STRICTLY CONFIDENTIAL

THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2012 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

(DECEMBER 2012 MAIN)

TIME ALLOWED : 3 HOURS

SUGGESTED SOLUTIONS

1. (a) (i) Replies to a circularization of receivables are both independent and reliable because they are generated outside the company.

Third party evidence is better than internally generated evidence because there is less likelihood that it has been altered or falsified in any way.

Receivables circularizations are reliable evidence because they are written evidence as verbal evidence alone is always of very little value.

The relative merits of the receivables are that there is no motive for the client's customers either to reply to the circularization or care to reply to it accurately. As such it is common for there to be a high level of non-replies (particularly where the customer is unable to pay) and a certain number of inaccurate balances (either due to disputes or errors) and to this extent circularization are often unreliable. Receivable circularization test the client's customers. **6 Marks**

(i) Suppliers statements are often sent on a monthly basis and are part of the day to day routine in the business and are subject to normal internal controls and as such are more likely very accurate than receivables circularizations.

Unlike receivables circularization, supplier's statements are not tainted with the reason for the close involvement of both auditor and the client and as such suppliers statements are more reliable than receivables circularization. Supplier statement is also reliable evidence as it is third party written evidence. **4 Marks**

(b) Accounting estimates are amounts appearing in the financial statements that are not of precise determination. A wide category of significant figures in the financial statements come under the heading of accounting estimates. Examples of accounting estimates include depreciation charges, provisions for the profit or loss on the sale of assets, inventory valuations, the provision for doubtful debts, the provisions for warranty claims and similar liabilities such as tax provisions. **1 Mark**

There is a three-stage process to the audit of accounting estimates. Auditors should: Review and test the process used by management to arrive at the estimate, which will involve reviewing the basis on which the estimate has been made to establish whether the assumption is reasonable (e.g. compare the percentage of debts not recovered in practice with the provision of doubtful debts). **1 Mark**

Perform their own calculation of the estimate to be made; **1 Mark**

Review events after the period-end; **1 Mark**

Sometimes a review of events after the period-end is all that is necessary. For example, if agreement to sell an asset before the period-end is finalized after the period-end, the profit will no longer be estimated and therefore be no need to review assumptions or auditors to perform their own calculation. **1 Mark**

5 Marks

(c) Audit evidence

Procedures for the collection of audit evidence include the following:

1. Inspection of documentary evidence such as invoices, ledgers day books and financial statements and inspection of tangible assets (to provide evidence relating to audit objectives, completeness and existence). **1 Mark**

2. Computation (and re-computation) of e.g. the expected tax charge, the depreciation charges, accruals and prepayments and other calculated figures in the financial statements (to provide evidence relating to accuracy. **1 Mark**

3. Analytical procedures providing evidence as to the completeness and accuracy of e.g. charges, depreciation charges, other profit and loss charges, sales, depreciation and other capable of being predicted. **1 Mark**

4. Observation of processes and procedures such as those performed at the inventory control in order to provide evidence as to the proper functioning of internal controls. **1 Mark**

5. Enquiry, both within the audited entity and outside, in the form of receivables circularization, inventory circularization, correspondence with lawyers etc. **1 Mark**

5 Marks

(TOTAL: 20 MARKS)

2. (a) (i) It is the responsibility of the management of an enterprise to ensure that the amount at which stocks are shown in the financial statements represents stocks physically in existence and includes all stock owned by the enterprise. Management satisfies this responsibility by carrying out appropriate procedures, which will normally involve ensuring that all stocks are subject to count at least once in every financial year. Where stocks are material in the enterprise's financial statements and the auditor is placing reliance upon management's stock take in order to provide evidence of existence, then the auditor should attend the stock taking. This is because attendance is normally the best way of providing evidence of proper functioning of management's stock taking procedures and hence of the existence of stocks and their condition. Where the auditor attends any physical count of stocks in order to obtain evidence, this does not reduce the responsibility of the directors to ensure that the amount shown for stocks in the financial statements represents stocks physically in existence. **4 Marks**

(ii) One of the main objectives of attending the count is to ensure that the company is following instructions prepared before the count. These instructions should have already been reviewed for their adequacy by the auditor who should, if necessary, discuss these with company officials. If the instructions are adequate but they are not carried out properly then clearly the auditor must take action, since the departures decrease the reliability of the count. In this case the auditor must immediately point out to the stock count controller that there has been a breakdown in procedures in one location which must be corrected forthwith. In addition the auditor will have to make extra counts of the material counted by the teams involved to satisfy themselves that they were not making an unusual number of count errors. If such errors arose a complete recount could be necessary. In order to ensure that such a breakdown does not occur in future the matter should be noted by the auditor in his working papers as a matter for discussion with management. **6 Marks**

(b) Stock must be valued in the financial statements at the lower cost or net realizable value. In the case of the bottles where the liquid has solidified there is no realizable value and though such items should be recorded on the stock sheets, their value should be shown as nil. The auditor should make a note in his working papers of the stock involved and check at the time of the count with the client's stock sheets to ensure that the condition of the stock has been noted on the stock sheets. After the count he can then check that a nil value has been placed on such items. The auditor could require that another box be opened and if a further inspection of some bottles shows them to be in a similar condition he can make a reasonable assumption that most of the stock is unsaleable and should be valued accordingly. It would also be prudent to value the few bottles which are in order at a nil value because of their age. There is considerable doubt when stock is of such age that it will in fact be sold. Even if it is, the likelihood is that the disposal will be at a nominal value. **6 Marks**

(c) The audit work that is required is a follows:

(i) Follow up any notes made at that stock take by client and/or audit staff of slow moving, damaged or obsolete and consider whether the valuation of such stocks has been reasonably valued so at to recognize its condition; **1 Mark**

(ii) Seek representations from management as to whether in their opinion there are any other stocks for which provision should be made; **1 Mark**

(iii) Review any new price lists issued since the year end and consider whether in relation to any material stock lines the selling price has been reduced, in which case the net realizable value should be compared with cost; **1 Mark**

(iv) Review post balance sheet sales for any evidence of goods being sold after the year end for an amount less than their balance sheet cost, suggesting that a reduction to net realizable value may be required for balance sheet valuation purposes; **1 Mark**

(v) Where any items have been valued at net realizable value check that the valuation has been correctly calculated and recognizes, as necessary, any costs of marketing, selling and distribution, when determining the further costs to be deducted from the eventual sales proceeds. **1 Mark**

Any four, 1 Mark each = 4 Marks

(TOTAL: 20 MARKS)

3. (a) A letter of engagement serves to avoid misunderstandings between the auditors and client as to the nature of the auditors' appointment, the scope of the audit work to be carried out and the respective responsibilities of the auditors and the client. It forms the basis of the contract between the auditors and the client. **3 Marks**

(b) The following important matters should be included in a letter of engagement:

(i) The objective of the audit of financial statements; **1 Mark**

(ii) Management's responsibility for the financial statements; **1 Mark**

(iii) The scope of the audit, including reference to applicable legislation, regulations, or pronouncement of professional bodies to which the auditor adheres; **1 Mark**

(iv) The form of any reports or other communication of results of the engagement; **1 Mark**

(v) The fact that because of the test nature and other inherent limitations of internal controls, there is an unavoidable risk that material misstatements may remain undiscovered; **1 Mark**

(vi) Unrestricted access to whatever records, documents and other information requested in connection with the audit; **1 Mark**

(vii) Arrangements regarding the planning and performance of the audit; **1 Mark**

(viii) Expectation of receiving from management written confirmation concerning representations made in connection with the audit; **1 Mark**

(ix) Request for the client to confirm the terms of engagement by acknowledging receipt of the letter; **1 Mark**

(x) Description of any other letters or reports the auditor expects to issue to the client; **1 Mark**

(xi) Basis on which fees are computed and any billing arrangements. **1 Mark**

Any five, 1 Mark each = 5 Marks

(c) Before the firm could consider accepting appointment as auditors they would have to contact the present auditors. The reason for this request is that previous auditor may be asked if they are aware of any professional or other reasons why they should not agree to be nominated as auditors to the company. The ethical guideline to the profession states that this procedure should be adopted on any change in professional appointment. It is also worth noting that the previous firm should obtain the permission of the company to reply to the new firm. If the company will not grant the initial request by the firm or will not grant the previous firm permission to reply then the ethical guideline requires that the nomination should be declined. **4 Marks**

(d) The audit engagement partner should consider the following matters:

(i) The historical background of the company and the nature of the business it is engaged in. **1 Mark**

(ii) The reason for the resignation/removal of the company's previous auditor. **1 Mark**

(iii) The extent to which previous years' audit reports relating to the company have been presented. **1 Mark**

(iv) The experience and qualifications of the company's management and their attitude towards control environment issues. **1 Mark**

(v) The current operating and financial position of the company. **1 Mark**

(vi) The directors' understanding of the role of the external auditor. **1 Mark**

(vii) The availability of adequate audit resources within the firm to carry out an effective audit on the company's financial statements. **1 Mark**

(viii) The accounting policies used by the company. **1 Mark**

(ix) Indications that the company or its management may be engaged in fraudulent activity. **1 Mark**

Any six, 1 Mark each = 6 Marks

(e) The new auditors should have the following rights with regard to:

(i) Access to records – a right of access at all times to the books, records, accounts and documents of the company. **1 Mark**

(ii) Information and explanations – a right to enquire from the company's officers such information and explanations as they think necessary for the performance of their duties as auditors. **1 Mark**

2 Marks

(TOTAL : 20 MARKS)

4. (a) Merits of adequate planning:

(i) Establishes the intended means of achieving the objectives of the audit. **½ Mark**

(ii) Assists in the direction and control of the work. **½ Mark**

(iii) Helps to ensure that the attention is devoted to critical aspects of the audit. **½ Mark**

(iv) Helps to ensure that the work is completed expeditiously. **½ Mark**

In order to plan his work adequately the auditor needs to understand the nature of the business of the enterprise, its organization, its method of operating and the industry in which it is involved, so that he is able to appreciate which events and transactions are likely to have a significant effect on the financial statements. The auditor should also consider the outline audit approach he proposes to adopt, including the extent to which he may wish to rely on internal controls and any aspects of the audit which need particular attention. He should take into account in his planning any additional work which he has agreed to undertake. Preparatory procedures which the auditor should consider include the following:

- reviewing matters raised in the audit of the previous year which may have continuing relevance in the current year; **½ Mark**

- assessing the effects of any changes in legislation or accounting practice affecting the financial statements of the enterprise; **½ Mark**

- reviewing interim or management accounts where these are available and consulting with the management and staff of the enterprise. Matters that should be considered include current trading circumstances, and significant changes in the business carried on and the enterprise's management; **½ Mark**

- identifying any significant changes in the enterprise's accounting procedures, such as a new computer based system. **½ Mark**

The auditor should also consider the timing of significant phases of the preparation of the financial statements, the extent to which analysis and summaries can be prepared by the enterprise's employees, the relevance of any work to be carried out by the enterprise's internal auditors. **1 Mark**

The auditor will need to determine the number of audit staff required, the experience and special skills they need to possess and the timing of their visits. **1 Mark**

6 Marks

(b) Reviewing his working papers for the previous year, where applicable, and discussing with management any significant changes in stock over the year; **1 Mark**

Discussing stocktaking arrangements and instructions with management; **1 Mark**

Familiarising himself with the nature and volume of the stocks, the identification of high value items and the method of accounting for stocks;

Considering the location of the stock and assessing the implications of this for stock control and recording;

Reviewing the systems of internal control and accounting relating to stocks, so as to identify potential areas of difficulty (for example cut-off); **1 Mark**

Considering any internal audit involvement, with a view to deciding the reliance which can be placed on it;

Ensuring that a representative selection of locations, stocks and procedures are covered and particular attention is given to high value items where these form a significant proportion of the total stock value; **1 Mark**

Arranging to obtain from third parties confirmation of stocks held by them. If the auditor considers such stocks to be material part of the enterprise's total stock or that the third party is not independent or reliable, he should arrange, where appropriate, that either he or the third party's auditor will attend a stock take at the third party's premises; **1 Mark**

Establishing whether expert help is needed to substantiate quantities or identify the nature and condition of the stocks, where they are very specialized. **1 Mark**

6 Marks

(c) (i) **Audit risk** is the risk that the auditor will issue an inappropriate opinion on the accounts. In other ways audit risk is that the auditor gives an unqualified opinion on the accounts when he should have given a qualified opinion or he gives an opinion qualified for a particular reason where the reason was not justified. **1 Mark**

(ii) (1) **Inherent risk** is the risk that derives from the characteristics of the enterprise and its environment prior to considering internal controls. Inherent risk arises from factors which may cause errors or irregularities to be present. **1 Mark**

(2) **Control risk** is the risk that internal controls will not prevent or detect material errors. **1 Mark**

(3) **Detection risk** is the risk that the auditor may fail to detect misstatements which have occurred. **1 Mark**

(d) **Four** conditions existing in the enterprise are as follows:

(i) Macroeconomic factors such as general recession (this might threaten the collectability of debtors). **1 Mark**

(ii) Factors from within the industry, e.g. consumer demand conditions which might jeopardize future viability of the enterprise, technological changes rendering stocks obsolete. **1 Mark**

(iii) Poor management. **1 Mark**

(iv) Key personnel with a motive for attempting to distort the financial statements (for instance, if managers are on a performance-related bonus scheme, or subsidiary company managers are pressurized by group management). **1 Mark**

(v) Poor quality control, potentially leading to production of defective goods that may subsequently be returned by customers. **1 Mark**

Any four, 1 Mark each = 4 Marks

(TOTAL: 20 MARKS)

5. (a) **Three** uses of the information technology is to enhance audit administration procedures and control over audit assignments.

(i) The use of word processing software to prepare and update audit programmes; **1 Mark**

(ii) Using word processing software to prepare audit working papers; **1 Mark**

(iii) The use of spreadsheet software to facilitate in the preparation of audit working papers; **1 Mark**

(iv) Using statistical sample software packages to assist in selection of samples of audit testing; **1 Mark**

(v) The employment of accounting software packages to prepare accounts in accordance with legislation and accounting standards; **1 Mark**

(vi) The use of electronic mail to communicate with audit clients or audit staff; **1 Mark**

(vii) The use of audit management software to prepare time/cost budgets for audit assignments, review actual time/cost and to report variances. **1 Mark**

Any three, 1 Mark each = 3 Marks

(b) The benefits to be derived from computer assisted techniques (CAATs):

(i) CAATs are likely to be the only effective way of examining a large volume of computer processed transactions both quickly and accurately; **1 Mark**

(ii) The ability of CAATs to test programmed controls existing in a specific application programme. **1 Mark**

(iii) Increased audit confidence is obtained from testing the integrity and performance of computer applications rather than relying upon print outs believed to be produced from the use of those applications. **1 Mark**

(iv) Provided an audit client does not constantly change its computer systems, once set up CAATs are normally cost effective. **1 Mark**

(v) The use of CAATs may overcome the problems of the traditional loss of data trail in the computer systems and enhance audit confidence as a consequence. **1 Mark**

5 Marks

(c) **Audit trail** is the facility that allows an individual transaction to be traced from source to completion or from completion back to source. For example in a manual accounting system the auditor may follow a purchases transaction from its source (goods received note) through to the entry in the purchases account in the nominal ledger. **3 Marks**

(d) 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 transaction including sales and debtors. However, many managers prefer to exercise control over computer processing by relying on exception reporting. For example a print out of all trade debtor balances in excess of K50,000 could be obtained. Similarly a manager might request a report of all trade debtor accounts with credit balances. The tendency to depend on exception reporting as a means of control rather than the routine printing of an audit trail after processing has been influenced by various factors including the cost of stationery, relatively slow printing speeds, storage requirements and the existence of visible display units. Whilst management may occasionally obtain a hard copy of an audit trail due to a specific problem arising, the consequence of the above is that a full audit trail for a period subject to audit is often not available – thus there is a loss of visible audit trail. **5 Marks**

(e) An audit test data pack normally comprises 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 transaction entries should include sales invoices with arithmetic errors, coding errors and invoices with values in excess of parameters set for inclusion in an exceptional report.

The auditor may choose to input the dummy data in a normal production run, whereby the dummy transactions are processed with live data. However, caution needs to be exercised to ensure that the dummy data does not affect the live data being processed. Alternatively the dummy transaction can be processed separately from live data, but in such circumstances the auditor

needs to ensure that the programs used and processing conditions are identical to that for live running of the system.

By comparing outputs after processing of the test data with predetermined expected results, the auditor can access the extent in which the necessary controls exist, and so determine the level of substantive testing to be carried out. **4 Marks**

(TOTAL : 20 MARKS)

6. (a) (i) **Internal audit** has been defined as an independent appraisal activity within an organization for the review of operations as a service to management. It is a managerial control which functions by measuring and evaluating the effectiveness of other controls. In practice the job of the internal audit department is defined by the organization of which it is a part and can embrace the following:

(1) Reviewing accounting systems and related internal controls;

(2) Examining financial and operating information for management including detailed testing of transactions and balances;

(3) Reviewing the economy, efficiency and effectiveness of operations and functioning of non-financial controls;

(4) Reviewing the implementation of corporate policies, plans and procedures;

(5) Carrying out special investigations. **3 Marks**

(iii) **Compensating controls** are controls the internal auditor relies on whenever he establishes that the controls he expected to find are missing. The internal auditor will always search for controls that compensate for the potential weakness. For example in auditing a purchasing system one control objective might be that procedures for ordering, payment and recording of the expenditure are properly documented and complied with. Internal auditors find that there are no procedure manuals (an expected control to meet the objective). However, staff operating the system are all highly experienced and knowledgeable and are closely supervised. In these circumstances, the internal auditors may consider the experience and knowledge of the staff and the level of supervision adequately compensates for the absence of manuals, and thus they may conclude that the control objective is adequately achieved despite the absence of the manuals. **4 Marks**

(iv) **Compliance testing** are tests of controls whose aim is to confirm that existing controls are operating as intended and are reliable. An example is checking that each invoice has been initialled to indicate that it was authorised by an appropriate manager. The primary aim of compliance testing is not to find errors, mistakes or potential frauds, but to identify controls that are not always performed as required. **4 Marks**

(v) **Substantive testing** is the accuracy and completeness of outputs rather than the adequacy of the controls. An example is checking that the amounts paid are the same as the value on the invoice. Substantive testing is used by internal auditors as a means of demonstrating the existence or seriousness of weaknesses, when they are unable to convince management by any other means. Internal auditors should bear in mind that substantive testing is usually not economical and may weaken their arguments if it fails to produce evidence of actual errors.

4 Marks

(b) **Five** methods of testing internal controls:

(i) Observation is particularly important where there is no permanent record of activities. **1 Mark**

(ii) Interviewing is useful when evidence is absent or unclear. **1 Mark**

(iii) Verification involves independently confirming the truth, accuracy or validity of transactions. Internal auditors use comparisons, confirmations and vouching. **1 Mark**

(iv) Re-performance is particularly relevant where calculations or measurements have been supposedly checked as a control and the auditor wishes to check that the control actually operated. **1 Mark**

(v) Analytical review consists of reviewing the reasonableness of significant ratios, trends or other data. **1 Mark**

5 Marks

(TOTAL : 20 MARKS)

7. (a) An auditor of a limited company has a responsibility imposed upon him by statute to form and express a professional opinion on the financial statements presented by the directors to the shareholders. He must report upon the truth and fairness of such statements and the fact that they comply with the law. In so doing, the Auditor owes duty of care to the shareholder imposed by statute. But such duty also arises under contract and may also arise under the common law (law of tort). The comments of Lopes L J when considering the degree of skill and care required of an auditor in ***Re: Kingston Cotton Mill*** are still relevant: 'It is the duty of an auditor to bring to bear on the work he has to perform that skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution must depend on the particular circumstances of each case.

Clearly with the advent of Statements of Auditing Standards, a measure of good practice is now available for the courts to take into account when considering the adequacy of the work of the auditor.

The law of tort has established that a person owes a duty of care and skill to our neighbours (common example is the neighbour principle seen in the law of trespass, slander, libel etc). In the context of professional auditor the wider

implications, however, concern the extent to which the auditor owes a duty of care and skill to third parties who rely on financial statements upon which he has reported but with whom he has no direct contractual or fiduciary relationship.

Recent decisions of the courts, including three important decisions of the House of Lords, have expanded the classes of case in which a person professing some special skill as an auditor may be liable for negligence to someone other than his own client. Such liability may arise whenever a professional person does work for his client in circumstances where he knows or ought to know or ought to know (a) that his work is liable to be relied upon by third party and (b) that the third party may suffer financial loss if the work in question has been done negligently. Liability will arise when the work in question is of a kind which it was reasonable for the third party to rely on for his particular purpose. If these conditions are satisfied, the third party is a person whom in the eyes of the law the professional man ought to have in mind in applying his skills to the work in question.

It is important to appreciate that a duty of care to a third party may arise when an auditor does not know that his work will in fact be relied upon by a third party, but only knows that it is work of a kind which is liable in the ordinary course of vents to be relied upon by a third party. For this purpose it is immaterial whether the third party be identifiable in advance or not. **6 Marks**

(b) In order to provide a means of protection for the auditor arising from the comments in (a) above, the following steps should be taken:

(i) Agreements concerning the duties of the auditor should be clear and precise, must be in writing and must be confirmed by a letter of engagement, including matters specifically excluded. **1 Mark**

(ii) Audit work should be relevant to the system of internal control, which must be ascertained, evaluated and tested, the work must be adequately planned before the audit commences and must be reviewed by a senior member of the firm to ensure quality control of the audit and to enable a decision to be made on the form of audit report. **1 Mark**

(iii) Any queries arising during an audit should be recorded on the current working papers, cleared and filed. **1 Mark**

(iv) A management letter should be submitted to the client or the Board of Directors in writing immediately following an audit and must be seen to be acted upon by the client. **1 Mark**

(v) All members of an audit firm should be familiar with the standards expected throughout the firm, the standards of the profession as a whole by means of adequate training. **1 Mark**

(vi) Insurance should be taken out to cover the firm against possible claims.
1 Mark
6 Marks

(c) The going concern concept is that the enterprise will continue in operational existence for the foreseeable future. This in particular means that the profit and loss account and balance sheet assume no intention or necessity to liquidate or curtail significantly the scale of operation. **2 Marks**

(d) A company rarely ceases to carry on business without any prior indications, either of inability to meet debts as they fall due or of other problems that raise questions about the continuation of business. The indications may vary in importance depending upon specific circumstances. They may be interdependent and some may only have significance as audit evidence when viewed in conjunction with others. Further, their significance may diminish because they are mitigated by other audit evidence. The following lists indicate factors that may indicate that a company is experiencing liquidity problems.

(i) Indications that the company may be unable to meet its debts as they fall due include:

- recurring operating losses
- financing to a considerable extent out of overdue suppliers and other creditors for example surtax, PAYE, insurance
- heavy dependence on short-term finance for long-term needs
- working capital deficiencies
- low liquidity ratios
- over-gearing in the form of high or increasing debt to equity ratios, and under-capitalization, particularly if there is a deficiency of share capital and reserves
- borrowings in excess of limits imposed by debenture trust deeds
- default on loan or similar agreements
- dividend in arrears
- restrictions placed on usual trade terms
- excessive or obsolete stock
- long overdue debtors
- non compliance with statutory capital requirements
- deterioration of relationship with banks
- necessity of seeking new sources or methods of obtaining finance
- the continued use of old fixed assets because there are no funds to replace them
- potential losses on long-term contracts.

(ii) Indications of problems that raise questions about the continuation of the business and which lead to an inability to meet its debts include:

Internal matters
- loss of key management or staff
- significantly increasing stock levels
- work stoppages or other labour difficulties
- substantial dependence on the success of a particular project or on particular asset
- excessive reliance on the success of a new product
- uneconomic long-term commitments

External factors
- legal proceedings
- loss of key franchise or patent
- loss of principal supplier or customer
- the undue influence of a market dominant competitor
- political risks
- frequent financial failures of enterprises in the same industry.

6 Marks
(TOTAL: 20 MARKS)

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