THE INSTITUTE OF CHARTERED ACCOUNTANTS, GHANA

NOVEMBER 2015 PROFESSIONAL EXAMINATIONS

AUDITING AND ASSURANCE (2.3)

EXAMINERS GENERAL COMMENTS

GENERAL PERFORMANCE

The general pass rate of candidates in the subject was 38%. That is, out of a total number of 240 candidates who wrote the paper only 92 passed and 148 failed.
The performance was below average.
High performers were concentrated in Accra and Cape Coast Centres whiles low performers were not concentrated in a particular centre. They are concentrated in a lot of the centres as such tuition in some of these centres are to be intensified.

The level of preparedness of some of the candidates were not adequate enough. This reflected in the abysmal performance of some of the candidates.

STANDARD OF THE PAPER

The standard of the paper for November, 2015 was a bit higher than that of May, 2015. The questions were a bit high at the knowledge level of this examination and they were too loaded.

STRENGTH OF CANDIDATES

Specific areas in which strengths were demonstrated were questions one (1) and four (4) where candidates pass rate was 67% and 51% respectively on the average.
Candidates were well prepared in those topics.

The under listed areas on which such strengths can be enhanced:

(i) Vigorous teaching and learning by both teachers and students.

(ii) A lot of mock tests should be administered to candidates prior to the main examination so that all rough edges could be smoothened.

(iii) More past questions should be practiced by students.

(iv) Setters of questions should be made to set questions from the Institute’s recommended texts.

(v) Other parameters that will strengthen the examinations.

WEAKNESSES OF CANDIDATES

Most of the Examinees demonstrated tremendous weakness in answering some of the questions. In fact, the candidates failed to relate their answers to the questions. There were a lot of deviations in their answers. That is worrying since candidates could not understand simple questions to be answered.

The weakness was somehow widespread since over 62% of candidates failed the examination in the period under review.

The reason for the weakness to our group of Examiners is that most candidates lacked basic foundational knowledge of the subject.

It therefore, behoves on instructors of the subject to ensure that students grasp the basic principles of the subject. Students should be made to do a lot of tests before they go in for the examination. Students should do a lot of reading and practice past questions for teachers to mark and discuss with candidates prior to the examination since it is true that practice makes man perfect, as the saying goes.

THE INSTITUTE OF CHARTERED ACCOUNTANTS, GHANA

NOVEMBER 2015 PROFESSIONAL EXAMINATIONS QUESTIONS

AUDIT AND ASSURANCE (2.3)

QUESTION ONE

Your firm is the external auditor of The Ceramicz Company, and you recently attended the year-end inventory count at the company's warehouse. The company manufactures high quality tableware (plates, cups and saucers etc.) and it maintains an integrated computerised system that shows the inventory held at any point in time.

At the year-end inventory count, reports showing the various categories of inventories (but not the quantities) are printed off the system and the quantities of inventories actually counted are inserted annually by the counters. Later the quantities are compared with those per the computer system.

The count instructions were received by both you and the counters the day before the count was due to take place. The instructions consisted of the following five points:

1. Counters must arrive at 8 am on the morning of the count.

2. They will work in teams of two people.

3. Each team will be assigned a specific area of the warehouse to count. They will receive inventory sheets listing the products to be found in their area.

4. The inventory sheets are pre-numbered.

5. Once the counters have finished the inventory count, the inventory sheets must be handed to the warehouse manager.

Your notes from the attendance at the count include the following observations:

Many areas in which the count took place were untidy and inventory was sometimes difficult to find because it was not in the allocated area. The same categories of inventories were sometimes found in several different areas and some inventory was incorrectly labelled.

The count was conducted in a hurry in order to close the warehouse before a public holiday and there were insufficient counters to conduct the count properly in the time available. The issue and receipt of inventory sheets (on which the quantities were recorded by counters) was not properly controlled. It was difficult to reconcile the inventory quantities recorded at the count to the computerised records and some significant differences remain outstanding.

Although no finished goods were dispatched during the inventory count, a large delivery of raw materials was received into the warehouse.

Required:

a) For the inventory count conducted by the Ceramicz Company:

   i. Identify and explain **FOUR (4)** deficiencies in the count.
   ii. Explain the possible implication of each deficiency and
   iii. Provide a recommendation to address each deficiency.

(12 marks)

b) Describe the audit procedures that auditor should perform at the year end to confirm each of the following:

   (i) The existence of inventory **(2 marks)**
   (ii) The completeness of inventory **(3 marks)**
   (iii) The valuation of inventory. **(3 marks)**

(Total: 20 marks)

QUESTION TWO

You are an audit senior for an audit firm and are currently working on the audit of Technolab, a company which produces sophisticated electronic laboratory equipment. The company imports a high proportion of the components it uses from China. The equipment is used by some laboratories dealing with hazardous chemicals.

As the audit draws to a close, the partner in charge has asked you to ensure that all procedures relating to subsequent events and going concern are properly performed. You are to consider the audit work to be performed in relation to ISA 560 Subsequent Events and ISA 570 Going Concern.

Required:

a) Describe the auditor's responsibilities for subsequent events occurring between:

   (i) The year-end date and the date the auditor's report is signed.

   (ii) The date the auditor's report is signed and the date the financial statements are issued.

(6 marks)

b) Going concern relates to the judgement that an entity will continue to trade for the foreseeable future.

   (i) Explain the responsibilities of directors and auditors in relation to going concern.

(3 marks)

   (ii) Explain the audit procedures that audit could carry out when conducting the going concern review of Technolab.

(4 marks)

c) Technolab has an internal audit department. The partner in charge of the audit is seeking clarification regarding how any deficiencies in internal control should be identified and communicated to management. The partner feels the report produced by the external auditors may duplicate the produced by the internal audit function.

Required:

Explain how the purpose and content of an internal auditor's report on internal control deficiencies differs from one prepared by the external auditor.

(7 marks)

(Total: 20 marks)

QUESTION THREE

You are the senior responsible for planning the audit of Hometown Football club Limited (HFC) for the year ended May 31, 2008.

HFC runs a football club which was promoted to the top division in the league this season. The football season starts on September 1 and ends on May 31 so that the players get a break over the summer months.

HFC own their football stadium which now has the capacity to seat 25,000 people. Of the 25,000 seats, 19,000 are allocated to HFC supporters (home supports) and are sold to season ticket holders only. The remaining 6,000 tickets are for away supporters and cannot be sold to HFC supporters.

Season tickets cost GHS175 for children. Following their recent promotion all the season tickets have been sold this year with 70% of season tickets sold to adults and the remaining 30% to children. Tickets for away supporters are always sold at GHS20 per ticket regardless of whether the ticket is sold to an adult or a child. On average 50% of away supporter tickets have been sold for each of the 14 home games played at HFC's stadium during the football season.

HFC's other revenue streams include the sale of football kits and other memorabilia from the club shop, and food and drink sales from the club snack bars.

Following promotion to the top division, the club added an extra stand to the stadium to increase the seating capacity to the current level of 25,000. Other existing areas of the stadium also underwent maintenance in order to restore them to their original condition. The work was carried out during June and July, 2007 and cost a total of GHS3, 360,000. To finance this HFC took out a GHS2, 900,000 loan on June 1, 2007. The loan carries an interest rate of 7% and is repayable over the next five years. The loan is secured on the stadium.

The directors feel that the club's greatest assets (other than the stadium) are the football players themselves. The players have performed so well this year that some of the other football clubs in the same division have made preliminary offers to buy three of HFC's players. HFC is particularly pleased about this as these players joined the club through their youth academy programme. Consequently the directors would like to value these three players as intangible non-current assets in HFC's financial statements. The players will be valued at the offer price received from the other clubs, the directors fell this is a prudent valuation because they are confident that the eventually selling price would be much higher than the preliminary offer.

One of the major drawbacks of the club's promotion has been that the club has had to increase the level of players' salaries. The total salary expense for the year is estimated to be in the region of GHS2, 800,000. This is a particularly surprising figure as it is higher than the other operating costs for the year which are estimated at GHS2, 400,000.

HFC has just appointed a team of internal auditors. They have not been in position long enough to help you with your audit work but the directors are keen for the internal auditors to improve the company's internal controls in relation to the club shop and snack bars.

Required:

a) Using the information provided, describe **FIVE (5)** audit risks and explain the auditor's response to each risk in planning the audit of HFC.

(10 marks)

b) Describe how the auditor could perform a proof in total calculation to confirm each of HFC's revenue from ticket sales, loan interest and payroll expense for players' salaries.

(4 marks)

c) Explain **THREE (3)** internal controls the internal auditors of HFC should implement relating to the club shop or snack bars, and state the objective of each of the three controls.

(6 marks)

(Total: 20 marks)

QUESTION FOUR

You work for a firm of accountants and auditors which has eight partners. The audit firm has been invited by the Managing Director (MD) and majority shareholder of Wellbeing Co, to accept appointment as statutory auditor of the company, replacing the current firm of auditors who will not be re-appointed.

The principal activity of Wellbeing Co is the manufacture and distribution of healthcare products. Your firm has several companies operating in the healthcare sector and its client portfolio.

The MD of Wellbeing has requested that your firm assists with the preparation of the company's tax computation, and provides consultancy services on an ongoing basis in connection with his plans to grow the business.

The MD has also suggested that a partner in your firm joins the board of Wellbeing Co as a non-executive director.

Required:

a) Identify and explain the threats to independence and objectivity which may arise from the provision of the services requested by the Wellbeing MD, and state how these threats should be resolved. **(8 marks)**

b) Describe the matters, other than independence and objectivity, to be considered and the procedures to be performed in order to determine whether it is appropriate to your firm to accept appointment as statutory auditor of Wellbeing Co. **(7 marks)**

c) Set out the benefits to audit firms and their clients of having audit and non-audit services provided by the same firm of accountant. **(5 marks)**

(Total: 20 marks)

QUESTION FIVE

Big Build is a listed construction company with an annual revenue of GHS350m. Big Build's draft statement of profit or loss shows a profit before tax for the year ended December 31, 2008 of GHS40m.

Big Build's audit firm are conducting an audit. This is the first audit of Big Build that this audit firm have conducted. An enquiry to the previous audit firm revealed no reasons for concern. On completing audit work at the company's premises, the audit senior drafts a memo, extracts from which are reproduced below:

(a) **Inventory valuation**

Inventories include GHS7m, at cost, for scrap rubber from used car tyres. This material is widely used as a road surface in other countries. Contracts for road building with this country's Highways Agency, the state authority for road construction, do not currently permit the use of this material. However, the matter was known to be under review and on being offered a special purchase of this material, Big Build speculated on a favourable outcome of this review and purchase the material. In February 2009, shortly before the financial statements were approved by the directors, the Highways Agency reported that it would not, currently, accept the use of this material. If used on non-Highways Agency contracts the material's net realisable value would not exceed GHS2m.

The finance director maintains that the issue of the Highways Agency report was a non-adjusting event after the reporting period. The write down of the inventory should, therefore, be reflected in the next period's financial statements.

(b) **Depreciation**

During the year ended December 31, 2005 the company purchased two computer controlled earth movers at a cost of GHS2,500,000 each and a further two at the same price during the year ended December 31, 2006. Depreciation has been provided at 10% straight line, the same basis as it previously depreciated conventional earth movers. This year, 2008, the company has decided that improvements in technology made it worthwhile scrapping their first two computer controlled earth movers and replacing them with the latest model at a cost of GHS6,000,000 each. The company provides a full year's depreciation charge in the year of acquisition and none in the year of disposal.

The company's chief engineer tells you that technology is developing so rapidly it appears likely they will continue to replace these machines every five years. In spite of this the finance director claims that the depreciation rate of 10% is in line with the industry standard and reflects the physical life of the machines. He urges that continued improvements in technology cannot be foreseen and that there is no justification for increasing depreciation to 20% because of the possibility of technological obsolescence.

(c) **Contingent liability**

The company is being sued for GHS50m by the Highways Agency for defective work on a recently completed road. The company maintains that it met the Highways Agency's specification and it is the Agency's engineers who are at fault in drawing up the specification. Big Build maintains that it has no case to answer, that the possibility of loss is remote and that the claim need not be disclosed as a contingent liability. An investigative journalist has recently published an article suggesting that other roads constructed by the company exhibit similar faults. The managing director has admitted that the company's road building techniques are under investigation by the Highways Agency. If the company were to lose the case its future going concern would be threatened. No disclosure has been made in the financial statements.

Required:

For each of the following three issues, discuss whether the financial statements require amendment and describe the impact on the auditor's report if the issue remains unresolved.

a) Inventory valuation **(6 marks)**

b) Depreciation **(7 marks)**

c) Contingent liability **(7 marks)**

(Total: 20 marks)

SUGGESTED SOLUTIONS

QUESTION ONE

(a)

Deficiency	Implication	Recommendation
Planning The inventory count was poorly planned as there were insufficient counters, inventory was untidy, inventory was not in its allocated area and was sometimes incorrectly labelled.	If the inventory count is not conducted in an organised way then inventories could be omitted from the count or items counted twice. Items could also be recorded as the wrong product line if different products are mixed up in the same location. If the inventory is not organised then it may be difficult to identify obsolete or damaged inventory. These factors mean that when the quantities are compared to the computerised records adjustment could be made unnecessarily. This would lead to incorrect quantities of items being recorded both in management's inventory records and the financial statements. This could lead the business to hold too much/too little of certain inventory lines or to have a material error in their financial statements.	In future, the inventory count should be properly planned and organised. Management should carry out a review of the warehouse a few days before the count is scheduled in order to ensure that the warehouse is tidy, inventory lines are stored together and obsolete or damaged inventory is segregated. Staff should be advised that they should communicate any problems with the inventory count to the manager in charge as soon as they are identified. If there is significant concern over the accuracy of the year end count, then the auditor may need to request that the warehouse is organised and a second count carried out at a later date and a roll-back reconciliation performed.
Inventory count sheets The inventory count sheets were not properly controlled. Employees were not required to sign for them and records were not kept of who was working from which sheet.	Inventory sheets may be lost or not used in the count. This could result in inventories being counted and not recorded in the final inventory count, or not counted at all. This means that inventories may be understated in the financial statements.	The pre-numbered inventory sheets should be signed in and out by the manager responsible for overseeing the inventory counts. A record should be kept as to which employees has which inventory sheet. At the end of the count, a sequence check of inventory sheets should be made to ensure they are complete.

Deficiency	Implication	Recommendation
Segregation of duties There is a lack of segregation of duties concerning the responsibility for the count as the inventory counters must hand the inventory sheets to the warehouse manager at the end of the count.	The warehouse manager has day to day responsibility for the inventory and also has control over the inventory count which is the most important procedure to determine the accuracy of the quantity of inventory at the year end. If there are significant differences between the quantity counted and recorded on the inventory sheets and the quantity recorded in the computerised inventory records then the warehouse manager has the opportunity to conceal these errors. This could lead to inaccurate information regarding inventory quantities and/or fraud going undetected.	Someone other than the warehouse manager should have overall responsibility for the inventory count, for example a supervisor or manager from the finance department. Once the count is completed, the inventory sheets should be reviewed and photocopied by this member of staff before being handed back to the warehouse manager. This will enable any subsequent changes to the inventory sheets to be monitored.
Procedures over the movement of inventory There are no formal procedures regarding the control of inventory movements whilst the count is being conducted.	There were no goods despatched during the count but goods were received while the count was ongoing. It is not clear whether these items were included in the count or not. However if there is no stipulation made regarding the cut off of inventory then inventory could be recorded in the wrong accounting period.	Ideally there would be no movements of inventory in and out of the warehouse whilst the count is being conducted. However if goods must be despatched during the count then they should be separated from the other inventory lines and not included in the year end count. Goods received during the count should also be segregated and recorded in the year end count. This process should be overseen by the finance supervisor/manager.

(b) **Existence**

Observe the inventory count in order to determine whether the inventory exists. Enquire of management whether any inventory is held for third parties.

Obtain a copy of the completed inventory sheets. Select a sample of items and physically verify that the products listed on the inventory sheets are in the warehouse.

For the raw materials delivered on the day of the count, discuss with management whether these goods relate to the year being audited, or whether they are to be included in the post year end period. Trace these items through to the final inventory figures to ensure they have been recorded in the correct accounting period.

Completeness

For a sample of product lines in the warehouse, verify that they have been included on the inventory sheets and that the quantity is accurately recorded.

Perform a sequence check of all inventory sheets to ensure that they have all been resumed to the warehouse manager at the end of the inventory count, so that all product lines are included in the year-end inventory quantity.

Enquire of management whether there are any items of inventory held off site which have not been included in the inventory sheets.

Valuation

For a sample of finished goods sold post year end, compare the sales price to the current price list or catalogue in order to check items are being sold at a price which is greater than the item's cost.

For a sample of items classified as work in progress at the year end, ask management how they have determined the percentage completion at the year end. Recalculate the costs incurred to date. Compare this to the future selling price of the completed item less the costs to complete in order to determine the net realisable value of the item. Trace through the final valuation of the item to the financial statements.

Review the inventory movement records to identify any particularly slow moving inventory lines. Discuss the saleability of these items with management and enquire whether any provision has been made in order to write the item down to its net realisable value (also check whether damaged inventory identified by Cermaicz Company during the count has been written down to its net realisable value).

EXAMINER'S COMMENT

The question was averagely answered by the students and 67 % of them passed.

QUESTION TWO

(a) (i) Between the year-end date and the date the auditor's report is signed, the auditors shall perform audit procedures which will identify and detect all material subsequent events which require adjustment of or disclosure in the financial statements.

Additional audit procedures are not required where satisfactory audit evidence has been gained.

(ii) The auditor has no obligation to perform any audit procedures between the date the auditor's report is signed and the date the financial statements are issued.

However, if a fact becomes known that would have influenced the auditor's report had the auditor known it at the date the auditor's report was signed then the issue shall be discussed with management to determine whether the financial statements need amendment.

Where the financial statements need amending, additional audit procedures shall be conducted on that area and the original subsequent events review extended to the date of the of the new auditor's report which will be issued.

If management refuse to amend the financial statements and the auditor's report has already been provided to the entity, and if management intend to issue the financial statements with this report, the auditor shall take steps to prevent reliance on the report. This might include speaking at the AGM or resigning.

(b) (i) It is the director's responsibility to make an assessment of an entity's ability to continue as a going concern and to prepare the financial statements on the going concern basis if that is believed to be appropriate. This may require the directors make judgments about inherently uncertain future outcomes of events or conditions.

It is the auditor's responsibility to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumption in the preparation of the financial statements and to conclude whether there is material uncertainty about the entity's ability to continue as a going concern.

(ii)Obtain a copy of the cash flow and statement of profit or loss forecasts for the year ahead. Discuss with management the basis on which they have been prepared and obtain supporting documentation, if possible, for any assumptions which are inconsistent with the performance of the current period. Compare the performance of the business post year end with the forecasts.

Discuss with management whether there have been any breaches of Health and Safety legislation or potential litigation which may influence Technolab's ability to trade.

Discuss with management whether there have been any supply problems and whether there are alternative suppliers available to the business should supply problems arise.

Review the order book in the post year period for evidence of continued demand for Technolab's products.

(c)**Differences between External and Internal audit's report to management**

External auditor's report
The external auditor's report to management only details significant deficiencies in the internal control systems which have come to the attention of the auditor as part of their normal audit procedures. It is not a comprehensive list of all deficiencies.

This reflects the wider role of the external auditor and that internal audit staff have the time available to take a more detailed approach. It also reflect the narrower aim of the external auditor, focussing on the accuracy of the financial statements.

Internal audit reports
Reporting on internal control deficiencies is one of the internal audit function's main roles. They carry out tests on systems and controls according to the needs of the business to ensure effective control and effective use of resources. This is likely to require internal auditors carrying out a series of assignments, each focusing on a particular aspect of operations and control.

The overall objective will be to assess the effectiveness of the organisation's control systems and the potential risks that the business faces. The impact of the risks can be assessed and alternative controls put into place if required.

The internal auditors have a wider focus than the external auditors. The external auditors will observe controls with a view to the impact on the financial statements. The internal auditors will have a wider more wide-ranging perspective, and will include operational efficiency and compliance issues as well as financial issues.

There is no prescriptive format to the internal audit function's reports, however the report should contain the following:

Executive summary
This will summarise the terms of reference, the key objectives of the assignment and the major findings and recommendations.

Body of the report
This will set out the detail of what work has been done, by whom, what observations were drawn, what recommendations have been made, when they should be implemented and by whom.

Appendices
These may contain details of the tests carried out and the results thereof. They may also include analyses of potential impacts of controls deficiencies.

EXAMINER'S COMMENT

The question was badly answered by candidates. Most of the candidates did not understand the question. Some deviated in their answers and only 31 % passed.

QUESTION THREE

(a)

Audit risk	Auditor's response
HFC has spent GHS3, 360,000 on its football stadium during the year and it appears that these costs are both capital in nature (the addition of the new stand) and expenses (the maintenance of the existing areas of the stadium). There is a risk therefore that management have classified all of the expenditure as a non-current asset under IAS 16 rather than separating out the expenses. Any errors in classification would lead to both non-current assets and profits being overstated.	The auditor should obtain a breakdown of the GHS3, 360,000 spent on the stadium and establish which costs relate to the addition of the new stand and which relate to maintenance. These amounts should then be traced through to the nominal ledger accounts to ensure that expenditure is appropriately classified.
HFC has taken out a loan during the year which is repayable over five years. One year of the loan has already passed leaving a liability which will be repaid over the next four years. At the year end this liability will need to be presented in the financial statements according to the portion which is a current liability and a non-current liability. There is a risk that this disclosure has not been made or is inaccurate.	Determine from management how they have calculated the portion of the loan which is due for repayment in the next 12 months. Re-perform the calculation and verify that the remaining amount is disclosed as a non-current liability.
HFC has pledged the football stadium as security for the loan and this also needs to be disclosed in the financial statements. There is a risk that this disclosure is incomplete.	Review the disclosure note relating to the loan to ensure that it contains all necessary information.
HFC wants to capitalise three players as intangible assets in the financial statements at the offer price made for them by other football clubs. These players are an internally generated asset and cannot be capitalised per IAS 38. There is a risk therefore that the company's assets will be overstated in the financial statements.	Explain to management that the capitalisation of these "home-grown" football players is not permitted under current accounting rules and principles.

HFC has a high level of operating costs which could lead the company to be loss making and suffer cash flow and possibly going concern issues. The revenue from ticket sales amounts to approximately GHS5.3m and expenses include loan interest of GHS0.2m, payroll costs of GHS2.8m and other costs of GHS2.4m (see part (b) for calculations). This means that the company is operating at a very low margin which could lead to concerns about the company's viability	Perform a detailed going concern review and discuss the company's forecast performance with management.

(b) Analytical procedures

Revenue

The auditor should perform a proof in total calculation as follows:

		GHS
Season ticket sales	Adults (19,000 x 70% x GHS260)	3,458,000
Children (19,000 x 30% x GHS175)		997,500
Away supporter sales	6,000 seats x 50% capacity x GHS20 x 14 games	840,000
Expected revenue		5,295,500

The expected revenue of GHS5, 295,500 should be compared to the actual revenue from ticket sales and any significant differences investigated and discussed with management.

Loan interest

Again the auditor should perform a proof in total calculation as follows:

	GHS
Loan value	2,900,000
Interest rate	7%
Expected revenue (GHS2, 900,000 x 7%)	203,000

The expected loan interest expense GHS203, 000 should be compared to the actual interest expense charged and any significant differences investigated and discussed with management.

Payroll costs

Here the auditor could obtain information about the players' salaries last year and calculate the average salary per player for the prior period.

He would then need to determine from management the average percentages increase in salary and calculate the average salary for the current year.

Multiplying the average salary for the current year by the number of players would give an expected payroll cost for the current year.

This should then be compared to the actual payroll charge and any significant differences investigated.

(c)

Internal control	Control objective
Each season HFC should invite suppliers of the different products sold by the club to tender for the contract to supply goods. Each supplier's products should be inspected/tasted to ensure they are of the quality required by HFC.	To ensure that all goods (products to be sold in the club shop and food and drinks for the snack bars) are purchased at the most competitive prices and represent the best value for money.
After each game, the snack bar manager should complete a schedule of quantities of drinks and food sold for each product. This information should then be reviewed by management to determine which games generate the most activity in the snack bars. This information should then be used to project the demand for food and drink at similar games in order to assist with the quantity of perishable food and drink ordered.	To ensure there is minimum food wastage which in turn will maximise the profits generated by the snack bars.

At the end of each game, the money in the tills at the club shop and snack bars should be counted. The sales revenue taken per the till receipt roll should also be reconciled to the amount in the till and any differences investigated. A float should be left in the till drawer and kept in a locked safe. Additional monies should be banked promptly.	To prevent and detect fraud and misappropriation of cash in the club shop and snack bars.

EXAMINER'S COMMENT

Candidates were ill-prepared and did not perfom well 25% passed. Areas covered by the question should be critically looked at by both lecturers and students.

QUESTION FOUR

(a) **Threats to independence** and **objectivity** arising from the provision of other services and how those threats should be resolved.

The IESBA code of Ethics for Professional Accountants states that the provision of non-audit services can create a threat to independence. Consequently, it is necessary to evaluate the significance of any threat created by the provision of other services. The significance of any threat created should be evaluated and, if the threat is other than clearly insignificant, safeguards should be considered and applied as necessary to eliminate the threat or reduce it to an acceptable level.

On-going consultancy services

Consultancy services is a very broad term and so it would depend on exactly which services the MD would want the audit firm to provide.

There are however **two main threats** arising from this:

(i) **A self-interest threat**. The auditor may therefore be tempted to issue an unmodified report when a modified report should be issued for fear of losing the audit/consultancy fees.

(ii) **Self-interest and self-review threats** arise when the firm takes on work which involves making judgments/taking decisions which are the responsibility of management. Assuming a management responsibility can also create a familiarity threat if the firm becomes too closely aligned with the views of management.

Possible safeguards against these threats include:

- Monitor the level of fees generated from Wellbeing as a percentage of the firm's total fee income to ensure that the firm is not perceived to be dependent on the client.
- Where independence may be threatened, the firm should consider refusing additional consultancy work.
- Ensure that there is an independent partner review of the audit.
- Ensure that the audit firm does not perform management functions or make management decisions by confirming

- The client acknowledges their responsibility for designing, implementing and maintaining internal control and for preparing the financial statements.
- The client authorises all transactions and amendments to records
- The client decides whether or not to implement the firm's recommendations/decisions

- Use a separate team for the other work.

Taxation

The MD has requested that your firm assists with the preparation of Wellbeing's tax computation.

Preparing the tax computation for an audit client creates a self-review threat because part of the audit will require you to verify the amounts for taxation which is a figure your firm has prepared.

It is likely that safeguards can be put in place to mitigate the self-review threat. Such safeguards will include using staff who are not members of the audit team to perform the work. Where the work is performed by a member of the audit team it will be necessary to have the tax calculations reviewed by an independent manager or partner.

Appointment as non-executive director

If a partner or employees of an audit firm serves as a director or officer (for example a company secretary) of an audit client this would create both a self-interest and a self-review threat.

There is a self-interest threat because the partner would have a direct interest in the performance of the client, since the partner would probably be remunerated by the client.

A self-review threat exists because a partner from the audit firm would have had influence over the company the firm is auditing.

These threats are so significant that no safeguard could reduce the threats to an acceptable level and the partner should refuse the offer to join the board.

(b) Matters to be considered and procedures to be performed to determine whether it is appropriate for your firm to accept appointment as statutory auditor

Adequacy of resources

- There must be sufficient staff of appropriate calibre (expertise and experience) to enable the audit to be completed on a timely basis.
- The firm must have the ability to provide a professional service without jeopardising its service to other clients.
- There must be sufficient staff available so that different teams can be used for Wellbeing Company and any of its competitors in the same line of business.
- Partner availability must be considered to ensure there are separate audit partners on each type of engagement.

Integrity of client identification procedures

- Consider the potential for money laundering/other unlawful acts
- Investigate any history of management/changing advisors/failed companies
- Review the latest financial information having regard to unusual accounting policies, reported problems regarding proper accounting records, liquidity and trading position.
- Review prior years' financial statements to identify any previously modified audit reports/differences between Wellbeing and its auditors.
- Undertake a company search on Wellbeing and other companies with which the directors are associated.
- Review any comments in the press/local hearsay and (with the prospective client's permission) obtain references.

Professional clearance

- The client's permission should be obtained to contact the retiring auditor to ascertain whether there is any professional reason not to accept the appointment.
- If permission is refused, the appointment should not be accepted.
- If the outgoing auditors fail to reply, the appointment may be accepted.

Confidentiality

Obtain informed written consent from any clients in the healthcare sector who are competitors of Wellbeing.

(c) Benefits to audit firms and their clients of having audit and non-audit services provided by the same firm.

Audit firms

- Enhances the ability of firms to attract a higher calibre of recruits who value the broad-based training provided by firms undertaking a variety of services.
- Enhances the firm's ability to audit tax and computer systems
- Creates a wider intellectual capital within firms

Clients

- A higher quality of service is given as the firm is in possession of the whole picture
- Services are provided at a lower overall cost as background information is pooled.
- Convenient/less disruptive for client (one-stop shop)
- There is comfort for the client from having services provided by a trusted source.

EXAMINER'S COMMENT

The question was fairly answered and 51% of Students passed.

QUESTION FIVE

(a) Inventory valuation

Whether the financial statements require amendment

IAS 2 Inventories states that inventory should be valued at the lower of cost and net realisable value (NRV).

As the Highways Agency will not allow the use of the material in roads, it appears that the NRV of the scrap rubber is actually GHS2m. This means that inventory is overstated by GHS5m, resulting in profits being overstated by a material amount.

The director's argument that the inventory should be written down in the next period is incorrect. The adjustment to the NRV of the inventory is an adjusting event after the reporting period (as it gives further evidence of a condition which existed at the reporting date) and the inventory value should be written down in this period.

Impact on the auditor's report
The error is material as it represents **12.5% of profit** before tax (GHS5m/GHS40m).
If management refuse to amend this error then the audit report will need to be modified. As management has not complied with IAS 2 and the error is material but not pervasive then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would need to be included explaining the material misstatement in relation to the valuation of inventories. The opinion paragraph would be qualified 'except for' – due to material misstatement.

(b) Depreciation

Whether the financial statements require amendment

Depreciation should be charged so as to write off the cost of the asset over its expected useful life to the business. IAS 16 Property, Plant and Equipment requires that the useful lives of assets should be reviewed at least at each financial year-end and if there has been a change it should be accounted for as a change in accounting estimate.

The assets have a useful economic life of only five years. The finance director is depreciating them over ten years.

Impact on the auditor's report

Yr of Purchase	Cost	Charge to 1.1.08	CV 1.1.08	Yrs left	Charge needed in 2008 in (based on 5yr life)	Actual charge 2008 (based on 10yr life)	Adj needed (diff)
	GHS'000	GHS'000	GHS'000			GHS'000	GHS'000
2006	5,000	1,000	4,000	3	1,333	500	833
2008	12,000		12,000	5	2,400	1,200	1,200
							2,033

The error might be material as it represents 5% of profit before tax (GHS2.03m/GHS40m). However, the matter is one of judgment and as it is only just within the parameters of materiality, the auditor may decide not to modify the auditor's opinion in the auditor's report on this issue alone.

If this is the case the auditor should record the error in the list of uncorrected misstatements and then consider whether, in aggregate, this amounted to a material misstatement at the end of the audit.

Given the existence of the inventory error above it is possible that there may be other errors and so the depreciation error could become material when take in aggregate with other errors.

If this is the case and management refuse to amend the error the audit opinion in the auditor's report will need to be modified. As management has not complied with IAS 16 and the error is material but not pervasive then a qualified opinion would be necessary.

A basis for qualified opinion paragraph would need to be included explaining the material misstatement in relation to the depreciation of non-current assets. The opinion paragraph qualified 'except for' – due to material misstatement.

(c) Contingent liability

Whether the financial statements require amendment

The directors believe that the possibility of losing the legal case is remote and so have not included a contingent liability. This is a matter of judgment and as such, the auditor cannot assume the financial statements are incorrect just because they do not include the disclosure of the lawsuit, since this would be the correct treatment if the directors' views are proved reasonable.

However, the evidence available at present appears to suggest that the directors' opinion is not reasonable. An investigation into other work performed by the company is underway and this implies that there is a greater chance of the company losing the legal case.

Were the case to be lost then this would bring into question whether the company was a going concern. There is therefore significant uncertainty about the basis on which the financial statements have been prepared.

Impact on the auditor's report

(i) Contingent liability

It would appear that the financial statements should include disclosure of a contingent liability as it is possible (rather than remote) that the company may lose the case.

Lack of disclosure of the contingent liability in the financial statements is a material misstatement which is likely to be material but not pervasive. A qualified opinion would be necessary.

A basis for qualified opinion paragraph would need to be included explaining the lack of disclosure. The opinion paragraph would be qualified 'except for' – due to material misstatement.

(ii) Going concern

The occurrence of litigation and a government inspection suggests that there may be a going concern problem with this client as there is a significant uncertainty as to whether it can continue to trade for the foreseeable future. The uncertainty is fundamental as it impacts on the going concern status of the company.

The directors do not wish to disclose the contingent liability nor the potential impact it may have on the going concern status of the company. The lack of disclosure regarding going concern is material and pervasive. An adverse opinion would be necessary.

A basis for adverse opinion paragraph would need to be included explaining the lack of going concern disclosure. The opinion paragraph would be adverse opinion – 'the financial statements do not show a true and fair view' – due to material misstatement.

EXAMINER'S COMMENT

The question was of a high standard and could even be administered at 3.2 level. This reflected in the abysmal performance of candidates. The candidates did not understand the question or were ill- prepared. Some candidates also deviated from the question. Only 12% of candidates passed.