# STRICTLY CONFIDENTIAL

THE INSTITUTE OF CHARTERED ACCOUNTANTS IN MALAWI

## 2015 EXAMINATIONS

## ACCOUNTING TECHNICIAN PROGRAMME

## PAPER TC7: AUDITING

**WEDNESDAY 2 DECEMBER 2015**

**TIME ALLOWED : 3 HOURS**
**2.00 PM - 5.00 PM**

# SUGGESTED SOLUTIONS

1. (a) (i) Benefits derived from the integrated computerized accounting system include:

- There is reduction in data input effort because it is mostly input once.
- It can be operated by less number of staff members, reducing staff costs.
- Since it is also real-time, it instantly update records and produces reports to date.
- It makes tracing tractions and access to data and information easier.

(ii) However, there are also risks to the use of the computerized accounting system as follows:

- Errors in input data will lead to production of erroneous reports, hence misleading their users and decision makers.
- Collapse of one part of the system will affect the operations of the whole system.
- There is the possibility that data and information in the system may be affected by malware such as viruses if not well protected.
- There is risk to access by unauthorized people who may change, damage or steal important information from the system.
- There is also risk to general hardware damage resulting from unforeseen occurrences such as fires.

(b) The general ways in which access to information and updating of files from remote terminal can be controlled would include:

(1) Access:

- Physical restriction to access to terminals and locking up of terminals rooms when not being used.
- The use of password or the insertion of a special bade or key into the terminal itself being necessary to gain access to computer files and program for processing.
- The terminal users being restricted to the use of certain files and programs.

- A combination above should provide reasonably effective safe guards, although it will always be possible for unauthorized person to gain access to terminal keys and to acquire knowledge of passwords.

Updating:

In a typical purchase system it is unlikely that there will be stringent controls over the retrieval of information such as ledger balances, in that these are not likely to be regarded as particularly confidential. The updating of standing data in the purchase system (e.g. a supplier's name and address should be restricted to the purchases department).

2. (a) The need for an audit arises from the division, in many companies, between ownership of the company and the day to day running of the company. In many companies, particularly public companies, the shareholders who are owners of the company will not normally be involved in the actual running of the company. The company will then be run by the directors, who are elected by shareholders at the annual general meeting of the company.

At the end of each year the directors will produce financial statements. The shareholders need confidence that these financial statements are correct i.e. that the directors have actually told the truth regarding the company's results. To ensure that the financial statements are correct shareholders employ an auditor. The job of the auditor is to check the financial statements and then report back to shareholders whether these financial statements show a true and fair view.

By having these independent check, the shareholders will gain confidence that the accounts are correct and therefore that their investment, in terms of money, is being properly looked after.

(b) The auditor of a Ltd company is appointed in different ways, depending on the situation, as noted below:

<u>Initial appointment, new company</u>: in a company that has just commenced trading, the directors have the power to appoint auditors, who will hold office until the first annual general meeting (AGM). If the directors or the shareholders do not appoint auditors, then the Registrar of Companies (RoC) will do so.

<u>On-going appointments: All companies</u>, at their AGM, appoint auditors to serve from the end of that meeting until the next AGM. The appointment of auditors is a statutory requirement of an AGM. If the meeting does not appoint auditors then the RoC must be informed within seven days and he will then appoint auditors.

<u>Appointment to fill a casual vacancy</u>: at certain times the office of an auditor may fall vacant through death or the resignation of the current auditor. In this situation, the directors may appoint a new auditor whose term of office will cease at the next annual general meeting of the company.

(c) For a person to be appointed as an auditor of a company under the Act:

(1) He must be qualified by being a member of a recognized professional accountancy body.

(2) He must have a valid practicing certificate.

(3) He should be proper and fit.

(4) He should also not be an officer or employee of the company, a partner of the company and persons disqualified to any other corporate body within the group.

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3. (a) A statutory audit is an audit required by the Companies Act as a condition of registration in that status. The rights and obligations of members, management and auditors are also provided for with regard to this audit in the Act. Non-statutory audits are voluntary audits carried out at the discretion of owners of an enterprise (or other persons of similar status in other entities), not limited to registered companies. These might be full audits carried out in a similar manner to statutory audits, or partial audits targeting specific matters of an entity. The engagement is carried out in accordance with the agreement between the concerned parties.

(b) Apart from statutory audits, individuals or firms of professional accountants may be engaged to carry out other engagements either assurance or non-assurance in nature as follows:

(i) Social and environmental audits, relate to assessment of social and environmental impact of undertaking certain activities by an entity (i.e. the environmental footprint accounting assessment).

(ii) Attestation services, are high level assurance services such as forensic audit carried out in response to a suspicion of wrong-doing to obtain evidence that might be used in legal proceedings.

(iii) Compilation of financial statements.

(iv) Liquidation and receivership work.

(v) Compilation of tax returns, tax planning and advice to clients.

(c) (i) The required complete set of financial statements should be composed of: statement of financial position, statement of comprehensive income, statement of changes in equity, statement of cash flows and the accompanying explanatory notes to the statements. These are complementary for the user to have a full understanding of the entity's state of affairs. A statement of cash flows reveals an entity's

dimension of information to the user which cannot be appreciated by other statements.

Even if the business is carried on cash basis, there is still a difference between the two statements in principles guiding their preparation and presentation. A statement of comprehensive income is prepared on accrual and prudence basis, so it may contain a number of non-cash items such as provisions, while a statement of cash flows basically reconciles the opening and closing cash/cash equivalents positions with all movements within the year.

Management should therefore prepare and present a full set of financial statements not only as a requirement, but also to satisfy the need of users.

(ii) If management stick to their stand, this will constitute a significant omission in financial statements. Financial statements will be incomplete and therefore misleading the users. The auditor can therefore issue the following opinions:

- An adverse opinion that financial statements do not show a true and fair view of the entity's state of affairs because of the significant omission.

- If they did not obtain adequate alternative evidence from the cashbook and other related documents to satisfy themselves about the accuracy and completeness of cash/cash equivalents movements (which would have been revealed by the statement of cash flows), they would issue a disclaimer of opinion on the basis that they had limited scope of audit.

4. (a) (i) The confidentiality principle requires that auditors, or members of the profession in general, should treat with confidentiality all information acquired in the course of their audit work or professional relationships with clients, and should not disclose any such information to third parties without proper all specific authority from clients, unless there is legal or professional right to do so. Members should also not use any such information for their own personal advantage or third parties.

(ii) There are also exceptions to these general principles as follows:

- When the disclosure is necessary to protect members' interests (i.e. defending actions against negligence).

- The disclosure is required by a process of law.

- Disclosure in the public interest (i.e. when the client is engaged in activities or practices regarded as against the public interest such as racism).

- Disclosure to non-governmental organizations that may have an interest or statutory powers to require disclosure.

- The members are obliged to disclose to relevant authorities if they know or suspect the client to have committed arrestable or serious crimes (i.e. dealing in money laundering, drug trafficking etc).

(b) (i) It is acceptable and usual practice for audit firms to have audit engagements with a number of clients running concurrently. However, the auditors should always respect the confidentiality principles with regard to each separate client.

In the given scenario both clients, ABC Ltd who initiated the take-over bid and PQR Ltd who defended themselves against the bid have valid causes to suspect that the auditor might have supplied pertinent information to trigger the take-over bid or to build the most appropriate defensive mechanism, the poisonous pill, respectively, knowing that the auditor has unlimited access to both companies' records and information, some of which might be confidential, sensitive or competitive in nature.

The audit firm should be concerned that whether there were some intended or unintended leak of information or it did not play any part in the events the suspicion contravenes the confidentiality principle in the code of ethics.

(ii) Some possible eventualities that may result from this event include:

- Loss of trust from both clients

- The more disgruntled client or both clients may sue the firm.

- Either client or both may seek to remove the firm immediately in an extra-ordinary general meeting or in the coming annual general meeting.

- It would also lead to bad publicity of the firm which may also attract appropriate disciplinary measures from professional regulatory bodies etc.

Though it would not be in the best interest of the audit firm to lose clients both in professional and business context, it is undeniable fact that the relationship between the firm and both clients has been adversely affected and may continue deteriorating, and whatever the case may be, engagement with one or both clients has to be terminated, possibly at the next annual general meeting.

In case where something comes up in the intervening period, such as being sued or summoned for disciplinary hearing, the firm should prepare how it would exonerate itself. The firm may also seek legal or professional advice from knowledgeable people

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5. (a) Audit evidence is the information auditors obtain in arriving at the conclusions on which their report is based. Factors to consider when assessing quality of audit evidence are:

- Audit evidence from external sources (i.e. from confirmations) is more reliable than that obtained from within the entity's records.

- Evidence obtained directly by auditors is more reliable than inferred evidence.

- Evidence obtained from clients' records is more reliable when its systems of controls operate effectively.

- Written evidence is more reliable than oral evidence.

- Original documents are more reliable than copies.

(b) It is important to document the audit work and evidence gathered for the following reasons:

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

- It provides evidence of work done for future reference.

- It assists planning and control for audits.

- It encourages a methodological approach and quality of audit work.

(c) The audit permanent file must contain matters of continuing importance in nature, to the audit. Such matters or information may be used again in future audits. These include:

- Copy of client memorandum and articles of association. This will be used for periodic reference by the auditors on the rules governing the running of the entity and its relations with its stakeholders some of which might have an effect on financial statements and an audit.

- Client basic information: description of nature of business, its history and the industry and environment it is operating. This will help the auditor make proper judgments on the audit evidence gathered and form valid conclusions.

- Copies of important documents such as long term agreements between the client and the third parties (i.e., lease agreements with financers). These will be checked by the auditors from time to time if the client is complying with their requirements.

- Audit engagement letters with the client, this will be maintained and reviewed from time to time as it contains the basis on which every audit engagements is to be carried out, responsibilities of both the auditors and client management to reduce any future misunderstandings.

(d) Use of standardized working papers such as checklists, internal control questionnaires and specimens and templates is desirable because of the following benefits:

- It generally improves the speed and efficiency of audit work.
- It enhances assignment of audit work to staff members.
- It makes audit work easier such that more tasks may be done by junior staff.
- The results are easier to analyze in predetermined formats.
- However it may lead to auditors following a mechanical approach to audit without applying required audit judgment.

6. (a) The auditor should carry out the following procedures to verify land and buildings in financial statements:

- Verify the existence of land and buildings indicated in financial statements through physical inspection, marching the detailed descriptions in the register with physical results.

- Check whether land and buildings are owned by the client by inspecting ownership documents (title deeds) and ensure that they are in the client's name.
- Verify through purchase documents (purchase invoices, quotations etc) and ensure they were acquired and paid for by the company.

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

- Trace any subsequent capital additions and ensure they meet the requirement to be classified as such (i.e. that the costs enhance the capability or capability of the buildings, not maintenance and other running costs).

- Check any subsequent revaluation of the land and 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 every reporting sheet date and any impairments are provided for.

- Check reasonableness of depreciation policies, adequacy and accuracy of the calculations of annual depreciation on buildings.

(b) The auditor should also carry out the following audit procedures on long term liabilities to verify completeness, disclosure and correctness of measurement of the amounts of liabilities:

- Obtain or compile a schedule of loans to support the totals in the financial statements.

- Compare opening balances to the previous periods closing balances and trace changes within the period.

- Trace them to the ledger and check clerical accuracy of the records.

- Check names and other details of lenders, repayment conditions and other pertinent clauses in the loan agreements.

- Trace additions and repayments and compare with borrowing limits imposed by the articles of association and other agreements.

- Verify interest rates in the loan agreements and interest charges and payments for the period in the cashbook.

(c) The auditor should also carry out the procedures to verify share capital:

- Check authorized capital limit to the memorandum and articles of association.

- Check changes to issued capital in the year, through fresh, rights or bonus issues, and confirm with its authorization to the board minutes.
- Trace all transactions involving cash to the cashbook and bank statement.

- Obtain confirmation that all statutory and appropriate returns have been made to the registrar of companies and inspect all statutory books for appropriate disclosures.

- Ensure that all related parties, including directors' interests and transactions with the company, have been properly disclosed in accordance with IAS 24 on related party disclosures.

(d) The auditor should also carry out the procedures to verify share capital:

- Ensure capital and reserves have been appropriately disclosed and presented in accordance with IAS 39 on financial instruments.

- Check the accuracy and presentation of share premium reserves in accordance with IAS 1.

- Check the distribution of dividends records to ensure that they have been distributed from distributable reserves only according to the Companies Act requirement.

- Check that the profit reserves are appropriately update with the retained profits/losses from each period, and any other adjustments that may be required arising from correction of previous errors in accordance with IAS 8.

- Check revaluation reserve against their corresponding assets which have been revalued in the period in asset ledgers.

- Check any other reserves that might be set for particular purposes for their authorization in board minutes and their subsequent update in their ledgers.

7. (a) True and fair view is a state in which an entity's financial statements reflect its true state of affairs and present them fairly. For them to give a true and fair view they should contain 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.

(b) According to ISA 701, modified reports, modifications arise when auditors do not believe that they can state without reservation that financial statements give a true and fair view, to issue unmodified report. There are two general types of modified reports:

(i) Matters that do not affect the auditor's opinion

- Emphasis of matter is a separate paragraph issued to bring to the attention of users any matters of uncertainty which are material but not pervasive.

(ii) Matters that do affect the auditor's opinion:

Qualified opinion is issued where there are material but not pervasive misstatements on matters regarding disagreements with the way they are treated or presented or uncertainty due to limitation of scope over them, where an "except for…." opinion is issued.

Adverse opinion is issued when there are material and pervasive misstatement on matters of disagreement such that the auditor concludes that financial statement do not give a true and fair view.

Disclaimer of opinion is where the auditor has not been able to form an opinion on financial statements because of limitation of scope on matters so significant or pervasive.

(c) (i) The irrecoverable debt is individually significant as sit is over 7% of the total receivables and over 50% of net profit for the year. Omission of this write off is likely to change the view the users of financial statements, (i.e. its inclusion will reduce net profit by over 50%). Therefore the suitable report to be issued is the one with an adverse opinion because financial statements do not give a true and fair view of the entity's state of affairs as they are misleading.

(ii) Matters to do with related parties to the company, such as directors in this case, always have to be disclosed even if they are not so significant, according to IAS 24, *Related Parties*. In this case the company needs to disclose that one of the directors (by name) owed the company that amount of money for over half a year, even if the amount has since been paid back. If the disclosure is not made, then the auditor needs to qualify the report in the except for category.

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