

**STRICTLY CONFIDENTIAL**

**THE PUBLIC ACCOUNTANTS EXAMINATION**  
**COUNCIL OF MALAWI**

**2014 EXAMINATIONS**

**ACCOUNTING TECHNICIAN PROGRAMME**

**PAPER TC 7: AUDITING**

**FRIDAY 30 MAY 2014**

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

**SUGGESTED SOLUTIONS**

1. (a) Analytical procedures involve identifying relationships between financial data and non-financial data. This is carried out for the following purposes:

To identify consistencies and patterns or significant fluctuations and unexpected relationships.

They help auditors' understanding of the business and may highlight risky areas.

The auditor is able to carry out his work more efficiently by deploying appropriate resources to areas highlighted.

As part of the final review of the accounts, the auditor can assess if financial statements are consistent with his/her expectations and knowledge of the entity's business.

- (b) (i) Having noted the decimal increase in gross profit margin and the drastic decrease in net profit margin despite a substantial increase in sales revenue, the auditor should focus his investigation on cost of sales and expenses by carrying out the following procedures:

Check posting and castings and balances in the purchases account to ensure that the purchases figure in the income statement has been correctly calculated.

Select a few purchases invoices and verify increase in prices to justify the higher purchases figures.

Check that all purchases expenditure was properly authorized by verifying through appropriate signatures on purchase orders.

Inspect all expenses balances and take note of the ones that have significantly increased and enquire from management the reasons for such increase.

- (ii) As for the increase in gearing, which has been mainly caused by converting some debentures into equity the following checks should be carried out:

Check authorized capital limit to the memorandum and articles of association to ensure that the capitalization is still within it.

Check authorization of conversion of the debenture to board minute book and verify condition of conversation in the debenture agreement.

Ensure that appropriate disclosures have been made in the statutory books and returns have been made to the Registrar of Companies.

- (iii) The increase in the cash operating cycle and worsening liquidity should be of concern and the auditor needs to find out why by carrying out the following checks:

Opening and closing inventory valuation was appropriately carried out at the lower of cost and net realizable value.

Check and obtain explanation from management as to why inventory has increased substantially.

Crosscheck receivable figure in the financial statements with the ledger balances. Test check the ledger entries with the invoices and payments to ensure their accuracy.

Check the payables in the financial statements with the purchases ledger balances and note any increases over the previous year.

- (c) Auditors should consider compliance with regulations governing the preparation and presentation of financial statements, by confirming that:

Presentations are overall in compliance with the Companies Act.

Accounting policies employed are reasonable and are consistent with appropriate GAAP.

They should also review consistency and reasonableness of presentations such as:

Whether they adequately reflect the information and explanations obtained and conclusions drawn during the course of the audit.

Taking note of the presence of any new factors which may affect the presentation of, and disclosures in the financial statements.

Carrying out 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.

- (d) The auditor should complete the audit work by carrying out the following procedures:

Summarize and aggregate all uncorrected misstatements from different areas and assess their overall impact on financial statements and his opinion.

Revisit the previously assessed audit risk levels and evaluate the adequacy of evince obtained as a reasonable basis on which to base the overall audit opinion which is not inappropriate.

Prepare a completion checklist outlining all the audit work performed and assess their adequacy against the audit program, carrying out limited additional work where necessary.

2. (a) The auditor would carry out the following audit procedures to verify cash and bank balance for Chikuluti Stadium:

Obtain the ticket sale recordings, with amounts indicating the kind of stands that were paid for in the respective cash offices.

Verify whether there is close supervision by the cashier's supervisors, including checking of record and counting of cash for any discrepancies before collecting to the accounts clerks.

Check that the cashiers and receiving clerks had secure facilities for temporal custody of the cash received.

Ensure cash was promptly banked or night safe facilities from their bankers are used for the cash that is received for stadium use during the week ends when formal banking facilities are not available.

Check whether the automatic transfers from the cash offices for both the physical cash and visa card transactions appropriately update the cashbook at the head by testing the system using audit software.

Verify the banking of physical cash for the daily amounts and in the bank pay-in slips.

Inspect the cashbook, taking note whether all expenditure was proper through signatures in their supporting documents.

Cast and balance the cashbook to ensure its accuracy.

Obtain bank statements and carrying out bank reconciliations, noting any discrepancies and long outstanding items.

Obtain direct confirmation of bank balances as at the year end from their bankers.

- (b) With regard to the sales figure for the period the auditor would carry out the following tests to confirm its completeness:

Obtain information about the capacities of each of the VIP, covered and open stands.

For the year under review obtain the total number of paying functions such as match competitions that were held and their patronages.

Enquire from management if there were any functions where special dignitaries or invited guests were not required to pay especially in the VIP or covered stands where there is limited space.

Trace the records and general history if there has been any incidence of fraud of misappropriation of collections by those involved and the selection criterion takes into consideration of this risk.

Make comparison of current income levels with previous periods levels noting whether there are any significant changes and obtain explanations for such changes.

Compare actual income to budgeted income for the year. Ask the directors to explain any significant deviations.

Obtain industry information on the popularity of stadium, and change in customer numbers and compare these trends to the results obtained by the stadium. Where it performed significantly better or worse than average, obtain explanations from the directors.

Verify whether their close supervision by the cashier's supervisors, ensuring that all the cash is submitted and each ticket cash is indeed agreed to sales information that has been transferred from them.

Carry out calculations to prove total through obtaining information from the folio or duplicates of all ticket sales and comparing the total income.

Check the numbering sequence of ticket folios or duplicates identifying each ticket office and enquire into any missing, taking note of any spoilt tickets.

Check and ensure that ticket books were bona fide Chukuluti's books.

Test check the sales account daily collection and entries and recast the account to verify the accuracy of the balances.

3. (a) A receivables' circularization is a direct confirmation of balances from account holders themselves. It is an important source of evidence because it provides a direct external evidence about debtors existence. It also confirms the right of the client to receive payment and the debtors' obligation to make such transfers at some point in the future. Using the results of the circularization the auditor can also confirm the effectiveness of the internal controls by counter-checking internal records against third parties. It would also reveal evidence of items in dispute.
- (b) A circularization may be positive, where the auditor requires the debtors to respond whether they agree with the balances or not, or negative where the auditors requires debtors to respond only where they don't agree with the balance indicated. In a positive circularization an auditor obtains reliable evidence from the responses of all balances circularized. Follow ups can be made for any non-response. A negative circularization is more suitable where the auditor has assessed the client's controls as reliable, and where there are a large number of small account balances.

In some circumstances such as where there is a small number of large balances and a large number of small account balances, a combination of both can be used in the same audit.

- (c) The auditor has the right to obtain information on the client he deems necessary to form his conclusions. Management refusal to allow the auditor to obtain direct confirmation from debtors on their balances constitutes a limitation of scope on audit work. The auditor should discuss with management and explain to them the importance of a direct confirmation to his work. If they insist the auditor should consider the materiality of the receivables and their risk of misstatement and the reliability of other evidence obtained using alternative procedures. If doubtful the auditor should qualify his report to the extent of their materiality.

- (d) Possible causes of disputes or disagreement with the account balances could be due to the following reasons:

Some items could be in transit such as posted cheque payments that have not yet been received by the Takondwa Traders.

The disputes may also be due to disagreements on certain invoice values, may be arising from unsuitable or damaged goods invoiced at normal price.

There could be errors in Takondwa Traders books or their debtors accounts.

There could be contra entries for debtors who also happen to be creditors by one party which is reciprocated by the other.

- (e) When selecting which account balances to circularize, particular attention should be paid to the following:

Consider all long outstanding accounts such as those that are more than two months which are amounting to K1,328,800. A substantial number of these then might be facing difficulties to pay and may end up as irrecoverable.

Accounts written off during the period under review should also not be overlooked to confirm reasons and whether they indeed could not manage to pay up.

The accounts selected should also include all the three accounts with credit balances, or those with zero balances because they are unusual and the auditor would want to confirm reasons why they are, such as contra entries. It may also be indicative of window dressing.

Accounts whose balances are large or individually material such as all ten debtors above K50,000 each because if any or a number of such accounts did not exist then it would represent a significant misstatement.

Accounts settled by round sum payments should also be considered because they may be indicative of the debtors liquidity problems.

4. (a) The effects of adopting a computerized accounting system of Maseko Limited include the following:

Computers are able to process large volumes of work at much faster speed than manual systems.

They are also likely to have less processing errors or more accurate, except errors that occur in input data.

Large volumes of information are stored in the computer memory, greatly reducing office paperwork, except where printouts are necessary.

It leads to easy loss of audit trail since some transactions may be entered on line from outside business partners with no apparent source documents. The integration of several processes and information storage is done in invisible media unless printouts are made.

Apart from the client systems being computerized, auditors may or usually use computers on their own part while conducting audit in the following ways:

Audit working paper organization such as using automated working papers such as schedules direct from the client's system and make the documentation of audit work easier.

Auditors can use software packages to perform audit functions such as analytical procedures, or drawing statistical samples on which to perform their audit tests.

Computers can also be used by auditors as a decision support system, for example, through automation of checklists, materiality estimations etc.

Because most processes and information storage is made in invisible media the auditor may have little alternative other than use of computer assisted audit techniques (CAATs).

- (b) Audit software is the software administered on the client systems to perform checks to client data similar to what would have been done manually, such as, interrogation software, used for carrying out 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.

Test data is 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.

- (c) A real time processing system is a computer system that is capable of processing data instantly that the results are available to influence the activity currently taking place. For example, in this integrated real time system an entry of a sales invoice at one of the terminals would instantly update the sales ledger and the sales figure in the draft financial statements.
- (d) General controls are those which relate to the environment within which computer based accounting systems are developed, maintained and operated, and which are applicable to all the applications.

Examples of general controls include:

Development of computer applications, in terms of design, programming and documentation, approval and training staff involved in its use.

Prevention of unauthorized changes to programs which may occur if there was unrestricted access to the computers.

Testing and documentation of program changes.

Applications controls are related to transactions and standing data in the computer based accounting system and specific to each application. The objective of these controls, which may be manual or programmed, are to ensure the completeness and accuracy of the accounting records and the validity of entries made in these records.

Examples of application controls:

Controls over inputs such as checks on input source documents for validity of data.

Controls over processing to ensure all input data is processed.

Controls over master files and standing data to ensure integrity of contents, say, through periodic printouts.

5. (a) Auditors gather audit evidence in order to satisfy themselves of the appropriateness of financial statements assertions in specific areas or account balances, by using a number of techniques or methods as follows:

Inspection

This involves physically checking the existence of a document or an asset. For example the auditor would physically inspect equipment and verify them against their details in the non-current assets register. They would also inspect supporting documents against their records in the statements.

Observation

This involves watching a procedure being performed. For example, the auditors may attend an inventory count and observe whether the procedures adopted can

be relied upon to produce reliable results for inventory values. He may also attend a wage pay-out procedure to assess whether employees are properly identified before being paid.

#### Enquiries

This involves seeking information from management and staff or even external sources about certain matters. For example, asking management to confirm the existence of leased assets, or asking the company's lawyers to confirm the existence of certain lawsuits or ask for their opinion over their likely outcomes.

#### Re-performance

This involves the auditor who may independently redo certain procedures or controls. For example the auditor may recalculate depreciation on certain non-current assets to check whether they were done in accordance with the set depreciation policies and rates. The auditor may also re-perform back reconciliations to confirm the cashbook balances.

- (b) An assurance engagement is the one in which a practitioner expresses a conclusion designed to enhance the degree of confidence of the intended user other than the responsible party about the outcome of the evaluation or measurement of a subject matter against a certain criteria. In an engagement such as a statutory audit, the elements mentioned can be analyzed as follows:

The three parties involved are: the professional accountant as the practitioner, management of the company as responsible party and shareholders as intended users.

The subject matter are the financial statements of the company.

The suitable criteria is whether they are prepared in accordance with appropriate financial reporting framework and governing legal requirements.

A written assurance report containing the conclusion reached by the practitioner on the subject matter.

- (c) Other assurance services the auditor may be engaged in include:

Social and environmental audits

Internal audits

Attestation services

Non-assurance engagements (or agreed-upon procedures) include:

Compilation of accounting records and financial statements

Liquidation and receivership work

Compilation of tax returns, tax planning and advice to clients.

- (d) Independence is an attitude of mind characterized by integrity and objective approach to professional work. Members should consider, in general, when providing professional services whether there are any threats to compliance with ethical principles, and in particular observe objectivity and independence when providing assurance engagements.

Offering other services to an audit client may affect his independence because it may lead to conflict of interests, for example, it may constitute a self review threat if other services include preparation of financial statements, which is the audit subject matter.

This may also impair the auditors independence since it would involve charging an additional fee from the client, creating a self interest threat by increasing the auditors financial dependence on such a client.

6. (a) An internal audit is an appraisal or monitoring function or activity established within an entity to examine, evaluate and report to management on the adequacy and effectiveness of accounting systems and internal controls.  
This ensures that in entities, especially large ones, management is assisted in achieving corporate governance objectives such as business risk management and improve the efficiency and general reliability of entity's information as an oversight mechanism to its control systems.

- (b) Similarities:

The work of both focuses on similar or overlapping areas such as reliability of the entity's financial and other related information.

They also normally use similar techniques or approaches to their work such as substantive procedures.

They are however distinctively different in a number of aspects as follows:

	External Audit	Internal Audit
Objective	It is carried out to enable auditors express an opinion on financial statements (whether they show a true and fair view or not).	It is carried out to improve the entity's operations.
Reports	Report to members/shareholders and other Stakeholders.	Report to the board of directors and others charged with governance and it is internal in nature.
Scope of work	Focus on financial statements of an entity.	Focuses on business risks and operations of an entity.
Relationship with the company	Auditors are appointed by members and must be independent of the members and management of the company.	Auditors are often employees of the entity, although the service may be outsourced from external firms.
Qualifications	Must be carried out by qualified member of recognized accountancy professional body.	Depends on the requirements of particular entities, but may also be qualified or affiliated to relevant bodies such as the Institute of Internal Auditors (IIA).
Authority	The service is largely governed by the Companies Act and professional standards (i.e from IFAC).	It is governed by rules of each entity and internal audit professional standards (i.e. from IIA) .

- (c) External auditor would consider the following factors in order to decide whether to rely on internal auditors' work or not.

The external auditor should firstly assess the need, materiality of the matters and the risk associated with them before relying on them because he will still be responsible for the overall conclusion including on matters he relied on others' work.

#### Organizational status

Consider to whom internal auditors report (preferably to the board of directors or audit committee of the board) and whether there exist some restriction to their work. This would enhance or affect their operational independence.

#### Scope of the function

Consider the extent and nature of their assignment performed and actions taken by management to assess the internal audit effectiveness in the entity.

#### Technical competence

Assess whether internal auditors are properly qualified and experienced through checking their membership of professional bodies such as ACCA, IIA and other relevant bodies.

#### Due professional care

Assess whether internal audit work is properly carried out such as: planning, supervision, review and documentation and the quality of their internal audit reports.

- (d) The auditor has the right to obtain information on the client he deems necessary to form his conclusions. If the internal audit is an established function within the entity then it is part of management from which the auditor may obtain any information and explanations. If it is outsourced then the provider of the service is amongst the client's service organizations from which the auditor may obtain information. The auditor should discuss his concerns with management and if they still insist any such refusal constitutes a limitation of scope on audit work. If such a limitation is on material items with high risk of misstatements and there are no other reliable alternative sources of evidence, the auditor should qualify his report to the extent of their materiality.
7. (a) Professional judgment is process used to reach a well reasoned conclusion that is based on relevant facts and circumstances available at the time of the conclusion. A fundamental part of the process is the involvement of individuals with sufficient knowledge and experience. It involves the identification without bias, of reasonable alternatives, and therefore careful and objective consideration of information that may seem contradictory to a conclusion is key to its application.
- (b) (i) 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 show a true and fair view when they actually do not or the other way. Audit risk has three components.
- (ii) (1) 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).
- (2) 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).

(3) 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 poorly planned his work, uses inappropriate audit procedures or over-relies on sampling.

(4) Audit risk is the product of the three risk components identified above ( $AR = IR \times CR \times DR$ ). ISA200 requires to plan and perform the audit work to reduce the risk to an acceptable level, giving reasonable assurance on the truth and fairness of financial statements.

(c) (i) Audit sampling is the application of audit procedures to less than 100% of the items within an account balance to enable auditors obtain and evaluate evidence about some characteristics of the items selected in order to form conclusions about the population sampled. It involves designing of a sample, selection of items and evaluation of sample results.

(ii) To select a sample for audit tests the auditor may use any (or a combination of) the statistical methods such as:

(1) Simple random is probability sampling method in which every member of the population has an equal probability of being selected. The selection involves construction of a sample frame of the population with each item assigned a number or a slip, from which the desired number of items can be selected using randomly generated numbers.

(2) Systematic selection is a sampling method which involves selecting a sample using some set intervals. For example, if one were to select 100 items out of a population of 1,000 then from a random starting point every tenth item would be selected if those items were arranged in some order.

(3) Stratified selection is a sampling method that involves classification of items of the population into different groups according to their characteristics then selecting specified sub-samples from each group using random selection method.

(4) Multistage selection is a sampling method which consists of a number of successive stages, where a larger than required sample size is initially selected using some criterion. Successive smaller samples are drawn narrowing down to the initially set sample size.

- (5) The auditor may also use his judgment to select items that he wants, such as to select all items that appear to be individually material in the account balances. The auditor may also use a combination of several methods as is convenient to select the best sample in order to arrive at a more reliable conclusion on certain account balances.
- (d) (i) Sampling risk is the risk that auditors' conclusion based on sample findings might be different from conclusions that would have been reached if the entire population had been subjected to the same audit procedures.
- (ii) This risk can arise when the characteristics of the sample selected are not representative of those of the population from which the sample is drawn (i.e. when the sample is biased). It can also arise if the sample was too small or he did not use proper judgment to include certain items which are material in their own respect which may end up being misstated.

**END**