STRICTLY CONFIDENTIAL

INSTITUTE OF CHARTERED ACCOUNTANTS IN MALAWI

2015 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

WEDNESDAY 3 JUNE 2015 **TIME ALLOWED : 3 HOURS**

SUGGESTED SOLUTIONS

1. (a) This computerized system is likely to face the following problems amongst others:

Segregation of duties

When remote terminals are located at the point at which data is originated, it may result in a situation where one is responsible for producing and processing the same information. To compensate for the reduction in the internal checks, supervisory controls should be strengthened.

Security problems

The ability of the person using a remote terminal to gain access to the computer will result in the need for special controls to ensure that files are neither read nor written to without proper authority, nor destroyed either deliberately or accidentally. Controls in form of restriction of physical access to terminals, use of passwords and restriction through logging of attempted violations, could prevent this problem.

(b) Security and confidentiality problems that could be encountered in this small computerized system include:

Lack of segregation of duties mentioned above may lead to enhanced opportunities for fraud and errors being undetected. The auditor may well have to perform extensive substantive verification work to compensate for this serious lack of controls.

Lack of controls over alterations to programmes: lack of expertise especially in the case of first time users may lead to imprudent purchases in terms of capacity and comparability, or programmes may be acquired or written and start using without adequate testing.

Lack of control over users: because the mini-computer may not have a comprehensively protected environment such as physical and data base management systems, the terminals are readily available to any user who may access any information, including company's classified information. Any ill-willing or disgruntled user can easily sabotage the company.

(c) Special security control issues that need to be considered by auditors are as follows:

The desirability for the auditor to request computer staff from the installation where the audit software is to be run to review the operating system instructions to ensure that the software will run in that installation.

It is usually appropriate for the auditor to test his software on small test files before running on the main data files used to avoid excessive consumption of computer time.

Once the audit software has been run, the auditor should check the identity and version of the data files used, whether supplied by the client or additional data supplied by himself. This will involve checking with external evidence.

(d) A mini-computer supplier may offer the following support services to clients:

(i) Provision of recovery services in the event of breakdown.

(ii) Any bugs in the programmes can be sorted out by the supplier.

(iii) Minor modifications to the programmes can be carried out by the supplier.

(iv) Assist clients in ensuring that adequate systems documentation and operator manuals have been provided.

(v) Offering training or ensuring that clients staff to be involved in operating the systems have received adequate instructions on the system.

2. (a) **Four** advantages for a small company to have an audit are:

(i) Shareholders not involved in management need the assurance given by audited accounts.

(ii) Providers of finance such as banks and other institutional creditors usually rely on audited accounts to make their lending decisions.

(iii) Audited accounts provide credible information from which tax authorities use to determine tax payable.

(iv) It provides assurance and confidence to trading partners in general such as: debtors, creditors etc.

(v) An audit also helps management improve the way they run their entities through advice obtained in the course of the audit.

(vi) An audit helps establish the credibility of the company at the company when fraudsters are committing long-firm fraud.

Four disadvantages for a small company to have an audit are:

(i) It is argued that an audit is only for compliance and does not assist management running the business as such.

(ii) The cost of the audit, which would be significant to small or medium entity, represents a non-productive expense and the money could have been better used elsewhere.

(iii) Banks and other lenders, including suppliers can make their own conditions of lending and do not entirely rely on audited historical accounts.

(iv) Where all the shareholders are also executive directors, or closely related to them, an audit would be of little benefit.

b) The auditor should take into consideration the following issues when auditing small companies:

Independence

(i) Small businesses present problems because of the professional relationships between auditors and directors of small companies. Auditors are often seen as advisers and tend to become involved with their clients at a much deeper level than auditors of large companies.

(ii) Auditors of small companies often prepare financial statements and usually perform other tasks for the business and this acquaintance with the client can constitute audit evidence, presenting a self-review threat.

(iii) Smallness and unsophisticated activities and the close personal relationship with auditors make a thorough knowledge of the business much easier but can make it difficult for the auditor to raise contentious issues with management.

(iv) Auditors of small companies must always stay objective and should not take over the management role. There is a danger that advice can evolve into active management.

Internal controls

(i) There tend to be inadequate or limited controls in most of the small entities, and the auditor is generally not able to rely on them for audit purposes to a significant extent.

(ii) Small businesses tend to have a concentration of management and ownership, few sources of income and uncomplicated activities, relatively uncomplicated record keeping and limited management information.

(iii) Small entities can only employ a limited number of staff, and each may be involved in doing a number of tasks.

(iv) Owner-managers generally have unlimited opportunities for overriding what controls there are.

Going concern and uncertainty

(i) Small businesses have more going concern uncertainty than larger business as they are often vulnerable to cash flow problems, limited number of customers, vulnerability to bad debts, and competition.

(ii) Lack of proper management information and limited financial expertise can compound the problems. Auditors can be drawn into acting as quasi financial directors if they are not careful.

(iii) In some occasions the uncertainty surrounding small business can be so pervasive that the business is unauditable. In such case it may be better to decline to accept or resign the post of auditors. There is no point in disclaiming an opinion as this really negates the purpose of carrying out any audit work and incur costs the client will be reluctant to pay.

(iv) Completeness is a major problem for small companies' audits due to lack of internal controls and the possible danger of owner-managed manipulating the business for their own purpose. It is not always possible for auditors to ensure that all the business transacted is reflected in the records.

3. (a) Independence is an attitude of mind characterized by integrity and objective approach to professional work. Members carrying on professional work are not supposed to be influenced by factors not relevant to the tasks at hand.

(b) Members providing assurance services such as audit are supposed to be impartial, unbiased and under no conflict of interests or undue influence from others or client members. They should not only be but also be seen to be independent of their audit client. This is because the reliability of the assurance from the audit depends on the perception of the end user such as shareholders have on the conduct of an audit. That is, even if the auditor was independent in the performance of an audit, if he did not appear to be independent there would be doubt as to whether the opinion on financial statements was reached objectively.

(c) In the given scenario, the auditor should consider discussing with the client and determine an appropriate stand with the client on a number of issues, which to some extent may also be interrelated:

(i) Scope of other work and possible conflict of interests: The auditor should first reassess the scope of the additional work environment with the client and discuss with management the extent to which this could pause conflict of interests. For example, mere preparation of a tax return could be acceptable, but going to the extent of representation in the Tax Arbitration Court would be worrisome as it would represent a significant advocacy threat to the auditor's work.

(ii) The ethical principles provide a clear guidance on the remuneration and determination of fees for work done by auditors. Fees should be computed based on the time spent by the partner and staff of the firm in the particular work. Contingent fees setting is a tricky issue which would affect the auditor's conduct of such a task. The auditor also needs to consider the change in the level of fees receivable from this client as a result of acceptance of the assignment as it may appear to affect his independence.

(iii) The terms and scope of such work must be clearly spelt out in the engagement letter as part of other services to avoid strange conditions and misunderstandings that may arise at a later period.

(iv) The auditor also needs to assess his firm's resource capacity to successfully perform both tasks within the time required. This may also include engaging different teams to carry out these tasks to avoid conflict of interest or threats to independence considered above.

(v) Again, depending on other assessments of the possible negative impacts acceptance of such an assignment might have on his other work or firm's reputational perception, they may simply decline or advise the client management to appoint a different firm for the task.

(d) The auditor should consider the following ethical issues:

(i) Under professional ethics an auditor may not disclose to any third party any confidential information which he may have obtained in the course of his professional relationship with any client or employer unless such client has expressly consented to such information being disclosed. Information acquired in the course of the auditors duties should also not be used for the auditor's or third parties advantage.

(ii) Confidentiality should be preserved both within and outside the auditor's organization. Other than seeking authority, disclosure can also be made where there is a professional obligation, a right or legal requirement or public duty to do so.

(iii) In the stated case the auditor has no professional obligation, right, legal or public duty to disclose the information regarding the financial position of CFCW. This would be tantamount to breach of confidentiality and could also influence a conflict of interest and impair his professional independence.

(iv) The auditor may however, without making specific reference to CFCW, encourage MWI Ltd management to reassess all receivable balances using publicly available and other information, with the view to discover CFCW or any other debtor's position and increase provision for doubtful debts in their accounts, (to cover themselves up in case something adverse occurred to CFCW).

(e) There are several steps or actions a professional body recognized by the IFAC can take on its wayward members or students, depending on the seriousness of the breaches or offenses. These are meted by the body irrespective of what the concerned member/student face with other third parties (i.e. law enforcement or employment status). These include the following:

(i) Reprimand or strongly condemning acts by concerned members including publishing their names and demanding penalty charge payments.

(ii) Suspension from the professional body for an appropriate time, including publishing their names and demanding penalty charge payments.

(iii) Expulsion from the body.

4. (a) The planning process is covered in general terms by ISA 300 *Planning an audit of financial statements*. Audit planning is important for the following reasons:

(i) Help the auditor devote appropriate attention to important areas of the audit.

(ii) Help the auditor identify and resolve potential problems on a timely basis.

(iii) Help the auditor properly organize and manage the audit so it is performed in an effective manner.

(iv) Assist in the selection of appropriate team members and assignment of work to them.

(v) Facilitate the direction, supervision and review of work.

(vi) Assist in coordination of work done by auditors of components and experts.

(b) Objectives of audit planning include:

(i) Proper planning ensures all engagement and ethical issues have been adhered to with the client.

(ii) The terms of engagement, scope and tasks are properly understood.

(iii) Establishing the overall audit strategy that sets the scope, timing and direction of the audit and guides the development of the audit plan.

(iv) Developing an audit plan and program that includes the nature, timing and extent of planned risk assessment procedures and further audit procedures.

(c) ISA 315 *Understanding the entity and its environment* states the key issues that auditors should understand about their client as follows:

(i) Nature of business and activities of an entity.

(ii) Its surrounding industry regulations and other external factors.

(iii) Objectives and strategies and their related business risks.

(iv) Internal control environment including selection and application of accounting policies.

(v) Its historical financial performance and its current and future expectations.

(d) The auditor would be worried about the likelihood of material misstatements arising in the above business because of some of the following issues:

(i) There are 30 outlets spread throughout in the cities of the country. The number of outlets is quite significant and geographically wide spread. Unless management of KFL have established strong controls coupled with regular inspections, chances of fraud and errors are high.

The company's takings are mostly in cash. These are also deposited by individual outlet cashiers at their respective branches of its bank. The cash based transactions also pause a significant risk in that some cashiers may be attempted to under-bank the daily takings.

(ii) Detection risk is the possibility that the auditors procedures may fail to detect material misstatements that exist in financial records, and hence fail to arrive at an appropriate conclusion on financial statements. The auditor will have difficulty in verifying the total sales revenue adequacy from all the outlets. Most of the materials are perishable, and there is inherent risk of inappropriate valuation. Some of the cash takings from each outlet is also used to replenish materials. Unless each outlet maintains proper records of all transactions.

5. (a) Opening balances are those account balances that exist at the beginning of the period. They are based on the closing balances of the prior period and reflect the effects of transactions of prior periods. Comparative information are amounts and disclosures included in the financial statements in respect of one or more prior periods in accordance with the applicable financial reporting framework. These are composed of corresponding figures and comparative financial statements where amounts or other disclosures for prior periods are included for comparison with the financial statements of the current period.

(b) The auditor's responsibilities with respect to opening balance and comparative figures include ensuring that:

- Opening balances do not contain misstatements that may materially affect current period financial statements.

- The prior period's closing balances have been duly brought forward as current periods opening balances.

- Appropriate accounting policies have been consistently applied, and that any changes to policies were reasonable and have been properly accounted for and adequately disclosed.

(c) (i) Goodwill is the excess of business value over the total sum of its identifiable assets. It normally arises on the sale of a going concern business to another. Some of the reasons why the extra value of a business may arise are when a business has built up or established a number of regular customers, when it has built up a good reputation over time, it is well managed because of experienced and efficient employees, it has established a stream of reliable supplier contacts etc.

(ii) The auditor may carry out the following procedures to verify the goodwill figures in the financial statements:

(1) Check the acquired business carrying values or fair values and its net assets at the time of acquisition.

(2) Check the reasonableness of the basis on which goodwill was estimated (i.e. usually based on the business's future expected profits or super profits).

(3) Verify the initial agreed goodwill figure by recalculation.

(4) Enquire from management whether an appropriate review has been carried out on the goodwill value, taking into consideration the existence of any new conditions that may affect its value.

(d) In this particular case:

The auditor should obtain the opening statement of financial position soon after acquisition.

Check whether the individual companies were priory audited, and seek permission to contact previous auditors for any explanation where necessary.

Assess the fair values of significant assets and liabilities at consolidation.

Carry out selected detailed verification of all significant items whose prior periods balances might affect the current period's balance.

(e) The auditor should also consider the following to assess the reasonableness of CC financial statements:

- That presentations are overall in compliance with the Companies Act.
- Accounting policies employed are reasonable and are consistent with appropriate GAAP.
- Whether they adequately reflect the information and explanations obtained and conclusions drawn during the course of the audit.
- The presence of any new factors which may affect the presentation of, and disclosures in the financial statements.
- An assessment of the results of analytical procedures, as to whether financial statements as a whole are consistent with auditors' knowledge of the business.
- An assessment of any apparent undue influence or pressure that may have been exerted on directors or management and may have an effect on the presentations.

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

(b) Duties of auditors at the planning stage with regard to inventory count include:

(i) Review the previous year's working papers and discuss with management any significant changes from last year.

(ii) Discuss the count arrangements with management.

(iii) Familiarize themselves with the nature and volume of inventory and especially identification of the high value items.

(iv) Consider the location of inventory items and the problem this causes for the client and the auditors.

(v) Consider internal audit involvement and reliance to be placed upon it.

(vi) Arrangements to obtain from third parties confirmation of client's inventory held by them.

(vii) Establish whether experts help may be required in verifying quantities or conditions of some of the items.

(viii) Ensure the audit team have copies of inventory count instructions, and that they have been reviewed.

(ix) Review surrounding systems of internal controls to identify areas of potential difficulty.

(x) Plan usage of audit staff to ensure their availability to cover all required locations.

(c) Inventory count procedures should cover the following characteristics:

(i) Good planning so that work is carried out carefully and systematically.

(ii) Division of inventory materials into manageable areas for control purposes.

(iii) Identification of items of especially high values.

(iv) Nomination of people responsible for each aspect of the count. These people should be independent from those charged with custody of the items.

(v) There should be written instructions for counting, weighing, measuring and checking. And all counters must be familiar with them.

(vi) There should be controls to ensure that all items are counted and once only.

(vii) There should be proper control over blank inventory sheets by numbering them and the control over the return of completed and unused inventory sheets.

(viii) There should also be control over movement of inventory items during the count (i.e. ensure no goods are let in or out).

(ix) Cut-off arrangements must be properly laid down.

(x) Presence of arrangements for identification of defective, damaged, obsolete and slow-moving items.

(xi) Identification of inventory on the premises but owned by third parties and the entity's inventory held by third parties.

(xii) Appropriate handling of sealed containers, dangerous goods and goods with specific problems.

(d) One of the main objectives of attending the count is to ensure that the company's counting staff are following the instructions prepared before the count. These instructions should have already been reviewed for their adequacy by the auditor who should, if necessary, discuss them with the company's officials. If the instructions are adequate but are not carried out properly then clearly the auditors should take action, since their departure decreases the reliability of the count.

In the case where instructions are not followed the auditor must clearly point out to the inventory count controller that there has been a breakdown in procedures in one location which must be corrected immediately. In addition, the auditor will have to make extra counts of materials counted by the team involved to satisfy themselves that they were not making a number of counting errors. If such errors arose a complete recount would 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.

(e) Cost and net realizable value are alternative methods of valuation of inventory, and inventory should be valued at the lower of cost or net realizable value.

Cost includes cost of actual items plus cost of bringing them to their present location and condition in the ordinary course of business. Cost can include: import costs, transport costs, handling costs and any other incidental costs.

Net realizable value is the actual or estimated selling price of those goods less any deductions in the ordinary course of business (such as selling and distribution costs) to the sale.

7. (a) (i) The following are some of the weaknesses identified from the scenario:

- The petty cash float is large, representing approximately three months expenditure. This is excessive and will increase the possibility of petty cash being stolen or errors not being identified.

- Petty cash vouchers are only signed by the person incurring the expenditure, indicating a lack of authorization control for that expenditure.

- Petty cash only appears to be counted by the accounts clerk, who is also responsible for the petty cash balance. There is no independent check that the petty cash balance is accurate.

- Petty cash vouchers are not pre-numbered so it is impossible to check the completeness of vouchers; unauthorized expenditure could be blamed on 'missing' vouchers.

(ii) The auditor would carry out the following audit tests with respect to the petty cash system and balances:

- Check that all vouchers have been signed showing that the expenditure has been authorized.
- Check through the pre-numbered voucher system and enquire into any missing vouchers.
- Trace details of payment analysis in the analytical cashbook postings to the general ledger.
- Check casting and balances for accuracy in the petty cash book.
- Verify the existence of the cash by attending a cash count and ensure all discrepancies have been resolved.

(b) (i) Control procedures expected in the Pabwalo Ltd cheque payment system include:

- Authorization of expenditure by appropriately senior staff such as the finance manager.
- Production of appropriate supporting documentation for such payment, before they are made.
- Maintenance of numerical sequence of vouchers and cheques, including cancelled ones.
- Prohibition of pre-signing cheques.
- Recording payment in the cashbook and posting to the appropriate accounts in the ledger.
- Carrying out regular reconciliations between the cashbook and bank statements.

(ii) It is important for the auditor to obtain confirmation direct from the bank because of the following reasons:

- Like other third party confirmation, banks offer alternative information which auditor can use to cross-check with that from internal sources.
- Banks are authoritative and credible institutions whose confirmations can be taken to be very reliable sources of evidence.

- The confirmations would be in written form, quite a reliable form of evidence which the auditor has recourse to at a later date for whatever reasons.

- Direct confirmations means that response will be sent directly, without the client interference, to the auditor.

(iii) The managing director's sentiments, that direct bank confirmations are unnecessary because the auditor ought to have been satisfied with evidence from the internal record and bank statements, are inappropriate as far as a credible audit process is concerned. As stated in (ii) above, the auditor needs to obtain this vital evidence to complement that from internal sources. Furthermore the managing director's assurance that he would provide the auditor with all information requested in the bank letter, and that the company's internal controls over cheque payments are very strong, seems to be a sinister distraction of the auditors work.
If he is still uncooperative, this will constitute limitation of scope of the audit work and the auditor should consider the effect on the overall conclusion and appropriately modify the audit report to the extent of its materiality.

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