STRICTLY CONFIDENTIAL

2014 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC7: AUDITING

TUESDAY 2 DECEMBER 2014 **TIME ALLOWED : 3 HOURS**

SUGGESTED SOLUTIONS

1. (a) Interrogation programs are part of the audit software used for carrying out such audit tests as analytical reviews, age analysis of debtors and other accounts, checking calculations, confirming completeness and other procedures auditors would have been doing by hand in a manual system.

Problems associated with their use by the auditor include:

(i) The software needs to be thoroughly tested before being used on the live data of the audit client.

(ii) Audit staff needs to be trained specifically to use the software.

(iii) Standard interrogation software may not be compatible with all specified computer application, especially mini-computers or micro-computers applications.

(iv) Difficulties are often encountered in obtaining computer time from clients to use the interrogation software.

(v) Initial set-up costs and costs involved in updating the software can be prohibitive.

(b) An audit trail is a step by step detailed traceability of the various stages of processing transactions go through, between their initiation to their final recording, or backward from the final records back to their initiation.

In a typical credit purchases scenario, the trail would involve: placing an order with the supplier of goods. When the goods are eventually delivered, checking the goods for quantity and quality and signing and maintaining a copy of the delivery note in acceptance of the goods. Recording the goods in the goods received note and updating stock ledger. When an invoice is received for the goods it is recorded in the purchases ledger and for payment to be made, the invoice is authorized for payment and a cheque is prepared, signed by authorized signatories and sent to the supplier.

(c) There is often loss of audit trail in most computerized systems because of the following reasons:

(i) Some transactions may be entered on line from outside business partners with no apparent source documents.

(ii) Integration of several processes and information storage is done in invisible media unless printouts are made. However most managers prefer exceptional reporting, where only selected outputs may be printed out to save on administration costs such as stationary.

(iii) Systems failure resulting from issues such as computer breakdown, power failures.

(iv) Loss of files due to invasion by viruses or inexperienced operators etc.

(d) Test data pack contains dummy data used by the auditor to test whether the client's system processes data as it should. The auditor uses both valid data to check that the system produces required documentation and automatically updates the accounting records, and invalid data to check on controls that prevent processing of data that is wrong (for example, giving it information that breaches the credit limits to any customer, or negative sales figures etc, to see whether it rejects them).

The auditor may choose to input the dummy data in a normal production run where the dummy transactions are processed with live data. However, caution should be taken to ensure that the dummy data does not affect the live data being processed. Alternatively, the dummy transactions can be processed separately from live data, but in such circumstances 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 assess the extent to which the necessary controls exist, and so determine the level of substantive testing to be carried out. The auditor should clear this data once through with checking, to ensure the client's system continues its normal operations.

(e) The standing data in the database management system is vulnerable to the following security threats:

(i) Threats of unauthorized changes to the standing data.

(ii) Threats of corruption due to virus and other malware attacks.

(iii) Unauthorized access such as by hackers with ill intentions such as corporate espionage or other ill use of the data.

(iv) Systems failure due to hardware damage or operating systems problems.

2. (a) A statutory auditor may be appointed in the following circumstances:

(i) The auditor is normally appointed by members of a company in an annual general meeting (AGM) to hold office till the next AGM when members would have to consider whether to reappoint or replace him with another one of their choice. Appointment is by agreement (i.e. a simple 50% + majority vote is adequate for appointment), following which a resolution will be passed to that effect.

(ii) Directors of a company may appoint the first auditor or any other subsequent auditors to fill temporal vacancies that may arise due to departures of previous auditors (i.e. due to resignations, dismissals or death).

(iii) The registrar of companies has the powers, under the act, to appoint an auditor for a company if the company members or directors have failed to do so and submit audited financial statements for the first twelve months of operations to the registrar, within eighteen months of registration.

(b) When circumstances arise such as serious disagreements with management such that the auditor feels it is inappropriate to continue with engagement, he should resign from the engagement through the following procedures:

(i) The auditor should submit his formal written resignation notice to the entity's registered office addressed to the company's shareholders.

(ii) The auditor should state any circumstances surrounding his resignation which needs the attention of members.

(iii) The resigning auditor should expect and is entitled to receive notice and attend any meeting which relates to his resignation.

(iv) A copy of the resignation notice may also be sent to the office of the registrar of companies.

(c) A statutory audit on financial statements only provides a reasonable assurance, not absolute assurance, as some users would expect (leading to the audit expectation gap, unfortunately), because:

(i) Auditing involves judgement in forming conclusions in many areas, including materiality.

(ii) Not all items in financial statements may be tested. Sampling is often times used to reach conclusions about the entire classes of populations (i.e. sampling risk).

(iii) There are inherent limitations (weaknesses) in accounting and control systems. One can never be 100% sure of their reliability to control or detect fraud, errors and other irregularities.

(iv) Audit evidence sometimes indicates what is probable but not necessarily what is certain.

(v) Audit report is often issued a long time after the reporting date, enough time to cover up any irregularity by those concerned.

(d) The auditor has a statutory right to receive information and explanations from the client in relation to the audit. This right of access gives the auditor a position of considerable power and privilege which must not be abused. Therefore confidential information regarding the client's business must not be divulged to any third party without the consent of the client unless there is a public interest duty or legal obligation to do so. Other issues to consider are given below:

(i) Information or data obtained during the audit regarding the client's affairs must not be used for auditor's personal or third parties gain, such as using insider information to deal or advise others to deal in the client's securities.

(ii) Confidential information obtained regarding one client during the audit of another client must not be disclosed or misused. Such conflict of interest means that the auditor may have to resign from the appointment to resolve the problem.

(iii) Conflict of interests may also arise when a professional acts for two clients who are in direct competition. In this case the confidentiality rule applies to both clients affairs such that the auditor needs to be very careful to ensure that neither client is disadvantaged as a result of acting for both. Whenever possible the auditor must have a Chinese wall between staff assigned to the two clients.

(iv) The auditor can only effectively perform the audit where the client accepts the duty to make all necessary disclosure to the auditor. The statutory responsibility of the auditor and the client are set up in the engagement letter at the commencement of the audit to avoid misunderstandings. Where the client does not accept this duty, then audit appointment should be terminated or declined.

(e) (i) The main issue here is that the audits of Soche Construction Ltd and Kanjedza Construction are confidential. Under no circumstances may information gained during one of the audits 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 requested is for specific purpose and therefore in the event that Kanjedza subsequently suffered financial difficulties, Soche may find it easier to succeed in action for damages if financial appraisal was negligently done. The Auditor should make a commercial judgment between the amount of fee income and the necessity to withdraw from the audit of Kanjedza (with loss of regular audit fee) if it were to go ahead with the financial appraisal work.

(ii) Under this principle members are required to display truthfulness, fairness and honesty in all their dealings and to be straight forward in their business and professional relationships. They should not associate themselves with reports, returns or other information they believe are materially false, misleading or obscure information

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3. (a) Audit risk is the possibility (or likelihood) that the auditor may give an inappropriate opinion on financial statements. The auditor may conclude that financial statements give a true and fair view when they actually do not, or the other way. There are three components in the audit risk model.

Inherent Risk

This is the risk or possibility of occurrence of material misstatements (either individually or when aggregated with others) due to the background characteristics of the entity or specific items, irrespective of internal controls in place (for example, some entities or areas within an entity are riskier than others by their nature).

Control Risk

This is the risk or possibility of occurrence of material misstatements (either individually or when aggregated with others) that have not been prevented, detected or corrected by existing internal control systems in an entity (for example, given similar entities such as banks, those with weaker controls will have higher chances of fraud and errors).

Detection Risk

This is the risk or possibility that the auditors procedures will fail to detect material misstatements that exist within account balances and financial statements. This can occur if the auditor inappropriately planned his work, uses inappropriate audit procedures or over-relies on sampling (i.e. sampling risk).

(b) An expert is a person or firm possessing special skills, knowledge and experience in a particular filed other than accountancy and auditing (for example: lawyers, engineers, chemists etc).

When planning to use the work of an expert the auditor should consider the following issues:

(i) Assess the need, materiality of the matter and the risk associated with the work of an expert, if the matter is very fundamental to the conclusions to be reached the auditor should be more cautious on reliance of other's work.

(ii) Expert's professional competence in his/her field, by assessing professional qualification, experience and resources of the expert.

(iii) Independence of the expert from the client company, by assessing whether he/she related in some way to the company. More independent experts are preferable.

(iv) The expert's scope and quality of work, which can be carried out by assessing; assumptions and techniques used and data sources, and the results of the expert's work in light of the auditors knowledge of the business of the client and the results obtained by auditor's other procedures.

(c) A letter of internal controls (also referred to as a management letter or letter of weaknesses) is a letter forwarded by the auditor to senior management of a company. The letter contains the weaknesses identified in the entity's system of internal controls when performing tests of controls, states the possible implications or eventualities of the existence of such weaknesses, and possibly some auditor's recommendations as to how they can be improved.

The letter should normally be forwarded soon after completion of internal control tests, or alternatively at the completion of the whole audit process. Some matters included in the letter might have been discussed with management at appropriate levels during the course of the audit.

(d) (i) Firstly, the auditor does not give an entity's financial statements a true and fair view as implied by the candidate. Rather, the auditor assess and states whether financial statements of an entity give (or reflect) a true and fair view of the entity's state of affairs.

Secondly, a qualified audit report, according to ISA 701 Modifications to the Independent Auditors' Reports, is a report where the audit expresses some misgivings on material but not pervasive matters relating to either disagreements with the way they have been presented or uncertainty due to limitation of auditor's scope over those matters. For example, in his opinion paragraph the auditor might state: "except for the overstatement of closing inventory …. financial statements give a true and fair view…. or, "except for any misstatement that might occur in closing inventory……. financial statements give a true and fair view……

(ii) A disclaimer of opinion, according to ISA 701, is a type of a modification where the auditor's uncertainty due to limitation of scope is on matters so pervasive or fundamental to the audit work that the auditor believes cannot reach any reasonable conclusion on financial statement, while an emphasis of matter is a type of modification where the auditor believes he ought to bring certain matters of uncertainty to the attention of users, but such matters do not affect the auditors opinion on current financial statements. Such matters are highlighted in a separate paragraph after the opinion paragraph.

4. (a) IAS 10 classifies events occurring after the entity's reporting date as:

(i) Adjusting events are events that provide additional information or evidence on conditions that existed at the entity's reporting date of financial statements under review. If such events occur, financial statements should be adjusted with the effect of the additional evidence they reveal.

(ii) Non-adjusting events are events which are new and completely relate to the accounting period after the reporting date of the financial statements under review. No action need to be carried out to the financial statements under review if such events occur, except their disclosure by note if they are material. Amendments may only be required in financial statements if such events cast doubt on the going concern status of a company.

(b) The auditors responsibility is to design and perform audit procedures to obtain sufficient appropriate audit evidence that all events up to the auditors' report that may require adjustments or disclosures in the financial statements have been identified and appropriate adjustments made by management of the client. The auditor should discuss with and advise management if such occurrence were not adjusted.

If such events occur and management still does not make appropriate adjustments, up to auditors' reporting date, where the auditor believes they need to, the auditor should consider the impact on financial statements and report to the extent of their materiality.

The auditor should continue monitoring the occurrence of such events after the report, but up to the financial statements issuing or passing date, and if he becomes aware of facts that may materially affect financial statements and/or need amendments and management not to amend the financial statements, which the facts would change the audit opinion, he should issue another report or opinion to replace the prior one. The auditor is generally not responsible for events after that date.

(c) The auditor should carry out the following procedures with respect to the events occurring after the reporting date:

(i) Discuss with management the steps taken to identify and act upon those events in preparing the financial statements.

(ii) Examine all financial records for the period between the reporting date and the auditor report, with special reference to cashbook for payments indicating liabilities at the reporting date, records for subsequent payments, files for correspondence etc.

(iii) Examine interim management accounts and minutes of directors meeting.

(iv) Ensure that all large or unusual items or significant variations are allocated to the correct period and that they are correctly recorded.

(v) Confirm that the letter of management representations cover all subsequent events.

(vi) Confirm that the going concern reviews includes a consideration for the impact of any events occurring after the reporting date.

(vii) Confirm that the effects of the subsequent events on contingencies are considered.

(viii) Consider the materiality of subsequent events identified by auditors of subsidiary and associated companies.

(ix) Ensure that the possible effects of the subsequent events between the date of the audit report and the date of the annual general meeting are considered where such events come to the notice of the auditors.

(x) Discuss the matters with internal auditors if available.

(xi) Discuss with management any matters that may arise as a result of the tests to assess what further action is necessary.

(d) Apart from management assurance that they have supplied all information requested by the auditor, including the above issue, they may also include the following issues in a management representation letter.

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

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

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

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

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

5. (a) Going concern is an assumption that an entity shall continue operational into the foreseeable future (at least twelve months from the reporting date). This means that there is neither intention, nor do there exist conditions that may force it to close down or severely curtail its current operations. This assumption has the effect on presentation of information in financial statements, for example, the distinction between current and non-current items. The alternative, if no going concern is assumed, is to present information on a realization basis.

Management is responsible for assessing the viability of their company and presenting financial statements on a basis that is consistent with company's reality on the ground, i.e. either ongoing concern basis or realization basis.

The auditors responsibility is to assess the appropriateness of the use or non-use of the going concern assumption in preparation of financial statements by considering the possible impact of any apparent factors that may affect its ability to continue as a going concern.

(b) The company is facing going concern problems in a number of areas, and upon realization it has embarked on finding their way out of the problem as follows:

(i) The economy is experiencing a general downturn. This means that most of the customers will experience lower income and this will in turn reduce demand for the bread and slows down business, and less profits. On the other hand the fixed cost components of the units produced is higher.

(ii) The company's products are uncompetitive on the market because of its higher prices resulting from higher costs, leading to loss of market share.

(iii) The company also consistent use of bank overdraft to finance its activities, which means it is unable to generate adequate funds to sustain itself.

Having realized the problems facing the company, management are trying to find some solutions to bail out the company as follows:

(i) The company plans to expand its facilities for producing white bread as this line had maintained its market share, in belief that this will make for the lost market share in other kinds of bread.

(ii) The Company has asked its bank for a loan to finance the expansion and also to maintain its working capital generally. Although obtaining a loan instead of an overdraft may be better as loans are slightly cheaper in terms of interests but more stable in terms of repayments, the financial risk is still high as liabilities will still be high.

(iii) Finally, there is little that can be done about the economic downturn as it involves factors that are exogenous to the company.

(c) Audit procedures adopted in the examination of the cash flow forecast would include:

(i) Consider how accurate company forecasts have been in the past by comparing past forecasts with actual outcomes. If forecasts have been reasonably accurate in the past, this would make it more likely that the current forecast is reliable.

(ii) Determine the assumptions that have been made in the preparation of the cash flow forecast. For example, the company is experiencing a poor economic climate, so you would not expect cash flows from sales and realization of receivables to increase, but either to decrease or remain stable. You are also aware that costs are rising so you would expect cost increases to be reflected in the cash forecasts.

(iii) Examine the sales department detailed budgets for the two years ahead and, in particular, discuss with them the outlets that they will be targeting. This would help the auditor determine whether the cash derived from sales is soundly based.

(iv) Examine the production department's assessment of the non-current assets required to increase the production of white bread to the level required by the sales projections. Obtain an assessment of estimated cost of non-current assets, reviewing bids from suppliers, if available. This would provide evidence on material cash outflows.

(v) Consider the adequacy of the increased working capital that will be required as a result of the expansion. Increased working capital would result in cash outflows and it would be important to establish its adequacy.

(d) You would inform management that it would not be possible to give a report on the accuracy of the cash flow forecast. The forecast is an assessment of cash flows in the future which is uncertain, particularly in the second year. The bank should be informed that the kind of report that you could give is a limited assurance or negative assurance report. You would be able to state in your report the kind of work you had carried out, the assumptions that management had made.

(e) Analytical procedures involves analysis and comparison sets of financial data with other financial data or comparison of non financial data to derive relationships and trends in those relationships. This include calculations of various accounting ratios such as profitability, liquidity and long term gearing etc and making comparisons, say, with other entities in the same industry or deriving their trends over time. This can help an auditor assess the performance and current status of the entity. For example low profitability, negative liquidity or high gearing will indicate the entity is in financial stress which puts its ability to continue as a going concern in doubt.

6. (a) The following table summarizes control objectives and control audit is expected over the purchases and payables system, and the auditors respective tests of the system to evaluate their effectiveness.

	Control objectives	Control procedures	Audit tests of controls
Ordering	To ensure that: Orders and expenditure for goods are properly authorized. Goods ordered are for the Benefit of the entity Orders are only made to authorized suppliers **(Any two, ½ Mark each = 1 Mark)**	Operational control policy for the choice of suppliers Production of evidence for the requirement of purchases i.e. purchase requisition authorization. Maintenance of pre-numbered order forms and safeguarding blank ones. **(Any two, ½ Mark each = 1 Mark)**	Check that all purchases have been authorized at appropriate level and check against purchase requisitions. Test-check number sequence of order forms and requisitions and enquire into any missing numbers. Check whether client staff responsible for purchases shop around before selecting suppliers. **(Any two, 1 Mark each = 2 Marks**
Receiving goods and invoices	To ensure Goods received are used for the organization's purpose. Goods are only accepted if they were ordered and orders were authorized and liability is recognized for goods received. Goods received are accurately recorded. **(Any two, ½ Mark each = 1 Mark)**	Goods received should be checked for quantity, quality and conditions. Recording of goods in pre numbered goods received notes. Comparison of goods received notes and purchase orders. Checking of supplier invoices against orders for quantity, prices and discounts if any. **(Any two, ½ Mark each = 1 Mark)**	Check if invoices for goods are supported by goods received notes Trace entries into stock records noting entries of any goods returned Check entries and additions into the purchase day book and the purchases ledger. Test number sequence of goods received notes and enquire into missing numbers **(Any two, 1 Mark each = 2 Marks)**
Maintaining accounting records	To ensure that: All expenditure is authorized and is for goods received. All expenditure credit notes received are recorded correctly and are made to correct accounts. Cut-off is applied correctly **(Any two, ½ Mark each = 1 Mark)**	Segregation of duties between those involved in ordering, receiving and accounting. Prompt recording of purchases and returns and regular maintenance of purchases ledger. Comparison of supplier statements with purchases ledger balances and reconciliation of control accounts with purchases ledger balances **(Any two, ½ Mark each = 1 Mark)**	Verify recording of invoices and credit notes in the purchases ledger. Check calculations and cross reference with authorization for payments. Check postings to the ledger and test chec castings and ledger balances. Check that control accounts are maintained and regularly reconciled with the purchases ledger **(Any two, 1 Mark each = 2 Marks)**
Total Marks	**3 Marks**	**3 Marks**	**6 Marks**

(b) The auditor should carry out the following additional tests on the year end payables balances:

(i) Obtain or compile a list of payables balances to support the total balance shown in the balance sheet.

(ii) Reconcile the purchases ledger totals with creditors' control account balances at year end.

(iii) Carry out a balance age analysis and enquire from management into any long outstanding balances.

(iv) For selected balances, check the appropriateness of debit and credit entries and balances, recast and rebalance the purchases ledger, especially accounts with large throughput.

(v) Obtain direct confirmation from selected balances through a circularization and enquire into any disputed balances.

(vi) Review the year end cut-off procedures for appropriateness to ensure that all items included really relate to the accounting period under review and that relevant items have not been excluded.

(vii) Carry out appropriate analytical procedures around purchases and payables such as calculating, creditors to purchases ratios and creditors days and comparing them with previous periods results or other entities in the same industry.

(c) Where goods delivered are taken straight to the requisitioning departments there is incompleteness in record keeping which may lead to errors or fraud, i.e. employees misappropriating goods without trace.

Therefore, as can be seen from the above, all goods received should be recorded in the goods received notes and updated to the inventory ledger. All issues are supposed to be supported by authorized requisition notes which are also used to update the inventory ledger so that all inventory movements can be properly traced.

7. (a) (i) A Contingent Liability under IAS 37 is a possible obligation arising from past events whose existence would be confirmed only by occurrence or non-occurrence of an uncertain future event not wholly within he entity's control.

(ii) A provision is an amount of money recognized as a liability to an entity when it becomes probable that an outflow of future economic benefits will be required to settle a previous contingent liability.

(b) Typical examples of situations which may give rise to contingent liabilities and for which must recognize a provision include the following:

(i) Guarantees: when an entity (A) undertakes in an agreement to pay off a loan obtained by another entity (B) in the eventuality that B fails, then non-payment by B will automatically make A liable instead.

(ii) Lawsuits: if an entity is involved in a lawsuit whose unfavourable outcome may require the entity to pay some amount of money, the entity should recognize it as liability.

(iii) Share options: when a company offers share option to top management to purchase the company's shares at less than their market value as an incentive for achievement of certain performance levels, the achievement of set performance level will make the entity liable.

(c) Considering that most such contingent liabilities and provisions matter's knowledge is confined to management and there is possibility of non-disclosure of such matters especially if they have unfavourable effect on the financial statements of the entity, the auditors should carry out the following procedures to confirm the adequacy of their disclosure in the financial statements:

(i) Make appropriate enquiries and obtain confirmations from management for any occurrence that may lead to contingent liabilities.

(ii) Review board minutes and assess any issues discussed from which such matters may arise.

(iii) Examine legal expenses account and obtain explanations for all the costs and ensure that there is no outstanding matter for which further payments may be required.

(iv) Obtain any other information regarding the entity's business that may lead to contingencies or provisions including obtaining experts' opinion such as legal opinions on lawsuits.

(v) For directly identified litigation or where the auditor reasonably believes they exist, he should seek direct confirmation from lawyers.

(vi) Obtain detailed list of provisions included in the financial statements and assess for each whether there is a present obligation as a result of past events and review correspondences to that effect and discuss with management.

(d) If the auditor believes that he/she has not obtained adequate evidence about contingencies and provisions, this constitute limitation of scope of an audit process, and will lead to uncertainty of the impact that any subsequent revelation of such liabilities might have on the financial statements.

Where the impact is unlikely to be pervasive or fundamental but significant, the auditor may have to highlight such matters through an emphasis of matter paragraph. Where the matters are likely to have a pervasive impact, the auditor should consider a disclaimer of opinion.

The auditor could also however cover himself from future claims for negligence by obtaining appropriates management representations on such matters. The auditor may not be expected to act beyond what management have honestly declared. If the auditor is really sure that management is in breach of their duty to provide information which the auditor reasonably exists, he should raise to the members in the subsequent annual general meeting, or may consider disassociating himself immediately by resignation as last resort. **s**

(e) (i) Substance over form is the principle that requires that transactions and other events are accounted for and presents in accordance with their substance and economic reality, and not merely their legal form. In most business transactions the substance and the form would normally be the same such as on normal sale and delivery of goods, while in other cases it may be less clear, or the substance of a transaction is markedly different from its legal form such as sale of goods on return basis. In such cases the guiding factors would be whether or not or to what extent risks associated with items, control and enjoyment of economic benefits have been transferred to the other party.

(ii) Since transfer of goods to a consignee or agent on sale or return basis cannot be recognized a sale as such because title has not completely passed to the consignee, management should make some adjustments to the financial statements as follows: adjust the sales figure downwards by K450,000, derecognizing the sales transaction, and adjust the closing inventory upwards by [450,000 ÷ 1.25] = K300,000.

This clears the unrealized profit which was recognized when goods were delivered to the consignee. Since the consignee can return the goods, the risk associated with them still rests in the hands of the principal.

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