, including operational considerations and compliance issues

External audit
- Financial records and processes, risk management processes

(iv) Approach

Internal audit
- Risk based approach
- Evaluation of internal control systems
- Test the systems
- Evaluation of operational efficiencies

External audit
- Risk based
- Test basis on which financial accounts produced and reliability of systems
- Verification of assets and liabilities

(v) Legal status

Internal audit
- Report to management
- No specific legal requirement but stock exchange listing agreement requires internal audit

External audit
- Report to shareholders
- Companies Act 1984

7. (a) Section 192 of the Companies Act 1984 states that "no person shall be qualified for the appointment as auditor of company nor shall act as such, unless eligible and entitled so to act under Public Accountants and Auditors Act. Some of the persons ineligible to act as auditors include: The whole purpose of this section is to secure independence of the auditor from the company.

(i) Officers and employees of the company – this is because there would be no independence in the way they would carry out the duties and this contravenes the ethical guidelines as issued by Accounting bodies.

(ii) Partners or employees of such person or partnership of which such person is a partners as in (i) above independence will be an issue.

(iii) Persons who have a connection with the company or where the company has a connection with an associate of his description.

It must be noted that it is an offence for a statutory auditor of the company when they know they are ineligible.

(b) Qualities required of the auditor can be summarized into the following areas:

(i) Independence
Auditors cannot give an unbiased report unless they are independent of all the parties involved. The dilemma here is that the auditor receives the fees from the client but this should not force him to be partial in the audit of the books of the client. Not only must the auditor be independent if fact and attitude of mind must be seen to be independent.

(ii) Competence
Auditors must be thoroughly trained and prove competence before they can sign audit reports. Only members of specified professional bodies can become auditors and this is an attempt to regulate the practice and ensure only properly qualified and trained people can act as auditors. These professional bodies have developed competence in their members by using difficult examinations and post-qualifying education i.e. Continuous Professional Development (CPD). In addition to this there is a requirement that members must register to become and continue to be registered as members.

(iii) Integrity
Qualified accountants are renowned for honesty, discretion and tactfulness. Registered Auditor firms are supervised and inspected by their professional bodies acting as the recognized supervisory bodies.

(c) Some of the inherent limitations of internal controls that the auditor need full awareness include:

- A requirement that the cost of an internal control should not be greater than the loss that it is trying to mitigate;
- Internal controls are directed at routine transactions and unusual or once off transactions are not subject to internal controls;
- Potential human error caused by stress of workload; alcohol, carelessness, mistakes of judgment and misunderstanding of instructions;
- There is possibility that internal controls can be circumvented through collusion or alone especially at the top end of management;
- Abuse of responsibility by the seniors managers resulting in management overriding internal controls;
- There could be changes in the environment making the controls ineffective;
- Where there is fraud.

The auditors are therefore required to perform some substantive tests to prove that the controls are working before they can place reliance on them. This is done because auditors are aware that there inherent limitation in the controls.

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