

EXAMINATION NO.

THE PUBLIC ACCOUNTANTS EXAMINATION
COUNCIL OF MALAWI

2013 EXAMINATIONS

ACCOUNTING TECHNICIAN PROGRAMME

PAPER TC 7: AUDITING

TUESDAY 26 NOVEMBER 2013

TIME ALLOWED : 3 HOURS
2.00 PM - 5.00 PM

INSTRUCTIONS

1. You are allowed **15 minutes** reading time **before the examination begins** during which you should read the question paper and, if you wish, make annotations on the question paper. However, you are **not allowed, under any circumstances**, to open the answer book and start writing or use your calculator during this reading time.
2. Number of questions on paper – 7.
3. **FIVE** questions **ONLY** to be answered.
4. Each question carries 20 marks.
5. Begin each answer on a fresh page.
6. **DO NOT OPEN THIS PAPER UNTIL YOU ARE INSTRUCTED BY THE INVIGILATOR.**

This question paper contains 7 pages

This question paper must **not** be removed from the examination hall.

1. Matawale Ltd is a medium size company which manufactures detergents. To order its materials, the production manager compiles a list of materials and sends it electronically to the ordering department. Staff in the ordering department use this list to place orders with authorized suppliers on the suppliers database using the electronic data interchange (EDI). The orders are confirmed by the suppliers using the same system.

All deliveries are checked against orders before acceptance by the goods inwards department, which then raises a goods received note (GRN). A copy of the GRN is sent to the accounts department. When invoices have been received, details are matched up with the GRN, which is then attached to the invoice. Invoice details are then entered into the computerized payables ledger awaiting payment. After 30 days, the payables ledger automatically generates a list of payments to be made, which is sent electronically to the chief accountant, who signs each invoice in approval of payment, and then forwards the electronic payment list to the accounts assistant, who completes it through the electronic banking system.

The company sells its products to a large number of customers ranging from large retail chain stores to small business entities, with receivables balances over a wide range, all with many different due dates for payment and credit limits. Again after 30 days, the receivables ledger automatically produces a list of receivables, analyzed by age and amounts, from which reminder statements are produced and sent to debtors by EDI. Most large customers also pay the company through electronic banking system.

Your audit firm has previously adopted an audit around the computer approach, but now wishes to use an audit software to assist with the audit payables and receivable balances above.

Required:

- (a) Explain the matters that the auditor needs to consider when planning for an audit of a client with a computerized accounting system. **2 Marks**
- (b) State the concept of audit around the computer and why this increases the audit risk for the auditor. **3 Marks**
- (c) State **eight** procedures that the auditor should use when carrying out the manual and computerized audit on payables transactions and balances of the Matawale Ltd. **8 Marks**
- (d) Define the following terms:
 - (i) Embedded audit facility **3 Marks**
 - (ii) Standardised audit working papers **2 Marks**
 - (iii) Automated audit working papers. **2 Marks**

(TOTAL : 20 MARKS)

2. (a) In a statutory audit of a client's financial statements, the primary responsibility of an auditor is to examine the financial statements and state, in his report, whether or not, in his opinion, the financial statements show a true and fair view of the entity's results of operations and its state of affairs at the end of any particular period.

Required:

- (i) (1) Define the term 'true and fair view'. **1 Mark**
 - (2) Explain the criteria that the financial statements must meet to show a true and fair view of an entity. **2 Marks**
 - (ii) Mention **three** benefits and **three** limitations of an audit. **6 Marks**
- (b) Before forming an overall conclusion on which the audit opinion is based, ISA 580, Management Representations, requires an auditor to obtain additional evidence from management, especially on matters whose knowledge might be confined to management.

Required:

- (i) What is a 'management representation letter'? **2 Marks**
- (ii) Mention **five** issues that should be included in a management representation letter. **5 Marks**
- (iii) Explain **four** issues that the auditor should consider when relying on representations as a source of evidence. **4 Marks**

(TOTAL : 20 MARKS)

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3. You work for Matola & Co. Public Accountants. One of your new clients this year is Rock Enterprises, a company whose net assets are K150 million. The audit work has been completed, except for one outstanding matter which you are currently investigating: the directors have decided not to provide for depreciation of buildings in the financial statements, contrary to what is required by the International Accounting Standards.

Your analysis has shown that the depreciation charge for the buildings for the year ended 30 November 2013, should be K4.5 million using the straight line method of depreciation at an annual rate of 5%. This would lead to a reduction in non-current assets by an accumulated depreciation of K36 million over eight years since they were acquired. This means that the profit for the year and accumulated reserves should also be reduced by those figures respectively. However, the client's equity is composed of K100 million ordinary shares, K30 million share premium reserves and only K20 million profit reserves, as most of the profits have been distributed as dividends in the past years.

Required:

- (a) Mention the fundamental accounting concept that has been violated in the above scenario and explain how it has been violated. **3 Marks**
- (b) State **seven** steps that you would take to correct the violation of one of the fundamental accounting concepts. **7 Marks**
- (c) Describe the type of audit opinion you would issue in your report, giving reasons about the appropriateness of such opinion in the audit report. **4 Marks**
- (d) The directors are displeased with your stand and have indicated that they would recommend to shareholders for your early removal in an extra-ordinary general meeting.

Required:

- (i) State the procedure that the directors should follow to remove an auditor before the expiry of his engagement. **4 Marks**
- (ii) State the right that you have as an auditor, in such circumstances. **2 Marks**
(TOTAL : 20 MARKS)

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4. (a) The IFAC Code of Ethics for professional accountants deals with a number of issues concerning the conduct of members of the profession including students. Amongst these issues are professional independence and courtesy.

Required:

- (i) State the Code's requirement in respect of courteous behavior of its members. **2 Marks**
 - (ii) State the reasons why members engaged in assurance services such as audit should not only be independent, but also be seen to be independent of their clients. **3 Marks**
 - (iii) What broad approaches should auditors adopt in cases where they perceive potential threats, or encounter actual threats to their independence? **3 Marks**
- (b) Consider the following scenarios and then answer the questions which follow.
- (1) Your firm's engagement partner, Mr Phiri, and the client's finance director, Mr Banda, have known each other socially for many years and in fact went to the lake together on Mother's Day holiday with their families. As a result of this friendship, the partner has not yet spoken to the client about the fee for last year's audit, 40% which is still outstanding.
 - (2) The wife of one of the audit managers in your firm which audits Kuseli Kulinji Ltd, has recently been appointed finance director of Kuseli Kulinji Ltd. Immediately prior to her appointment, she had been employed by one of Kuseli Kulinji's competitors. Each of the directors of Kuseli Kulinji Ltd is entitled to an annual bonus based on the reported profit of the company.
 - (3) Your firm audits the financial statements of two private limited companies whose majority shareholder and managing director is Mr Mazaza, an astute entrepreneur with a very dominant personality. The annual total fee income of your firm is around K6 million, and the combined audit fees attributable to the two companies is K480,000. Mr Mazaza has recently approached your firm with a view to appointing it as auditors of a third limited company under his control. The projected annual fee attributable to the third company is K750,000.

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Required:

For each of the above scenarios:

- (i) Comment on any concerns that you may have regarding the threats to auditors' independence and objectivity. **6 Marks**
 - (ii) Recommend the appropriate actions that should be taken by the audit firm to safeguard against any threats identified. **6 Marks**
- (TOTAL : 20 MARKS)**

5. (a) ISA 620: "Using the work of an expert" explains how an auditor may use an expert to obtain audit evidence.

Required:

- (i) Define the term "expert" as stipulated in ISA 620. **2 Marks**
 - (ii) State **three** factors that the external auditor should consider when assessing the competence and objectivity of the expert for his work to be reliable. **3 Marks**
- (b) You are a member of an audit team of your firm assigned to carry out an audit of Machilitsa Hospital, a medium size private hospital in your town. At the audit briefing you noted that most of the hospital's non-current assets are in form of medical equipment such as: suction machines, resuscitators, pulse oximeters, dialysis machines, stress rheometers, x-ray machines, microscopes, and endoscopes.

Your manager has assigned you to lead a team that is to verify the non-current assets to obtain sufficient appropriate evidence to satisfy assertions relevant to non-current assets, but you are not so conversant with the assets mentioned above.

Required:

- (i) List **four** assertions relevant to the audit of tangible non-current assets and state one audit procedure which provides appropriate evidence for each assertion. **4 Marks**
 - (ii) Explain the type of evidence and the scope of work that you would expect an expert to carry out to assist you meet your audit objective over the medical equipment amongst other non-current assets. **8 Marks**
 - (iii) Why is an auditor still held responsible for conclusions drawn based on an expert's assistance in areas where the auditor's knowledge is limited? **3 Marks**
- (TOTAL : 20 MARKS)**

6. (a) ISA 320 Materiality in planning and performing an audit provides guidance on the

concept of materiality when planning and performing an audit.

Required:

- (i) (1) Define the term ‘materiality’. **1 Mark**
 - (2) Mention **three** issues that you would consider in determining materiality levels. **3 Marks**
 - (ii) Define the term ‘misstatement’. **2 Marks**
- (b) Auditors often ascertain and evaluate clients’ internal controls to determine whether they are reliable so as to decide how much substantive and other tests to carry out. If controls are inadequate or unreliable, then they have to carry out more extensive substantive and other tests to obtain satisfactory evidence on which to base their conclusions.

Required:

- (i) State **three** main objectives of internal controls. **3 Marks**
- (ii) State **four** benefits derived from documenting audit work in working papers. **4 Marks**
- (iii) State **five** reasons why auditors should exercise caution when placing reliance on a client’s internal controls. **5 Marks**
- (iv) Mention **four** methods that an auditor may use to document his understanding of internal controls of a client. **2 Marks**

(TOTAL : 20 MARKS)

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7. Your firm has been auditing a client company for four years. You are part of a team that is carrying out the audit in the current year and you are finalizing the audit of sales and

debtors. You have noticed that over the past two years there has been an increase in the company's bad debts, making it a significant expense in the income statement. Your initial suspicion is that this may be attributable to harsh economic conditions companies are facing out there, or it may be due to the client's poor credit policy which leads to selling goods on credit to un-credit worthy customers.

Before considering this further, you discover that one of the debtors previously declared as bad has recently paid up his balance, which was then duly recorded in the bad debts recovered ledger. On further investigation, you discover that this debtor has been declared as bad more than once before, and wondered why the company had continued selling goods on credit terms to a customer who has had difficulty in payment. You have now found out that there was collusion between the credit controller and an accounts assistant and probably third parties.

The credit controller is responsible for assessing new customers, determining their credit limits before goods can be sold on credit, and also carries out periodic debtors age analysis, sending reminder statements and declaring bad debts that he believes are not recoverable. The accounts assistant is responsible for receiving all payments to the company, maintaining the cashbook and carrying out regular reconciliations with bank statements. The credit controller and the accounts assistant have been pocketing some receipts from debtors who had been declared as bad.

In the recent incident the receipts were duly recorded as recovered bad debt by another accounts assistant who temporarily took over the cashbook responsibilities because the usual person had gone on leave.

Required:

- (a) Define the following terms:
 - (i) Professional skepticism 2 Marks
 - (ii) Fraud 2 Marks

 - (b) Outline the respective responsibilities of the auditor and client's management to detect fraud and other irregularities in the client. 5 Marks

 - (c) Outline **three** additional audit tests that you would carry out with respect to bad debts to establish the full extent and estimated amount involved in the scam, and the steps that you would take with such information. 6 Marks

 - (d) State **five** controls that should be instituted to prevent a similar incident recurring in the future. 5 Marks
- TOTAL : 20 MARKS)**

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