STRICTLY CONFIDENTIAL

THE PUBLIC ACCOUNTANTS EXAMINATION COUNCIL OF MALAWI

2013 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

TUESDAY 26 NOVEMBER 2013 **TIME ALLOWED : 3 HOURS**
2.00 PM - 5.00 PM

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SUGGESTED SOLUTIONS

1. (a) The firm should firstly consider whether they are generally competent to complete the assignment successfully as required by the competence, due skill and care ethical requirement. If not they should consider withdrawal.

We would then consider whether we have appropriate tools to audit Matawale's company as specified above, and how we would approach it such as which audit software or test data to use etc.

The firm should then assign proficient and experienced staff in auditing computerized environment.

(b) Audit around the computer is an audit approach adopted to obtain evidence in a computerized accounting system where audit tests concentrate on inputs and their corresponding outputs, ignoring the processing procedures within computer programs. This audit approach assumes that auditors could fulfill their function without having any detailed knowledge of what is happening inside computers.

However this approach may not be suitable in more complex and integrated system where most of information is received, processed and stored electronically. This increases audit risk because the auditor may be ignoring the bulk of the computer files and programs. Errors occurring between inputs and the outputs will be difficult to trace. All this will make an auditor less sure about the appropriateness of his conclusions.

(c) The auditor may use both computerized and manual procedures and system, as is appropriate, to obtain evidence from this client as follows:

(i) Use interrogation software to carry out completeness and accuracy tests, such as total number transactions processed and those rejected and the total value. Check them against input data.

(ii) Inspect the master files from the creditors to ensure the integrity of the information and that only authorized creditors and correct information is used when ordering goods.

(iii) Use test data of fictitious creditors similar to those on master file and test whether the system processes and produces results as expected by the auditor.

(iv) Use the audit software to carry out analytical procedures with respect to purchases and creditors over the period such as creditors days, cash operating cycle and enquire into any unusual items and trends.

(v) Obtain a list of creditors balances from the computerized ledgers as at the year end. Cast the list and agree the total to the general ledger and financial statements to confirm completeness and accuracy of the figures recorded in financial statements.

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(vi) Obtain a sample of creditors balances from the list above and agree to supplier statements, reconciling them with the ledger balances at the year end to confirm their validity.

(vii) Carry out appropriate cut-off procedures, noting the serial numbering and dates of invoices and their attached goods received notes entered after the year end, to ensure that all the liabilities were recorded in the correct year.

(viii) Review the creditors ledger for old unpaid invoices and enquire from the chief accountant the reasons for the non-payment. This might indicate disputed accounts or the worsening company's liquidity problems.

(ix) Inspect credit notes for any goods that were returned or for any other reasons and ensure that proper entries were made in the creditors' ledger so that creditors are not overstated at the year end.

(d) (i) Embedded audit facility is a form of audit software which is embedded in the client's computerized systems over a long period of time such as an entire accounting period to allow it to carry out continuous review of the data recorded and the manner in which it is treated by the systems. The audit firm can make an arrangement with the client to insert their integrated test facility at the beginning of the accounting period. The facility carries out continuous systems check and notes on any lapses. The auditor retrieves the results at the year end, analyzes them, and with collaborative evidence from other sources, form conclusions based on the evidence obtained.

(ii) Standardized audit working papers are pre-designed working papers to guide a standard approach by the auditor to obtain information required pertaining to certain issues or areas of interest such as a client's screening forms, internal controls questionnaires, checklists, schedules etc.

(iii) Automated audit working papers are working papers created and maintained in electronic form. These include information such as audit programs, narrations of work carried out and conclusions reached in specific areas, work schedules, summaries and checklists that would be updated automatically as audit work progresses.

2. (a) (i) (1) **True and fair view** is the state of financial statements that reflect factual information supportable by reliable evidence, and ensure that all relevant and reliable required information has been appropriately disclosed without bias and to an appropriate level of detail of an entity's state of affairs.

(2) To fulfill the above qualities financial statements should be prepared in accordance with the provisions of appropriate legal framework (such as Companies Act) in terms of the required statements and that principles, policies, procedures and

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assumptions followed in record keeping and compilation of financial statements should be in line with acceptable accounting regulatory framework such as the International Financial Reporting Standards or any appropriate national standards.

(ii) Benefits

The major benefit of an audit is to assure members of a company of the credibility of directors in carrying out their duties and the reliability of financial statements submitted to them.

It also helps management improve the way they run their entities through advice obtained in the course of the audit.

The awareness that whatever management is doing will be subjected to an independent check makes them more alert and helps deter potential fraud and other irregularities.

In addition other users of financial statements also benefit such that it provides assurance and confidence to trading partners such as: debtors, creditors and providers of finance such as banks may be enhanced by audited financial statements.

Limitations

The level of assurance from an audit is not as high as most users would expect. (The auditor offers an opinion whether financial statements show a true and fair view). This has lead to the creation of an audit expectation gap.

An audit is time consuming on management part in that it has to spend considerable time attending to auditors, providing information and explanations, answering queries, each time an audit is carried out instead of concentrating on productive and profitable enterprise activities.

An audit is a resource consuming service, only carried out by most entities because they are required by law, because audit fees payable at the end are significant, like most other professional fees.

(b) (i) This is a letter submitted by management to the auditor in acknowledgement of their responsibility for financial statements for their fair presentation and in accordance with relevant financial reporting framework, and supply specific information to the auditor as may be needed from time to time during the course of audit, especially where other sufficient appropriate evidence cannot be reasonably expected to exist such as where knowledge of the facts of some matters are confined to management.

(ii) Specific representations in the letter might include matters such as:

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(1) As far as management are concerned they believe that all appropriate information has been provided to the auditors as required.

(2) That they are not aware of any irregularities involving management or employees that could have a material effect on financial statements.

(3) That management believe that the company has complied with all contractual agreements, and complied with all regulatory requirements, whose non-compliance would have material effects on financial statements.

(4) Issue confirmation on the entity's management intention to continue as a going concern and that they are currently not aware of any serious occurrences that they may adversely affect the going concern status.

(5) That management have currently no intention of significantly altering the entity's business or discontinue any major operations in the foreseeable future.

(6) That the entity has satisfactory title to all assets, except those disclosed as held on lease or under lien or as security to financers.

(7) That all liabilities, both actual and contingent and associated provisions, have been appropriately disclosed.

(iii) The auditor should consider the following matters when relying on management representations as a source of evidence:

Seek corroborative evidence from other sources to assess the reliability of such representations.

Evaluate the reasonableness of the representations and their consistence with other relevant information.

Consider the position, responsibility and authority of those making representations and if they appear to be well informed on particular matters they are making representations on.

Evaluate any representation that seem to contradict other evidence and consider whether it casts doubt on the reliability of other evidence from the representations.

3. (a) Not providing for depreciation of the building used in the business violates the matching/accruals concept. Depreciation of non-current asset basically entails proration, to different accounting periods, of its cost or useful value over its useful life to an entity which is more than one accounting period. This matches the asset

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cost or useful value to the entity's revenue that it helps to generate over that period instead of deducting the whole amount in a single period.

By not depreciating the buildings they are implying that the buildings have or are currently not contributing to the company's revenue generation, and probably that they intend to deduct the whole value sometime in the future which is a clear mismatch of revenue and its associated cost of generation.

(b) The auditor should carry out the following additional procedures:

Trace the original cost of each building through the asset register, and cross-check with purchase documents, or verify through costing records if they were self-constructed.

Check any subsequent extensions, renovations and revaluation of the buildings for reasonableness, especially noting the competence of valuers, assumptions and methods used to arrive at the values.

Check whether annual reviews are carried out at the balance sheet date and any impairments are provided for buildings.

Verify the existence of each building through physical inspection, matching the detailed descriptions in the non-current assets register with the actual buildings assets, noting the specific use to which they are currently deployed.

Check the extent to which buildings are owned by the company by inspecting land title deeds or leasehold documents and ensure that they are in the client's name, otherwise they may be held under encumbrances or attached conditions from any third party.

Discuss with management all your concerns, explaining to them the implication and impact their action will have, and tell them to adjust the financial statements.

Obtain a written management representation on the matter to confirm their stand on which the auditor can rely when concluding and determining what report to issue.

(c) The most appropriate audit report to issue is a modified/qualified audit report due to the seriousness of the above issues, which also has implications over other areas in the financial statements (such as total assets value, capital structure etc). In the opinion paragraph the audit report should clearly state that financial statements do not show a true and fair view of the company's financial performance for the year and position as at the year end, because they are misleading to the users who are likely to have an impression different from the one they would have of the entity, had they known about such matters.

(d) A company may remove an auditor before expiry of his engagement, but it has to ensure all procedures and each party's rights are respected as provided for by the Companies Act as follows:

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To convene an extra-ordinary meeting of the company with a required quorum and pass an ordinary resolution to remove an auditor.

A special notice to such a meeting must be given to the auditor within at least 28 days before the meeting.

If the auditor is contesting the removal, he may make representations to the company in which he states circumstances which have led to his removal and give reasons why he ought to stay in office. These representations may be sent to the members, or the auditor may require them to be read out at the meeting.

These may however neither be sent out or read in the meeting if, on application of either the company or any other aggrieved persons, the court is satisfied that the auditor's right is being abused, or there is needless publicity of the matter.

In such a situation the auditor has the right to receive notice and attend a meeting at which his term of office would be expiring and/or at which it is proposed to fill the casual vacancy caused by his removal and to be heard in such a meeting.

The auditor also has a right of lieu for clients books or items in his custody for the work performed if unpaid.

The auditor may also report to the registrar of companies.

4. (a) (i) The IFAC Code of Ethics for Professional Accountants requires its members to behave with courtesy and consideration toward all with whom they come into contact in their dealings. They should comply with all relevant laws and regulations. They should avoid exaggerated marketing claims for the services they are able to offer, or comparison of the superiority of their competence over other members. Their behavior should be beyond reproach, and should avoid involving themselves in situations that will not only discredit themselves but also bring disrepute to the profession.

(ii) In an assurance engagement such as an audit, the value of its product, the report, does not only depend on its quality, which reflect the skills and competence and objectivity with which it was carried out, but also the perception users have on the process through which it was carried out.

Therefore, for auditors, while ensuring they carry out their work in conducive environment to make objective conclusions, they should avoid any other undertakings that may cast doubt from the audit report users whether the auditors independence, objectivity and professional skepticism had not been compromised.

(iii) The auditors have a number of general approaches to adopt where there is potential or actual threats to their independence, depending on their seriousness, such as:

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Removing the subject matter, such as withdrawing a member of an audit team upon whom the threat is directly hinged.

Seeking professional advice, such as in complex areas of conflict of interest where the auditor has limited knowledge by seeking legal advice before taking any action.

Declining appointment or withdrawal from an existing engagement is another approach. This is appropriate where matters are so serious that it may be improper or not be possible to continue.

(b) The long time association between our engagement partner, Mr Petersen and the client's finance director, Mr Andersen, is a clear threat to independence in that Petersen cannot objectively or critically assess the work of the client where the finance director is a close friend. A further matter signifying the extent of the collapse of independence is the partner's failure to remind the company about the outstanding previous year's audit fees balances. The whole audit firm is in subordination to the effects of the dual's long term association.

The audit firm may overcome this problem by overhauling the team engaged with this particular client especially replacing the engagement partner and some key team members. They should also consider complete withdrawal, especially if the problem of non-payment of audit fees seems to be consistent.

The fact that each of the directors of Paw Ltd is entitled to an annual bonus based on the reported profit of the company alone is a pointer of higher audit risk. The appointment of one of our audit manager's wife as the company's finance director will pause a threat to audit independence since there will be conflict of interest. That as a director she will also be entitled to such an annual bonus makes the case even more serious because the audit manager will effectively also be benefiting from the bonus from the wife. This will make it difficult for the manager to approach his work in the client objectively.

The audit firm should replace the audit manager in the team with another to this client to overcome this problem. They should also consider complete withdrawal, especially if he is irreplaceable.

The astuteness and dominance of Mr Mazaza means that auditors must be very careful in their business dealings with him by not allowing their professional and objective approach to work to be overridden by his demands. Apart from this potential threat, there is currently no apparent financial threats to independence since the audit fees received from the two companies is only 8% of the firm's total annual income (0.48m/6m x 100).

But if the firm accepts appointment to audit a third company with an additional fee income of K0.75 million, then the independence threshold will be surpassed. The audit fees received from the three companies controlled by one person will be 18% (1.23m/6.75m x 100) which will affect the auditors independence. The firm should therefore decline the offer for audit of a third company.

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5. (a) (i) An expert is a person or firm possessing special skills, knowledge and experience in a particular field other than accountancy and auditing. An expert may be engaged by the client to provide specialized advice on certain matters, or may be engaged by the auditor to help obtain certain evidence and assurance on certain matters regarding financial statements where the auditor has limited skills and knowledge (for example: lawyers, engineers, chemists etc).

(ii) The auditor should consider the following factors when assessing the competence and objectivity of the expert who he wants to rely on:

Expert's professional competence in his field should first be verified by assessing professional qualification, experience and resources of the expert.

The auditor should consider the expert's scope and quality of work through assessing assumptions and techniques used and data sources, and the results of the expert's work in light of the auditor's knowledge of the business of the client and the results obtained by auditor's other procedures.

Independence of the expert from the client company can be determined by assessing whether he is an employee or not, or related in some way to the company. More independent experts are preferable.

(b) (i) Ownership (rights and obligation)

Check whether assets are owned by the client by inspecting ownership documents (i.e. registration books for motor vehicles, title deeds for land and buildings etc) and ensure they are in the client's name.

Valuation

Trace the original cost of each asset through the asset register and cross-check with purchase documents and ensure they were appropriately classified as capital expenditure.

Existence

Verify the existence of each asset through physical inspection, matching the detailed descriptions in the register with actual assets.

Presentation

For each asset confirm whether appropriate details about each asset are contained in the register such as, dates of acquisition and original cost, names and details of suppliers, description of each asset etc.

(ii) I would require the assistance of an expert such as a medical engineer who would help in identification of the items. I would obtain the non-current

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register and ensure all items (or groups of items) are described with appropriate information, and ask the expert to identify each item, its normal and current use and location and condition.

After verifying their costs with purchase documents such as invoices, I would ask the expert for further assurance with regard to reasonableness of the cost with respect to the make and models of the items.

The expert can assess the assets' useful lives from which the auditor would crosscheck with the reasonableness of the depreciation rates and charges for the items to determine their book values.

The expert can also be asked to assist in ensuring whether items have been properly classified as non-current, excluding all usable medical items, and have been properly presented in financial statements.

As an auditor I would then verify that the items belong to the client by checking that they were authorized, ordered and paid for by the client, and that any borrowed or leased equipment are separately disclosed in the financial statements. Check to ensure that any equipment under pledge or security for any financing arrangement are clearly disclosed.

(iii) Even if an auditor relies on expert's work, he is still responsible for the overall assessment and conclusion drawn from each part of the audit. The ultimate decisions as to where and how to obtain sufficient appropriate audit evidence for such purposes lies in his hands. The auditor should not make any reference to the work of experts in his overall conclusion.

6. (a) (i) (1) Materiality is the relative significance of an item such as a misstatement in financial statements.

(2) The significance can either be because of size of the item, for example misstatements involving large amounts are always material, or nature of the item, such as items that require separate disclosure irrespective of their sizes, and impact such that items whose omission would have a significant impact would be material even if they are small in size. An item should generally be considered material if its omission or commission could significantly affect the conclusions or opinions of the reader or user of financial statements.

(ii) A misstatement is the difference between the amount, classification, presentation or disclosure of a reported financial statement item, and that which is required for the item to be in line with applicable financial reporting framework. It can be factual such as a clear breach of the required standard, or judgmental such as an unsuitable estimation.

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(b) (i) Internal controls try to ensure desired management intentions are achieved, while preventing undesirable occurrences from happening as follows:

To ensure an orderly and coordinated execution of an entity' activities.

To ensure completeness, accuracy and validity of transactions.
To ensure existence of the resulting assets and records.

(ii) **Four** benefits derived from documenting audit work in working papers are:

It enables the reporting partner to ensure all planned work has been completed adequately.

Provides evidence of work done for future reference.

Assists planning and control for future audits.

It encourages a methodological approach and quality of audit work.

(iii) Auditors should reserve caution when placing their reliance on controls because they have inherent limitations such as follows:

(1) The effectiveness of controls application is usually subject to cost-benefit balance by management.

(2) There is a potential of controls not being as effective as desired due to human error of judgment or lack of their proper understanding.

(3) They are only suitable and applied to systemic and routine transactions, but not for the unforeseen situations.

(4) There is possibility that controls can be overridden by their executors through loopholes (i.e. segregation of duties can be overridden by staff collusion).

(5) Staff can get around controls or management can simply override controls.

(6) Controls need to be updated with changing times and situations because they may become obsolete.

(iv) Auditors should document their understanding of the systems of internal controls through:

Narrative notes
Flow charts

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Internal control questionnaires
Organizational charts

7. (a) (i) Professional skepticism is an attitude the auditor should adopt, this means that the auditor should always be aware or suspect or recognize that circumstances may exist such as fraud, errors and other irregularities which may cause financial statements to be materially misstated, unless or until he checks and satisfies himself otherwise. Such an attitude should be maintained throughout the audit and apply it in critical assessment of audit evidence.

(ii) Fraud is an intentional act carried out by an individual or a number of them to obtain an unjust benefit as a result of their entrusted responsibilities in their normal course of work in an entity.

(b) The responsibility to put measures in place to prevent, detect and correct fraud, errors and other irregularities primarily rests in the hands of directors or those charged with governance of an entity.

The auditors responsibility is to carry out suitable audit tests to obtain evidence which supports their conclusions on financial statements, whether they are misstated or not. Auditors have to recognize that fraud and errors are some of the serious causes of misstatements in the financial statements.

Therefore, though the auditor is not primarily responsible for detecting fraud and errors, he is expected to design and carry out audit procedures with a reasonable expectation of discovering all material misstatements that would affect financial statements, including fraud and errors.

(c) The auditor should carry out the following additional work to establish the full extent and estimated amount involved:

Obtain the total written off figure for the period and obtain as much background information about each debtor as possible. Establish the specific reasons why they were written off by tracing correspondences between the client company and each debtor.

Trace all recovered debts which were previously declared as irrecoverable.

Make comparisons between previous provisions for irrecoverable debts against subsequent actual write offs, carrying out limited check on the previous periods write offs and provisions.

Try to make contact from traceable debtors written off (non response might indicate that they have gone completely out of business, or that goods might have been sold to unscrupulous customers who disappear with them).

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Make calculations of sales revenue to debtors, and written off balances to year end debtors balances and make comparisons with previous periods results, and make judgment of their reasonableness from the auditor's own knowledge of the business and industry the client is operating.

Once the overall findings have been concluded, the auditor should report them to the appropriate level of management, and discuss with them the possible effects of the findings on the financial statements and advise them to carry out appropriate adjustments where necessary.

(d) Institute a culture of honesty and responsibility amongst staff members, including establishment of channels for whistle-blowing and anonymous tip-offs, for malpractices.

Institute an internal audit function to carry out regular information reviews for accuracy validity and completeness.

Segregation of duties and/or rotation of work. The person responsible for assessing debtors as irrecoverable should be different from the one responsible for assessing the creditworthiness of customers before goods can be sold to them on credit.

Rotation of work for those involved in highly vulnerable items such as cash book, inventory etc.
The credit controller's work should be properly supervised by some more senior member of staff such as the finance manager.

Carrying out regular reviews and reconciliations of the sales ledger control accounts and the debtors memorandum accounts. **k**

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