

THE INSTITUTE OF CHARTERED ACCOUNTANTS, GHANA
NOVEMBER 2015 PROFESSIONAL EXAMINATIONS
ADVANCED AUDIT AND ASSURANCE (3.2)

EXAMINERS GENERAL COMMENTS

GENERAL PERFORMANCE

The performance in the paper was better than the previous diet, however it fell below expectation considering the nature of the questions and the syllabus coverage. It is however, gratifying to note that answers provided by candidates reflected individual effort as there was no evidence of copy work among candidates. Overall performance in the paper was generally good but could be better.

STANDARD OF THE PAPER

The paper met the required standard in terms of clarity, level of difficulty, test of learning outcomes and syllabus relevance. The questions ranged from those requiring definitions and explanations to those requiring comments, discussion, evaluation and comparing and contrasting

COVERAGE OF SYLLABUS

The paper covered wider range of the syllabus. The paper covered seven (7) sections out of the nine (9) sections of the syllabus usage and weighting. Sections not featured are Section A – Regulatory Environment and Section 1 – Current Developments. However in terms of weighting and marks allocation some sections were unduly favoured. Section B featured three (3) sub-questions with total marks allocation of 1.5 instead of 10, Section D, three (3) sub-questions with total marks of 30 instead of 20 and Section E – three sub-questions with total marks of 20 instead of 10.

SECTIONS OF SYLLABUS COVERAGE AND WEIGHTING

SECTIONS	A	B	C	D	E	F	G	H	I	TOTAL
SYLLABUS WEIGHTING	10	10	10	20	10	10	10	10	10	100%
MARKS ALLOTTED TO QUESTIONS	NIL	15	7	30	20	5	10	13	NIL	100%

SUGGESTED SOLUTION TO QUESTIONS

The suggested solutions were very comprehensive and adequately responded to the requirements of the questions. They thus facilitated equitable and fair allocation of marks to the points at issue.

WEAKNESSES OF CANDIDATES

The usual problem of lengthy and unproductive preambles to answers was still on display. Many candidates did not take time to understand the requirements of the questions before making attempts. This resulted in many cancelled answers when candidates later realized that they had deviated.

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QUESTIONS

QUESTION ONE

- a) You are the partner responsible for the audit of ABC Co, for the year ended 30th April, 2014. The final audit has been completed and you have asked the audit manager to draft the audit report. The manager is aware that there is guidance for auditors relating to audit report in ISA 706 Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report. The manager has asked for your assistance in this matter.

Required:

- i) Define an 'Emphasis of Matter paragraph' and explain, providing examples, the use of such a paragraph. **(6 marks)**
- ii) Define an 'Other Matter paragraph' and explain, providing examples, the use of such a paragraph. **(4 marks)**

Note. You are not required to produce draft paragraphs

- b) You are also responsible for providing direction to more junior members of the audit department of your firm on technical matters. Several recent recruits have asked for guidance in the area of auditor's liability. They are keen to understand how an audit firm can reduce its exposure to claims of negligence. They have also heard that in some countries, it is possible to restrict liability by making a liability limitation agreement with an audit client.

Required:

Explain **five** methods that may be used by an audit firm to reduce exposure to litigation claims. **(5 marks)**

- c) The Auditor General is required in Ghana to submit his Report to the Public Accounts Committee off Parliament within six months of the end of the year to which it relates.

Required:

Identify the principal matters to which this Report must draw attention. **(5 marks)**

(Total= 20 marks)

QUESTION TWO

The Afigya Sekyere District Assembly has appointed Ms Afi Kakrabah as the Internal Auditor. She was appointed by the District Chief Executive (DCE) after he attended a seminar at GIMPA for newly appointed DCEs where the importance of pre-auditing of all payments by Internal Auditors for expenditures incurred by all Government Ministries, Departments Municipal, and District Assemblies (MMDAs) was stressed.

Ms Kakrabah has just completed National Service at the Internal Audit Agency, holds an HND in Accounting and is a native of the same village as the DCE of Afigya Sekyere District.

Ms Kakrabah will report to the District Finance Officer.

At the first meeting after the appointment of the DCE, the District Assembly had set up its standing committees and one of them was the Audit and Finance Sub-Committee. The first meeting of the sub-committee requested Ms Kakrabah to prepare briefing notes to show her vision and approach to the Internal Audit function at the District Assembly and to discuss how she will maintain her independence as well as her knowledge and understanding of Internal Audit Practices recommended by the Institute of Internal Auditors (IIA) as in the IIA's International Professional Practices Framework (IPPF).

You are an Auditor in Public Practice and the Auditor General of Ghana has appointed you to perform the statutory audit of the Afigya Sekyere District Assembly. The Audit and Finance Sub-Committee of the District Assembly has requested that you attend the meeting at which the Internal Auditor will brief them and help them in assessing the Internal Auditor's briefing.

Required

- (a) Comment on the matters that you will consider on the appointment of Ms Kakrabah and her reporting lines as discussed above. **(5 marks)**
- (b) State the issues that you should expect Ms Kakrabah to discuss in her briefing to Audit and Finance Sub-Committee of the District Assembly. **(10 marks)**
- (c) The IIA's definition of Internal Auditing states, among others that:

“Internal Auditing is an independent, objective *assurance and consulting activity*....”

Required:

Compare and contrast an Assurance and a Consulting Audit activity. **(5 marks)**

(Note your answers should include but may not be limited to information from IIA publications)

(Total=20 marks)

QUESTION THREE

You are a manager in BS Cipax, a medium-sized firm which offers a range of services to audit and non-audit clients. You have been asked to consider a potential engagement to review and provide a report on the prospective financial information of Filtane Limited, a company which has been an audit client of BS Cipax for six years. The audit of the financial statements for the year ended 31 August 2015 has been completed and your firm issued an unmodified report.

Filtane Limited operates a chain of fashion stores across the country. Currently its merchandise are out of date and it sells clothing which do not reflect the latest and in mode fashion labels which are becoming more popular especially with the youth. Management is planning to revamp its image and stock the latest fashion in Africa and across the other continents. It also intends to invest in the latest technologies to include online real time trading on the internet in order to attract more customers, especially the up-and-coming youth, trendy middle-aged persons and even those far from its shops by attracting them to shop over the internet. The company has sufficient cash to fund half of the necessary capital expenditure, and has approached its bank, Bofo Bank Limited, with a loan application of GHS32 million for the remainder of the funds required. Most of the cash will be used to invest in acquiring inventory and the technology for ensuring secure and safe online trading. The remaining cash will be used for refurbishment of the shops.

Management had informed the Audit team, in the invitation to start the audit, of its intention to use the audited financial statements as the basis for preparing the prospective financial information to be used to seek for the loan from Bofo Bank Limited.

The draft forecast statements of profit or loss for the years ending 31 August 2016 and 2017 are shown below, along with the key assumptions which have been used in their preparation. The audited statement of profit or loss for the year ended 31 August 2015 is also shown below.

Forecast statement of profit or loss				
	Year ended 31 August 2015 (audited)	Note relevant to forecast informati on	Year ending 31 August 2016 (Forecast)	Year ending 31 August 2017 Forecast
	GHS '000		GHS '000	GHS '000
Revenue	140,000	1	172,000	184,000
Operating expenses	(113,000)	2	(126,000)	(128,400)
Operating profit	27,000		46,000	55,600
Finance costs	(6,800)		(8,000)	(7,600)
Profit before tax	20,200		38,000	42,000

The forecast has been prepared for use by the bank in making its lending decision, and was to be accompanied by other prospective financial information including a forecast statement of cash flows.

Note 1: The forecast increase in revenue is based on the following assumptions:

(i) All shops will be stocked with new modern and in mode fashion to attract new customers to the shops and many persons who don't live in the vicinity of the shops will also be attracted through on-line shopping by December, 2015.

(ii) Prices will increase by an average of 25% in December 2015.

Note 2: Operating expenses include mainly staff costs, depreciation of property and fittings, and repairs and maintenance to the shop fittings and equipment as well as ensuring continuous safe and secure on-line shopping.

Required:

(a)
(i) Explain the matters to be considered by BS Cipax before accepting the engagement to review and report on the prospective financial information of Filtane Limited. **(5 marks)**

(ii) Assuming the engagement is accepted, and the results of the examination procedures show that the prospective financial information have been prepared in accordance with the assumptions and appear reasonable, discuss the issues that will be in the report your firm will issue in respect of the forecast statement of profit or loss. **(8 marks)**

(b) Boafo Bank Limited gave the loan to the Filtane Limited on 15 October 2015 and a review of the first six months of operation in May 2016 of the new shops revealed that the company was not doing well and could not pay the first installment for the loan from Boafo Bank Limited. Further investigation revealed that the audited financial statements signed by BS Cipax which showed a profit of GHS20.2M should have been of a loss of GHS4.3M.

Boafo Bank Limited has indicated its intention to sue your firm for negligence on the basis that it placed reliance on the financial statements audited by your firm.

Required:

Comment on the matters that you should consider in deciding whether your firm will contest the matter in court or seek an out of court settlement with the bank. **(7marks)**

(Total=20 marks)

QUESTION FOUR

You are a manager in the audit department of Yao Asaglo & Co, a firm of Chartered Certified Accountants, and you have just been assigned to the audit of High-Tec Limited, a new audit client of your firm, with a financial year ended 31 May 2015. High-Tec Limited, has just been listed on the Ghana Stock Exchange (GSE.) It is an e-commerce facilitator and has grown rapidly in the last few years.

High-Tec Limited was formed ten years ago by Ms. Ama Tawiah, a graduate in e-commerce from Ashesi University. The company designs, develops software for e-commerce with high security features which have won industry awards. In the last two years the company invested GHS400m in creating new software to appeal to a large, number of multi-national companies and sales are now made in over 10 countries. The software is developed in this country, but the manufacture of the security features, for the obvious reason, takes place overseas.

The software is largely sold through retail outlets, but approximately 30% of High-Tec Limited's revenue is generated through sales made on the company's website.

In some countries High-Tec Limited's products are distributed under a franchise agreement which give the franchise holder the exclusive right to sell the products in that country. The cost of each franchise to the distributor depends on the estimated sales in the country to which it relates, and the franchise last for an average of five years. The income which High-Tec Limited receives from the sale of a franchise is deferred over the period of the franchise. At 31 May 2015 the total amount of deferred income recognised in Ted Co.'s statement of financial position is GHS72 million.

As part of a five-year strategic plan, High-Tec Limited obtained a GSE listing in December 2014. The listing and related share issue raised a significant amount of finance, and many shares are held by institutional investors. Ama Tawiah retains a 20% equity shareholding, and a further 10% of the company's shares are held by her family members.

Despite being listed, the company does not have an internal audit department, and there is only one non-executive director on the board.

- (a) Comment on the matters that you should consider specific to initial audit engagement when developing the audit strategy for High-Tec Limited **(6 marks)**
- (b) Evaluate the audit risks to be considered in planning the audit of High-Tec Limited. **(14 marks)**

(Total= 20 marks)

QUESTION FIVE

- a) You are the manager in Dee Kay Company, a firm of Chartered Accountants. You have just attended a monthly meeting of audit partners and managers at which client-related matters were discussed. Information relating to one client which were discussed at the meeting is given below.

Tap Co

Tap Co is a clothing manufacturer, which has recently expanded its operations overseas. To manage exposure to cash flows denominated in foreign currencies, the company has set up a treasury management function, which is responsible for entering into hedge transactions such as forward exchange contracts. These transaction are likely to be material to the financial statements. The audit partner is about to commence planning the audit for the year ending 31 July 2014.

Required:

Discuss why the audit of financial instruments is particularly challenging, and explain the matters to be considered in planning the audit of Tap Co's forward exchange contracts.

(10 marks)

- b) You are senior manager in MM & Co, a firm of Chartered Accountants. Recently, you have been assigned specific responsibility for undertaken annual reviews of existing clients. The following situation have arisen in connection with two clients.
- i) MM & Co, was appointed auditor Pen Co last year, and has recently issued an unmodified opinion on the financial statements for the year ended 31 March 2013. To your surprise, the tax authorities has just launched an investigation into the affairs of Pen on suspicion of under declaring income.
- (7 marks)**
- ii) Your firm has provided financial advice to the Scot family for many years and this has sometimes involved your firm carrying out transactions on their behalf. The eldest son, Gino, is to take up a position as a senior government official to a foreign country next month.
- (3 marks)**

Required:

Identify and comment on the ethical and other professional issues raised by each of these matters and state what action, if any, MM & Co should now take.

(Total= 20 marks)

SUGGESTED SOLUTIONS

QUESTION ONE

a)

- i) An Emphasis of Matter (EoM) paragraph is a paragraph in the auditor's report that is appropriately presented or disclosed, but which is so important that special emphasis is needed for users.

An EoM is different from a modification to the auditor's opinion. An EoM paragraph does not modify the opinion; indeed it should state clearly that this is the case. An auditor should only include an EoM if s/he has sufficient appropriate audit evidence that the matter is not materially misstated.

The EoM should provide a clear reference to the matter, and to where the appropriate disclosures and other information can be found in the financial statements.

Examples of when an EoM should be used include:

- An uncertainty relating to the future outcome of exceptional litigation
- Early application of a new accounting standard that has a pervasive effect on the financial statements.
- A major catastrophe that has had a significant effect on the entity's financial position
- Significant going concern issues

(6 marks)

- ii) An Other Matter (OM) paragraph has in common with the EoM the fact that it does not modify the auditor's opinion. However, whereas the EoM refers to a matter within the financial statements, and OM refers to information that is rightly not present in the financial statements, but which is so important for users' understanding of them that it needs to be highlighted in the auditor's report.

Examples of situations include:

- Law, regulation or generally accepted practice may require or permit the auditor to elaborate on matters that provide further explanation of the auditor's responsibilities or report.
- The auditor may be reporting on more than one set of financial statements (eg a set of statements prepared under national reporting framework, and a set of statements prepared under International Financial reporting standards).
- Any restriction on the distribution of the auditor's report

The OM is thus a means for the auditor to communicate with users, and should state explicitly that the matter referred to is not required to be included in the financial statements.

(4 marks)

b) An audit firm's exposure to litigation claims can be reduced by a number of methods.

1) Client acceptance procedures

Firms should accept only those clients that carry a low enough risk of litigation for the firm to manage, given its resources. Screening procedures should be used to identify factors that create potential exposure, for instance, a new client with going concern problems is likely to carry more risk than one without such problems.

2) Performance of audit work

Firms should make sure that all audits are carried out with professional standards and best practice, adhering to the requirements of ISAs. It is crucial in particular that proper documentation is kept, as this will be useful in the event of litigation.

3) Quality control

Firms should implement quality control procedures in line with guidance contained within ISQC1 Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements and ISA 220 Quality Control for an Audit of Financial Statements. This includes both firm-wide procedures and those related to individual assignments.

4) Issue of appropriate disclaimers

There is a risk of a legal duty of care arising to a third party even if the auditor is unaware of this duty. Disclaimers may be used in an attempt to restrict the auditor's duty of care to shareholders, but there is no guarantee that they will be effective in law.

(5 marks)

c) The Auditor General's Report must draw attention to any cases in which he has observed that:

- An officer or employee of Government has wilfully or negligently omitted to collect or receive any public money due to the Government;
- Any public money was not duly accounted for and paid into the consolidated Fund or other designated public account;
- An appropriation was exceeded or was applied for a purpose or in a manner not authorised by law;
- An expenditure was not authorised or properly vouched for or certified;
- There has been a deficiency through fraud, default or mistake of any person;

- Applicable internal controls are inefficient or ineffective;
- Resources have not been used with due regard to economy, efficiency and effectiveness in relation to the results attained.
- In the public interest, the matter should be brought to the notice of Parliament.

(5 marks)

EXAMINER’S COMMENT

QUESTION ONE (A I – II)

These two sub-questions required definition and explanation together with relevant examples of “Emphases of matter paragraph” and “other matter paragraph” in Independent Auditor’s Report in accordance with ISA 706.

Performance was mixed as some candidates gave the right answers while other candidates treated themselves to modified opinions under ISA 705.

QUESTION ONE (B)

Candidates were required to explain five (5) methods that could be used by an audit firm to reduce exposure to litigation claims. The correct answers were given by most candidates. A few candidates dwelt too much on engagement performance to the exclusion of the other matters. **Good performance.**

QUESTION ONE (C)

This was a straightforward question on the contents of the Auditor-General’s Report to the Public Accounts Committee of Parliament. There was clear divide between those who knew the right answers and those who tried to use their own knowledge of the management report to answer the question – **Mixed performance.**

QUESTION TWO

a) **Comment on the matters that you will consider on the appointment of Ms Kakrabah and her reporting lines as discussed above. (5 marks)**

1. The Institute of Internal Auditors (IIA) recommends that the appointment of the Internal Auditor (IA) be done by the Board of Directors or the Audit Committee (in this case the Audit and Finance Sub-Committee of the District Assembly) acting for the Board and not by Executive Management (the DCE in this case)
2. Her Educational Qualification and level of experience appears in appropriate for the responsibility she is expected to shoulder. It appears the DCE wants someone he can easily manipulate in the position.
3. The fact that she comes from the same village as the DCE could support the point made in 2 above and suggest the position was not advertised to open it up to competition and this will make the IA believe she must return the favour done her by the DCE and she will not be able to report objectively.
4. The IIA recommends that the IA should report functionally to the Board Audit Committee and administratively to the Chief Executive, placing her both administratively and functionally under the District Finance Officer is inappropriate and hinder her independence in reporting on financial issues.

(2 marks for discussion of any of the issues to maximum of 5 marks)

b) **State the issues that you should expect Ms Kakrabah to discuss in her briefing to Audit and Finance Sub-Committee of the District Assembly.**

(10 marks)

The IA will discuss the following issues from the the IIA's International Professional Practices Framework (IPPF).

The IIA's **definition of Internal Auditing** and to explain the need for ensuring the **independence** of the IA even though the IA is an employee by making sure the **appointment of the IA** is done by the Board or its Audit Committee and the IA also **reports functionally** (by sending his/her Internal Audit reports) to the Audit Committee and not the DCE or District Finance Office (DFO).

The IA should also discuss **objectivity** as a requirement for the IA to be free from any bias. The IA should discuss the need for the **Internal Audit function to adopt an Internal Audit Charter** that is consistent with the Definition of Internal Auditing, the Code of Ethics, and the International Standards for the Practice of Internal Auditing (the Standards) of the IIA that **will define the purpose, authority, and responsibility of the Internal Audit activity.**

The Charter must be in compliance with the recommendation of the IIA and approved by the Board prior to its adoption.

The IA will discuss briefly the **Code of Ethics** and the **International Standards for the Practice of Internal Auditing (the Standards)** recommended by the IIA and their importance to the IA.

The Internal Audit function must adopt a version of the Code of Ethics recommended by the IIA that is appropriate for the entity

All the reports of the IA must mention that the Internal Audit assignment was performed in compliance with the Standards and any significant non-compliance must be disclosed in the report.

The IA should mention how she personally will ensure that the Internal Audit activity at the District Assembly (DA) functions to add value to the activities of the DA and ensure it achieves its objectives in a more efficient, effective and economic (3 E's) manner and that she will comply with the Code of Ethics that will be adopted and deal fairly with all stakeholders of the DA.

(1 mark for any point up to a maximum of 10 marks)

c) The IIA's definition of Internal Auditing states, among others that:

“Internal Auditing is an independent, objective assurance and consulting activity....”

Compare and contrast an Assurance and a Consulting Audit activity.

All activities an auditor performs will be either an assurance or a consulting assignment depending on the type of report that will be issued as a result of the assignment and whether or not the activity may be performed on the basis of a contingent fee (that is a fee based on the outcome or results of the assignment). The differences are:

Assurance audit activity	Consulting audit activity
Auditor expresses an opinion which he/she expects others to rely on in the report	Auditor reports on only facts that came to his/her attention in the assignment
The activity may not be performed on the basis of a of a contingent fee (fee based on the outcome of the assignment)	The activity may be performed on the basis a contingent fee

(2 marks for each difference and 1 mark for showing presentation, table or other visual display of the differences, maximum 5 marks)

EXAMINER'S COMMENTS

QUESTION TWO (A & B)

These involved knowledge of Internal Auditing related to the mode of appointment, reporting lines, responsibilities and ethical requirements in terms of independence and objectivity. Many candidates were able to provide the right answers – **Second best attempted question.**

QUESTION TWO (C)

Candidates were to compare and contrast Assurance and consulting activity in Internal Auditing. This question was not handled well. Only few candidates gave the correct answers – **Poor performance.**

QUESTION THREE

- a) i. **Explain the matters to be considered by BS Cipax before accepting the engagement to review and report on the prospective financial information of Filtane Limited.**

Before accepting the engagement to review the company's prospective financial information, there are several matters to be considered. A significant matter is whether it is ethically acceptable to perform the review. The review would constitute a non-assurance service provided to an audited entity, and IESBA's Code of Ethics for Professional Accountants states that this may create self-interest, self-review and advocacy threats to independence. In this case, the advocacy threat may be deemed particularly significant as Hunt & Co could be perceived as promoting the client's position to the bank. The review engagement should only be provided if safeguards can be used to reduce the threat to an acceptable level, which may include:

- Having a professional accountant who was not involved with the non-assurance service review the non-assurance work performed or otherwise advise as necessary.
- Discussing ethical issues with those charged with governance of the client.
- Using separate teams to work on the audit and on the review engagement.

As well as ethical matters, ISAE **3400 *The Examination of Prospective Information*** requires that certain matters are considered before a review engagement is accepted. The firm must also consider the specific terms of the engagement. For example, the firm will need to clarify whether the bank has requested a review report to be issued, and what exact information will be included in the application to the bank. It is likely that more than just a forecast statement of profit or loss is required, for example, a forecast statement of cash flows and accompanying narrative, including key assumptions is likely to be required for a lending decision to be made.

ISAE 3400 also requires that consideration should be given to the intended use of the information, and whether it is for general or limited distribution. It seems in this case the review engagement and its report will be used solely in connection with raising bank finance, but this should be confirmed before accepting the engagement.

The period covered by the prospective financial information and the key assumptions used should also be considered. ISAE 3400 states that the auditor should not accept an engagement when the assumptions used are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use. For example, the assumption that the necessary capital expenditure can take place by September 2014 may be overly optimistic.

The firm should also consider whether there are staff available with appropriate skills and experience to perform the review engagement, and the deadline by which the work needs to be completed. If the work on the shops is scheduled to be completed by September 2014, presumably the cash will have to be provided very soon, meaning a tight deadline for the review engagement to be performed.

(5 marks)

ii.

The report by an auditor on an examination of prospective financial information should contain the following:

(a) Title;

(b) Addressee;

(c) Identification of the prospective financial information;

(d) A reference to the ISAE or relevant national standards or practices applicable to the examination of prospective financial information;

(e) A statement that management is responsible for the prospective financial information including the assumptions on which it is based;

(f) When applicable, a reference to the purpose and/or restricted distribution of the prospective financial information;

(g) A statement of negative assurance as to whether the assumptions provide a reasonable basis for the prospective financial information;

(h) An opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework;

(i) Appropriate caveats concerning the achievability of the results indicated by the prospective financial information;

(j) Date of the report which should be the date procedures have been completed;

(k) Auditor's address; and

l) Signature.

m) Such a report would

- State whether, based on the examination of the evidence supporting the assumptions, anything has come to the auditor's attention which causes the auditor to believe that the assumptions do not provide a reasonable basis for the prospective financial information.

e.g.

Based on our examination of the evidence supporting the assumptions, nothing has come to our attention which causes us to believe that these assumptions do not provide a reasonable basis for the forecast.

- Express an opinion as to whether the prospective financial information is properly prepared on the basis of the assumptions and is presented in accordance with the relevant financial reporting framework.

e.g.

Further, in our opinion the forecast is properly prepared on the basis of the assumptions and is presented in accordance with International Financial Reporting Standards (IFRS)

- State that actual results are likely to be different from the prospective financial information since anticipated events frequently do not occur as expected and the variation could be material.

(8 marks)

(a) **Comment on the matters that you should consider in deciding whether your firm will contest the matter in court or seek an out of court settlement with the bank.**

An injured party must prove **ALL** of the following three things in order to succeed in a claim for financial loss against an auditor for negligence:

- That the auditor owes a duty of care;
- That the duty of care has been breached;
- That financial loss has been suffered that was caused by the negligence.

(2 marks)

- i) Looking at the strict interpretation of the first requirement, **the auditor owes a duty of care** only to the shareholders as a body and not to Boaf Bank Limited as an outsider. The courts, however have accepted that if the Auditor, at the time of signing the report knew that someone, other than the shareholders as a body will rely on the report, then the duty of care extends to the person. The facts of this case show that at the time the auditor signed the Audit Report, he was aware that it was Financial Statements going

to form the basis for preparing the projected financial information to be used to seek for the bank facility from Bofo Bank Limited. Paragraph 3 of preamble to question). This means it is probable that a court will rule that requirement 1 above has been proved. **(2 marks)**

- ii) **A breach of duty of care** must be proved for a negligence claim against the audit firm to be successful. Duty of care generally means that the audit firm must perform the audit work to the required standard and that relevant legal and professional requirements and principles have been followed. For an audit firm, it is important to be able to demonstrate that ISAs have been adhered to. This is no evidence in the facts as given to enable us reach the conclusion that the duty of care has been breached or not. Looking at the fact that a loss of GHS4.3M was stated as a profit of GHS20.2M, a difference of GHS24.5M, if this error in the Income statement is confirmed, it is likely to be interpreted by a court to mean that the auditor did not perform the duties expected of him/her with all the skill, care and caution which a reasonably competent, careful and cautious auditor would use. What is reasonable skill, care and caution will depend on the particular circumstances of each case.

In this case, however, an error is material by all standards and will be proof that the auditor has acted negligently unless he can prove that the circumstance that caused this material error was beyond his/her control.

Requirement 2 appears to be likely to be proved.

(2 marks)

- iii) Requirement 3 is easy to prove since the loan was given on the basis of the projected financial information based on the audited financial statements, it is likely that a court will not need any serious persuasion to agree with the Bank that its financial loss was caused by the negligence of the auditor. From this discussion, the Auditors must seek an out of court settlement to avoid the bad publicity and likely litigation costs since it is probable that they would be found to be professionally liable to the Bank and the Bank is likely to the Bank for negligence.

(1 mark)

(Total 7 marks)

EXAMINER'S COMMENTS

QUESTION THREE (A I)

This question relates to matters to consider before accepting an engagement to examine and report on Prospective Financial Information (PFI) prepared by an audit client for the purpose of obtaining a loan from a bank. Many candidates wrote on the general procedure for accepting assurance engagement rather than the specific requirements for review of PFI – **Mixed performance**.

QUESTION THREE (A II)

This question requires the contents of the auditor's report on PFI. While some candidates were able to provide the right answers, many candidates rather used figures in the preamble to prepare the PFI. Other candidates outlined the procedures to examine the PFI – **Performance was not good.**

QUESTION THREE (B)

This question involved negligence and litigation between the auditor and a bank which relied on the work of the auditor to make a loan. Candidates were able to discuss the matters the auditor should consider before deciding to contest the case or resort to out-of-court settlement – **Good performance**

QUESTION FOUR

- a) **Comment on the matters that you should consider specific to initial audit engagement when developing the audit strategy for HighTec Limited (6 marks)**

In an initial audit engagement there are several factors which should be considered in addition to the planning procedures which are carried out for every audit. ISA 300 Planning an Audit of Financial Statements provides guidance in this area.

- **ISA 300** suggests that unless prohibited by laws or regulation, arrangements should be made with the predecessor auditor, for example, to review their working papers. Therefore communication should be made with the previous auditor to request access to their working papers for the financial year ended 31 May 2014. The review of the previous year's working papers would help us in planning the audit, for example, it may highlight matters pertinent to the audit of opening balances or an assessment of the appropriateness of HighTec Limited's accounting policies.
- It will also be important to consider whether any previous years' audit reports were modified, and if so, the reason for the modification.
- As part of the client acceptance process, we should request from previous auditors if there are any professional or other reasons why we cannot take up the audit of HighTec Limited.
- Any matters which were brought to our firm's attention by the previous auditor should be considered for their potential impact on the audit strategy.
- There should also be consideration of the matters which were discussed with HighTec Limited's management in connection with our appointment such as significant accounting policies which may impact on the planned audit strategy.

- Particular care should be taken in planning the audit procedures necessary to obtain sufficient appropriate audit evidence regarding opening balances, and procedures should be planned in accordance with ISA 510 Initial Audit Engagements – Opening Balances. For example, procedures should be performed to determine whether the opening balances reflect the application of appropriate accounting policies and determining whether the prior period’s closing balances have been correctly brought forward into the current period.
- With an initial audit engagement it is particularly important to develop an understanding of the business, including the legal and regulatory framework applicable to the company. This understanding must be fully documented and will help the audit team to perform effective analytical review procedures and to develop an appropriate audit strategy.
- Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of any experts.
- Our firm should have quality control procedures in place for use in the case of initial engagements, for example, the involvement of another partner or senior individual to review the overall audit strategy prior to commencing significant audit procedures.
- Given that this is a new audit client, that it is newly listed, when developing the audit strategy, consideration should be given to using an experienced audit team in order to reduce detection risk.

(1 mark for each correct answer maximum of 6 marks)

b) Evaluate the audit risks to be considered in planning the audit of HighTec Limited

- **Rapid growth**

We were told that the company has seen rapid growth has occurred during the last few years. The growth could indicate a control risk, in that systems and personnel may struggle to keep pace with the volume of transactions which are being processed, leading to accounting errors being made. This is exacerbated by the lack of an internal audit department to provide assurance on systems and controls.

- **Management bias**

The second audit risk identified relates to HighTec Limited becoming a listed entity during the year. This creates an inherent risk at the financial statement level and is caused by the potential for management bias. Management will want to show good results to the new shareholders of the company, in particular the institutional shareholders, and therefore there is an incentive for the overstatement of revenue and profit.

There is a related risk of overstatement due to Ama Tawiah and her family members retaining a 30% equity interest in HighTec Limited, which is an incentive for inflated profit so that a high level of dividend can be paid.

It appears that governance structures are not strong, for example, there are too few non-executive directors, and therefore Ama Tawiah is in a position to be able to dominate the board and to influence the preparation of the financial statements.

- **This increases the risk of material misstatement due to management bias.**

There is also a risk that management lacks knowledge of the reporting requirements specific to listed entities, for example, in relation to the calculation and disclosure of earnings per share

- **E-commerce**

With 30% of revenue generated through the company's website, this represents a significant revenue stream, and the income generated through e-commerce is material to the financial statements. E-commerce gives rise to a number of different audit risks, including but not limited to the following:

For the auditor, e-commerce can give rise to detection risk, largely due to the paperless nature of the transactions and the fact there is likely to be a limited audit trail, making it difficult to obtain audit evidence. For the same reason, control risk is increased, as it can be hard to maintain robust controls unless they are embedded into the software which records the transaction. The auditor may find it difficult to perform tests on the controls of the system unless audit software is used, as there will be few manual controls to evaluate.

- A risk also arises in terms of the recognition of sales revenue, in particular cut-off can be a problem where sales are made online as it can be difficult to determine the exact point at which the revenue recognition criteria of IAS 18 Revenue have been met. Hence, over or understatement of revenue is a potential risk to be considered when planning the audit.
- HighTec Limited also faces risks relating to the security of the system, for example, risks relating to unauthorised access to the system, and there is an increased risk of fraud. All of these risks mean that there is high audit risk in relation to the revenue generated from the company's website.

- **Franchise income**

The Franchise income which is deferred in the statement of financial position represents 13.4% of total assets and is therefore material.

There is a risk that the accounting treatment is not appropriate, and there are two separate risks which need to be considered.

First, it may be the case that the revenue from the sale of a Franchise should not be deferred at all. The revenue recognition criteria of IAS 18 need to be applied to the transaction, and if, for example, it were found that HighTec Limited has no continuing management involvement and that all risk and reward had been transferred to the buyer, then the revenue

should be recognised immediately and not deferred. This would mean a significant understatement of revenue and profit.

Second, if it is appropriate that the revenue is deferred, for example, if HighTec Limited does retain managerial involvement and has retained the risk and reward in relation to the Franchise arrangement, then the period over which the revenue is recognized could be inappropriate, resulting in over or understated revenue in the accounting period.

- **Foreign exchange transactions**

HighTec Limited's products sell in over 60 countries and the products are manufactured overseas, so the company is involved with foreign currency transactions which can be complex in nature. There is a risk that the requirements of IAS 21 the Effects of Changes in Foreign Exchange Rates have not been followed. For example, if transactions have not been retranslated to HighTec Limited's GHS at the date of the transaction, then the amounts involved may be over or understated.

There is also a risk that outstanding receivables and payables have not been retranslated at the year-end closing exchange rate, leading to over or understatement of assets and liabilities and unrecorded exchange gains or losses.

(Max of 14 marks)

EXAMINER'S COMMENT

QUESTION FOUR (A)

Matters specific to developing an audit strategy for an initial audit engagement were demanded of candidates. Many candidates were able to provide the right answers.

QUESTION FOUR (B)

Candidates were to evaluate audit risks to consider in planning the audit of client involved in software development, e-commerce and franchise arrangements as well as having been recently listed on the Stock Exchange.

Many candidates made use of the preamble to the question and were able to identify and evaluate the relevant risks. Few candidates vaguely explained the three components of audit risk without relating them to the requirements of the question. **However this was the best answered question by most candidates.**

QUESTION FIVE

a) Audit of financial instruments

Financial instrument themselves may be difficult to understand. Management themselves may fail to understand the risks involved with them, which may expose the entity to substantial risks.

Financial reporting requirements in this area can be complex, which increases the risk of misstatement. It is possible that neither management nor the auditor will properly understand how the instruments should be accounted for.

Accounting for financial instrument may also involve an element of subjectivity, eg in determining fair values. Fair values may be estimated with the use of models which will involve making assumptions. Is therefore a risk that the assumptions made by management are not reasonable.

Given the presence of subjectivity, it is all the more important that the auditor is professionally skeptical in this area, although this is likely to be difficult.

Alternatively, some financial instruments may be fairly simple to audit, eg where there is an active market, it may be possible to agree fair values to a broker's report. This would of course be subject to the requirements of ISA 500 Audit Evidence in relation to the use of a management's expert.

It may be necessary to make use of an auditor's expert, in which case the auditor must ensure that the expert is independent and competent, and must evaluate the suitability of the expert's work as audit evidence. This may not be straightforward to do, given the complexity of the subject matter.

Using an auditor's expert may also have the effect of increasing the audit fee, which should be explained to and discussed with the client.

Matters to consider

The company's treasury management function has only been set up recently, so it is possible that there will be problems in an area such as this. **Internal controls** may not be well established, so the auditor will need to spend time obtaining an understanding of them. This increases audit risk in this area.

Consideration should be given to the level of competence of staff in the new department. If they are skilled in this area then they may be new to the company, in which case there may be difficulties integrating the department with the rest of Tap Co's finance function.

Alternatively, there is a risk that staff do not have adequate knowledge or experience in this area.

It will be necessary to obtain an understanding of the kinds of financial instruments Tap Co uses to hedge transactions, including Tap Co.'s reasons for entering into them and the kinds of risks it may be exposed to thereby.

The materiality of the instrument should be considered, bearing in mind especially the possibility that transactions with either no, or very little, initial value may turn out to have effect on the financial statements that are material. Some types of derivative financial instruments may fall into this category.

Management's method for valuing financial instruments should be considered, and the auditor must choose whether to audit management's valuation model, or whether to construct a model of its own. This would depend on the assessed reliability of internal controls in this area.

(10 marks)

b) i) **Pen Co.**

Client acceptance procedures

As Pen, a relatively new client, is being investigated for tax fraud, it is possible that MM & Co. quality control and other procedures on acceptance of a client may not be as robust as would be ideal, and that they have accepted a client without obtaining sufficient knowledge and understanding.

In accepting a new client, MM & Co. should have completed the following.

- Obtained references about key personnel in the company and the company
- Obtained professional clearance from previous auditors
- Carried out procedures in line with MM & Co.'s anti-money laundering policies which should include detailed client identification procedures and customer due diligence

It is possible that MM & Co did not obtain appropriate references or obtained professional clearance. There is no reason why the client identification procedures would necessarily have raised any issues if Pen has previously had a clean record.

Concealed, previously undiscovered fraud?

Alternatively, given that under-declaring income is a fraud, it is possible that staff at Pen were under-declaring income and concealing the fact, and that both the old and the new auditors were unaware that it was going on. There is not necessarily any suggestion that negligent audits were carried out.

Confidentiality

MM & Co. has a duty of confidentiality to its client, and the partners and staff of MM & Co. must ensure that they do not breach their duty of confidentiality if asked questions by the tax authorities during the course of their investigation.

This may be complicated by the fact that Pen has been under declaring income, this may become an investigation into crime of money laundering, in which case MM& Co. may have legal duties of disclosure that are not subject to the duty of confidentiality and for which they have protection under qualified privilege.

Members are entitled to make disclosures to defend themselves and their professional reputation, and if the investigation includes members of the tax department of MM & Co. personally, they may need to make disclosures in their own interest.

Action to take

MM & Co. should take legal advice on disclosures that they are required to make and disclosures that they are not permitted to make before they make any disclosures to the tax authorities in the course of this investigation.

(7 marks)

ii) **Scot family**

Carrying out transactions on behalf of a client

Particularly in the light of the money laundering requirements incumbent on accountants and auditors, it is extremely ill-advised for auditors to carry out transactions on behalf of their clients, in case they inadvertently carry out the crime of money laundering.

In addition, being asked to carry out a transactions on behalf of a client might give rise to a suspicion of money laundering that the accountant was required to report to the appropriate authority.

Actions to take

MM & Co. should stop carrying out transactions for client, however innocent they may have been in the past, so as to avoid any suspicion or any problem arising.

Politically exposed persons (PEPs)

Gino's new position as a senior foreign government official makes him a politically exposed person (PEP). This increases the reputational risk for MM & Co. as there will be more publicity if something goes wrong.

Actions to take

The senior partner at MM & Co. should be alerted of the change in circumstances and judge whether the firm should continue to act as advisors for Gino and the Scot family given the increased risk. If the relationship continues, the firm should take reasonable measures to

establish the source of Gino's wealth and conduct ongoing monitoring of MM & Co. relationship with Gino.

MM & Co. should also ensure that it has a risk management system in place to determine whether individuals are PEPs on acceptance or if circumstances change.

(3 marks)

EXAMINER'S COMMENT

QUESTION FIVE (A)

Discussion of why audit of Financial Instruments is particularly challenging and explanation of matters to be considered in planning the audit of forward-exchange contracts were required of candidates. The challenges were correctly discussed as well as the matters to be considered in the planning of the audit of the forward exchange contracts – **Very good performance.**

QUESTION FIVE (B I)

This question required knowledge of client acceptance procedures in line with a firm's risk tolerance, procedures to uncover fraud and money laundering and confidentiality issues in relation to a client being investigated for tax fraud when the auditor has issued an unmodified opinion on the accounts.

Some candidates were able to point out that the auditor's client screening and acceptance procedures were not rigorous enough and their engagement performance was suspect hence their inability to discover the tax fraud. Other candidates did not have the slightest idea – **Poor performance.**

QUESTION FIVE (B II)

This question related to auditor's performing transaction on behalf of audit clients and dealing with Politically Exposed Persons (PEP). Some candidates were able to identify the ethical issues involved and proved the right answers – **Good performance by most candidates.**