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# CPA

## Section 6

## REVISION PARTNER

## ADVANCED AUDITING & ASSURANCE

Philip Ndeda Sagwa

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I sincerely express my gratitude to Kenya Accountants and Secretaries National Examination Board for the kind permission to use past question papers. The suggested solutions in this publication are mine and not necessarily those of the Board.

I would also like to place on record special appreciation to Ms.Lena Kamau,Mr.Erick Mwambuchi and Mr.Job Kenyani for their efforts and constant support at all the stages in the preparation of this work.

Finally, I am indebted to the ALMIGHTY GOD who gave me the strength and wisdom to complete this work through His dear Son Jesus Christ, my Lord and Savior. O Eternal One teach me how to worship, to serve and to reflect You.





## INTRODUCTION

I am glad to present this revision book to candidates and lecturers of Advanced Auditing and Assurance.

This book is designed to serve as a revision partner for lecturers and candidates appearing in CPA Part III Advanced Auditing and Assurance Paper No. 17

The book contains Questions and suggested solutions including recent KASNEB examination past paper

Solutions to past paper questions in this book have been arranged topically, giving appropriate weighting to various topics. The solutions are based on the 2009 KASNEB revised syllabus which was examined for the first time in December 2009 examination series.

In order to make effective use of this revision book, candidates are here advised to widely read recommended text books so as to have adequate background knowledge related to topics covered under the revised syllabus.

Candidates are here reminded that CPA examinations are rigorous and standards are high because the examination is benchmarked on the International Standards promulgated by the International Accounting Education Standards Board (IAESB). Candidates are thus advised to cover the syllabus and to allocate sufficient time for revision.

This revised revision book will no doubt address the revision needs of candidates and lecturers of the examination paper in Advanced Auditing and Assurance.



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## SYLLABUS

## PAPER NO.17 ADVANCED AUDITING AND ASSURANCE

## GENERAL OBJECTIVES

To develop the candidate's knowledge of audit and assurance.

## 17.0 SPECIFIC OBJECTIVES

A candidate who passes this paper should be able to:

- Plan and execute audit arid assurance services
- Explain legal and professional requirements of an audit and assurance assignment
- Carry out risk assessment and review the client's systems
- Discuss corporate governance issues
- Generate audit assurance reports

## CONTENT

**17.1 Assurance services and non assurance services**
- Audit engagement
- Compilation engagement
- Agreed upon procedures
- Review of prospective financial statements
- Audit and assurance reports

**17.2 Management of professional accounting firms**
- Structure of a professional accounting firm
- Multinational accounting firms
- Quality control and review
- Professional ethics (meaning of professional ethics, standards of conduct and personal integrity, independence and objectivity, prudence, due care, competence, diligence, honesty, confidentiality, good faith, personal and professional relationship, audit fees, soliciting for clients and advertising)

**17.3 Legal Liability**
- Auditors liability under contract law
- Auditors liability under law of tort
- Civil and criminal liability
- Legal precedence
- Minimizing auditors legal liability
- Current developments in respect of legal liability





**17.4 Risk assessment**
- Audit risk
- Engagement risk
- Business risk

**17.5 Conduct of an audit**
- Audit strategy
- Developing an audit plan and audit programme
- Audit documentation
- Review of accounting system and internal control system
- Errors and frauds
- Substantive procedures on financial statement items

**17.6 Review of an audit**
- Going concern
- Post balance sheet events
- Audit of contingencies
- Management representations
- Management letter

**17.7 Auditors report**
- Purpose of auditor's report
- Contents and elements of auditors' report
- Qualities of a good audit report
- Types of audit report
- Consequences of various audit reports
- Applicable cases

**17.8 Group audits**
- Audit of holding and subsidiary
- Audit of branches
- Joint audits
- Related party transactions

**17.9 Accounting and auditing standards**
- Standards setting process
- Presentation and disclosure of accounting standards
- Role of auditing standards, accounting standards and assurances standards in the audit

**17.10 Corporate governance**
- Audit committees
- Reporting on corporate governance issues
- Internal audit



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**17.11 Current issues and developments**

- Forensic audit (whistle blowing, reporting unethical behavior)
- Environmental audit
- Social reporting
- Value for money (VFM) audits
- Audit disengagement

*Candidates will be expected to demonstrate in-depth knowledge of international standards on auditing (ISAs)





# QUESTIONS

# TOPIC 1

## ASSURANCE SERVICES AND NON ASSURANCE SERVICES

**QUESTION 1**

c) There is a growing demand in both the public and private sectors for professional accountants to provide assurance on a variety of subject matters by expressing a conclusion regarding its quality or context.

**Required:**

Discuss the above statement in the context of International Standard on Auditing (ISA) 100: 'Assurance Engagements'.

*JUNE 2012 QUESTION FIVE C*

**QUESTION 2**

You are an audit manager in the audit firm of Tuna Weza &Co. Certified Public Accountants. Your audit client, Mbao Ltd designs and manufactures wooden chairs and tables. The business has expanded rapidly the last two years, since the arrival of Mr John Sella, an experienced and well-connected sales and marketing manager.

The directors of Mbao Ltd. intend to secure a loan of Sh 200 million in order to expand operations following the design of completely new range of wooden garden furniture.

The directors have approached Mpesha bank Ltd. for the loan. The bank has a lending criteria which stipulates the following:

"Loan applications must be accompanied by a detailed business plan including an analysis of how the finance will be used .Mpesha Bank Ltd would like to ensure that the finance requested for is adequate for the proposed business purpose. The business plan must be supported by an assurance opinion on the adequacy of the requested finance.

Mbao Ltd has provided the following information on the estimated expenditure of the required financing of Sh 200 million:

| | Sh.'million' |
|---|---|
| Construction of new factory | 84 |
| Purchase of new machinery | 66 |
| Initial supply of timber raw materials | 17 |
| Advertising and marketing of new product | 33 |
| Total | 200 |



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Your Firm has agreed to review the business plan and to provide an assurance opinion on the completeness of the request for financing. A meeting between the directors of Mbao Ltd and your firm has been scheduled to discuss the assurance engagement.

**Required:**

a) Explain the matters relating to the assurance engagement that would be discussed at the meeting.
b) State the enquiries you would make with the directors of Mbao Ltd.to ascertain the adequacy

*JUNE 2011 QUESTION THREE*

**QUESTION 3**
Your client Birnba Ltd. Sells machines subject to a warranty of one year included in the statement of financial position of Birnba Ltd. as at 30 April 2011 is a warranty provision of Sh 300,000,000 (2010: Sh 290,000,000).the managing director who owns 60% of the shares of the company estimates the cost of repairing detective machinery reported by customers. The estimates from the managing director form the basis of the warranty provision.

This is your first year as the auditors of Bimba Ltd whose turnover is Sh15 billion for the year 2011 compared to Sh13 billion for the year 2010.

**Required:**

b)(i) Describe four quality control procedures that are applicable to an audit engagement.

(ii) Explain the challenges that might be faced by a small firm of certified public accountants in implementing quality control procedures and recommend measures that could be taken to overcome the challenges.

*JUNE 2011 QUESTION FOUR B*

**QUESTION 4**

a) Describe four quality control procedures applicable to individual audit engagements.

*DECEMBER 2009 QUESTION ONE B*

**QUESTION 5**
There is a growing demand in both the public and private sectors for professional accountants to provide assurance on a variety of subject matters by expressing a conclusion regarding the quality or context of the subject matter.

**Required:**

(a) Identify the five key elements of an assurance engagement.
(b) Explain the engagement risks that face a professional accountant who accepts an assurance engagement.
(c) Explain why an absolute level of assurance may not be given and the circumstances in which a reasonable assurance can be given.



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(d) Identify and explain the potential threats to the independence of an accounting firm involved in assurance engagements.

*DECEMBER 2005 QUESTION TWO*

**QUESTION 6**
(a) State the respective responsibilities of the directors and management of a company and its external auditors with respect to the financial statements.
(b) Describe the inherent limitations facing auditors in undertaking their work.
**(Hint: Don not confuse inherent limitations with inherent risk)**
(c) Describe the significant types of judgements made by auditors in:
i) Gathering evidence
ii) Arriving at an opinion on the financial statements.

*DECEMBER 2005 QUESTION FIVE*

**QUESTION 7**
Before accepting other assurance engagements for audit clients, an auditor should consider the impact of the proposed engagement on the integrity and independence of the audit.

**Required:**
(a) Define the term "assurance engagement" and explain its purpose
(b) Explain the engagement risk that faces a practitioner who accepts an assurance engagement.
(c) Describe the forms of audit assurance reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk.
(d) Describe the forms of audit assurance reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk
(e) Identify and explain the potential threats to the independence of a firm involved in assurance engagements.

*JUNE 2005 QUESTION TWO*

**QUESTION 8**
You are the partner in charge of the audit of Futuristic Components Limited, a private company which intends to seek a public quotation for its shares.

The company is required to prepare a prospectus which must incorporate a report by the auditors of the company. The directors intend to include a profit in the prospects and you, as the company auditor, will therefore be required by the Stock Exchange to report on the base and calculations for the forecast.

**Required:**

(a) What are the preliminary considerations to be borne in mind before you would accept responsibility for reporting on the profit forecast?
(b) In your staff briefing as to the method of approach to be adopted in the profit forecast review, list six pertinent issues which staff should consider in their examination of procedures followed by the company in preparing the forecast.
(c) If you do not consider that certain assumptions in the forecast appear to be realistic, what action should you take?

*JUNE 2003 QUESTION ONE*

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**QUESTION 9**

John Mwangi has recently asked your firm's advice on whether to purchase Nathoo Merchants Ltd, which is a small builders' supply merchant. John Mwangi has previously been the proprietor of a small do-it-yourself business (which is a similar trade to the builders' supply merchant, but sells mainly to individuals), and he has recently been left a substantial sum of money on the death of his father.

Natho Merchants ltd sells:

1. Paint and decorating material
2. Hand tools and small electrical tools (for instance electric drills).
3. Electrical fittings, and
4. Building materials (bricks, wood, sand and cement).

The current owner of Nathoo Merchants ltd is retiring and is proposing to sell his business to John Mwangi. Nathoo Merchants ltd is financed by equity, bank loans and overdrafts. Their are no current accounts or loan accounts between the directors and the company.

The audited accounts of Nathoo Merchants ltd for the three years ended 30 April are available and John Mwangi has asked you to carry out an investigation into whether the accounts are reliable. The accounts of Nathoo Merchants ltd have been prepared by the auditor. From your knowledge of the auditor's reputation and the weakness in the system of internal control in Nathoo Merchants ltd, you believe there may be material errors in the accounts.

In the year ended 30 April 2002, Nathoo Merchants ltd had a turnover of 34 million. The company operates from its own freehold premises and it sells mainly to small builders and some individuals. Most of the sales are on credit but its sales to individuals are for cash. If he decides to purchase Nathoo Merchants ltd, John Mwangi plans to work full-time in the business.

Your are required to:

(a) List and briefly describe the investigations you would carry out in checking:
  (i) The profit and loss accounts for the three years ended 30 April 2002.
  (ii) The balance sheet as at 30 April 2002.

(b) List and briefly describe,the factors you would consider in advising John Mwangi whether:
  (i) To purchase all the shares in Nathoo Merchants ltd or
  (ii) To purchase the assets, goodwill and liabilities from the company. Your answer should describe the factors, which you would consider in advising John Mwangi which assets and liabilities of Nathoo Merchants ltd he should purchase.

*JUNE 2002 QUESTION THREE*

**QUESTION 10**

Mr. Kimani and Mr. Mathenge are each 50% shareholders and the only directors of K&M Ltd., a company which operates as a building contractor involved in civil engineering contracts which frequently take more than one year to complete. The turnover of the company in the year ended 31 March 2000 was in the region of Sh.1,200 million. The company has been suffering cash flow problems in recent times. Mr. Kimani and Mr. Mathenge have disagreed on the management policies of the company. As a result of this disagreement, Mr. Mathenge has agreed to sell his shares to Mr.





Kimani and has resigned as a director with effect from 31 March 2000. The consideration for the shares is to be fixed by a valuation of the shares based on the audited accounts for the year ended 31 March 2000.

You have been appointed the investigating accountant to review the valuation of the shares. Mr. Kimani and the auditors of K&M Ltd. have agreed to cooperate fully.

**Required:**

As the investigating accountant, detail those matters which you would pay particular attention to in carrying out your review.

*JUNE 2000 QUESTION FIVE*

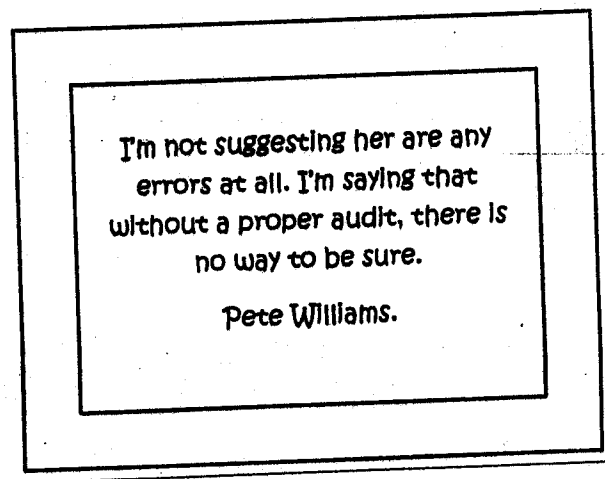
**QUESTION 11**

(a) Auditors are frequently required to provide assurance for a range of non-audit engagements

**Required**
List and explain the elements of an assurance engagement.

(b) ISA 320 materiality in planning and performing an audit provides guidance on the concept of materiality in planning and performing an audit.

**Required**
Define materiality and determine how the level of materiality is assessed



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# TOPIC 2

## MANAGEMENT OF PROFESSIONAL ACCOUNTING FIRMS

### QUESTION 1

(a) Recommend measures that might be taken to enhance the independence of auditors.

*JUNE 2012 QUESTION FIVE A*

### QUESTION 2

Quick services Ltd. is a family owned entity which provides call center- services to various organisations. Mr. and Mrs. Omar Masumbuko are the major shareholders. The company is expanding rapidly in terms of its client base the number of staff it employs and profit growth.
You have been approached by Quick services Ltd. to perform the audit of the company for the year ending 31 December 2009. Yollr firm has not audited this company before. Quick services Ltd. has had three firms of auditors since its incorporation five years ago.

The directors of Quick services Ltd. have indicated to you informally that the reason they wish to change the previous auditors is because of a disagreement about certain disclosures in the financial statement in the previous year. The directors consider the disagreement to be a trivial matter and have indicated that their chief accountant will be able to provide you with the details once the audit has commenced. Your firm has explained that before accepting the appointment, there are various matters to be considered within the firm and other procedures to be undertaken, some of which will require the corporation of the director.

The directors have requested your firm of auditors to commence the audit immediately in order for the accounts to be presented to their bankers your firm has other clients operating call centers and is currently engaged in various audit assignments.

**Required:**

a) Describe the matters to consider within your firm and other procedures that must be undertaken before accepting appointment as auditors of Quick Services Ltd.
b) Explain why it would be inappropriate to commence the audit before concluding the matters and procedures referred to in (i) above.
c) Explain the purpose of an engagement letter and list its contents.

*DECEMBER 2009 QUESTION TWO*

### QUESTION 3

You have recently been appointed auditor of Leisure Hotels limited a company which owns several hotels. The company has an established internal audit department; which operates at the head office and visits the hotels for audit on regular basis. Each hotel has a computer which records the booking of rooms for overnight accommodation and produces the billing account for each guest.



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**Required:**

a) Explain the factors you would consider and the work you perform to enable you to assess the extent to which you could rely on the work of the internal audit staff.

*JUNE 2009 QUESTION FOUR B*

### QUESTION 4

Rural and Urban Housing Ltd. is a large company whose main activities relate to the house building market. Your firm has audited Rural and Urban Housing Ltd. for several years. During the audit for the year ended 30 September 2000, the audit manager has come across two items that he feels require discussing with the audit engagement partner. Details of the relevant items are:
During statistical testing of delivery notes, an observant audit assistant had noticed that the delivery address of several items of purchase materials was that of the managing director. Using the costing records, these materials were traced to job spoo-l which was the construction of a swimming pool. No sales invoice had been raised for this job. On investigation the audit manager discovered that the job as the construction of a 'demonstration' swimming pool which prospective purchasers could view. It has been included in Rural and Urban Housing Ltd.'s balance sheet as a fixed asset. The maintenance and running costs of the pool have been charged to the profit and loss account as promotion and selling costs.
Several large payments have been made to unidentified agents and described as commissions in respect of obtaining building contracts. Most of these payments have been made in cash, some of which were in foreign currencies, however, some payments have been made by cheque. Enquiries relating to the payee of the cheques have revealed that they are in the name of a nominee and the beneficiary cannot be identified. There is no supporting documentation for any of the payments. The finance director of Rural and Urban Housing Ltd. Has said that such commissions are common practice and the agents represent valuable contracts whose identity must be kept confidential as otherwise Rural and Urban Housing Ltd.'s competitors would be able to 'poach' work from them.

**Required:**

As the engagement partner for the audit of Rural and Urban Housing Ltd., discuss the matters you would consider including any further inquiries you would make, in determining the appropriate treatment of:
a) job spoo-l;
b) the payments of the commissions

*DECEMBER 2000 QUESTION TWO*

### QUESTION 5

a) Explain the situations where an auditor may disclose confidential information about a client.
b) You are an audit manager in McKay & Co, a firm of Chartered Certified Accountants. You are preparing the engagement letter for the audit of Ancients, a public limited liability company, for the year ending 30 June 20x6.
Ancient has grown rapidly over the past few years, and is now one of your firm's most important clients.

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Ancients has been an audit client for eight years and McKay & Co has provided audit, taxation and management consultancy advice during this time. The client has been satisfied with the services provided, although the taxation fee for the period to 31 December 20x5 remains unpaid. Audit personnel available for this year's audit are most of the staff from last year, including Mr. Grace, an audit partner and Mr. Jones, an audit senior. Mr. Grace has been the audit partner since Ancients became an audit client. You are aware that Allyson Grace, the daughter of Mr. Grace, has recently been appointed the financial director at Ancients.

To celebrate her new appointment, Allyson has suggested taking all of the audit staff out to an expensive restaurant prior to the start of the audit work for this year.

**Required**
Identify and explain the risks to independence arising in carrying out your audit of Ancients for the year ending 30 June 20X6, and suggest ways of mitigating each of the risks you identify.

**QUESTION 6**

You are the audit manager in the audit firm of Dark & Co. One of your audit clients is NorthCee Co, a company specializing in the manufacture and supply of sporting equipment. NorthCee have been an audit client for seven years and you have been audit manager for the past three years while the audit partner has remained unchanged.

You are now planning the audit for the year ending 31 December 20x7. Following an initial meeting with the directors' of-NorthCee, you have obtained the following information.

(i) NorthCee is attempting to obtain a listing on a recognized stock exchange. The directors have established an audit committee, as required by corporate governance regulations, although no further action has been taken in this respect. Information on the listing is not yet public knowledge.
(ii) You have been asked to continue to prepare the company's financial statements as in previous years.
(iii) As the company's auditors, NorthCee would like you and the audit partner to attend an evening reception in a hotel, where NorthCee will present their listing arrangements to banks and existing major shareholders.
(iv) NorthCee has indicated that the fee for tax return preparation services rendered in the year to 31 December I 20x5 will be paid as soon as the taxation authorities have agreed the company's taxation liability. The delay in the tax authority agreeing the terms is due to a dispute in relation to whether an immaterial amount is allowable for taxation.
Finally, yon have just acquired about 5% of NorthCee's share capital as an inheritance on the death of a distant relative.

**Required**
a) Identify, and explain the relevance of, any factors which may threaten the independence of Dark & Co's audit of NorthCee Co's financial statements for the year ending 31 December 20X7. Briefly explain how each threat should be managed.





# TOPIC 3

## LEGAL LIABILITY

**QUESTION 1**

You are the auditors of Pickley Ltd. a company quoted on the stock exchange. Your audit reports for the company for the last three years have been unqualified, including the report for the current financial year ended 30 April 2011.

On 15 May 2011 a potential investor in Pickley Ltd.'s shares sent a registered letter to you which contained the following:

We wish to advise you that we intent to make substantial investment in Pickley Ltd. of which we understand you are the auditors. We shall place material reliance on the audited accounts of the company in making decision relating to our contemplated investment. We riote in particular the earnings per share of the company have been quite impressive."

Thereafter, the potential investor purchased substantial shares in Pickley Ltd. The investment turned out to be unprofitable since the market value of the shares of Pickley Ltd. dropped by over 60%. The investor has asked your audit firm to admit liability for the loss since the investor relied on financial statements which were later confirmed to contain material errors.

**Required:**
a) Citing relevant cases under common law, discuss the liability of the auditors of Pick ley Ltd.
b) Explain the factors which have contributed to the increased number of lawsuits against auditors from third parties in recent years.
c) Outline measures that could be taken by practicing auditors to minimise their legal liability.

*JUNE 2011 QUESTION ONE*

**QUESTION 2**

You are the audit manager on the audit of Super Furniture Ltd a company which manufactures office and household furniture. The financial year-end of the company is 30 June 2002 and you took charge of the audit assignment on 20 august 2002 after the resignation of the previous audit manager.

The following are extracts from the audit-planning memorandum.

(a) Shareholdings
Currently all shares are held by the directors. A takeover offer has been received from Dominant Furniture Ltd, a listed company to buy 51% of the equity shares in Super Furniture Ltd. Negotiations are still under way.

(b) Materialiality
The materiality level has been set at Sh 1.5 million.



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While reviewing the audit working papers for the year ended 30 June 2002, you find the following notes prepared by the senior in charge of the audit.

| | 2002 Sh. 000 | 2001 Sh. 000 |
|---|---|---|
| 1. Sundry accruals | 3,774 | 5,028 |
| 2. Provision of leave pay | 1800 | 6,180 |
| 3. Provision for major maintenance | 7954 | 12,000 |
| 4. Provision for legal costs | 480 | - |
| 5. Provision for losses on insurance claims | - | 1,050 |
| 6. Provision for credit notes | 750 | 750 |
| 7. Provision for management and provisions | 1,800 | 2,245 |
| Total sundry accruals and provisions | 16,558 | 27,253 |

Notes

1. Sundry accruals
   For a full list of accruals see working paper H2.1. Supporting documentation has been seen for all accrued amounts over Sh 60,000 totaling Sh.2, 565.000 (68%). All accruals are for normal expenses of the company and appears to be reasonable.
2. Provision for leave pay
   This amount agrees with the total leave pay due as reflected on the printout from the salaries system. We have reviewed the controls in the salaries system, including the computerized leave records and have tested the controls through compliance testing. No weaknesses or exceptions have been found.
   The reason for the lower provision is that the company has changed its leave policy. From 30 April 2002, only management may carry forward leave due to them from one year to the next. I have discussed and confirmed the new policy with Mr. Chege the financial director.
3. Provision for major maintenance
   The only movement on this account during the year has been maintenance expenses of Sh 4,046,000 debited against the account. I have seen supporting documentation for expenses totaling Sh 850,000 being 21% of Sh 4,046,000.
4. Provision for legal costs
   This amount has not been incurred at the year-end and concerns the estimated legal costs for the company's defense of a claim for damages against it by an ex-employee. The employee was retrenched in January 2002. As the court case started in September 2002, this is an over provision (carried forward to the list of immaterial errors.
5. Provision for credit notes
   This provision is maintained at Sh 750,000 and is for possible credit notes after the year-end relating to invoices issued before the year-end. As the average monthly credit notes amount to approximately Sh 720,000 the provision is considered to be sufficient.
6. Provision for management bonuses
   All managers are entitled to a bonus based on criteria which are determined a year in advance at their annual performance review interview. Mr. chege refused to give me a list of bonus amounts or the letters setting out the bonus criteria, as the amounts have not been finalized and are still confidential.

The provision appears to be reasonable when expressed a as percentage of turnover - 0.45% (2002) compared to 0.47% (2001)



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Your are required to:

(a) Define inherent risk and indicate in respect of the line item "sundry accruals and provisions" what effect the proposed turn over has on:
   1. Your assessment of the inherent risk
   2. Your audit approach

(b) Draff review notes to the senior in charge of the audit on any five of the seven items making up the balance of sundry accruals and provisions. In each case you should indicate
   i) Whether you are satisfied with the basis of calculation and the accounting principles applied.
   ii) What additional audit work, if any, needs to be performed?

*DECEMBER 2002 QUESTION TWO*

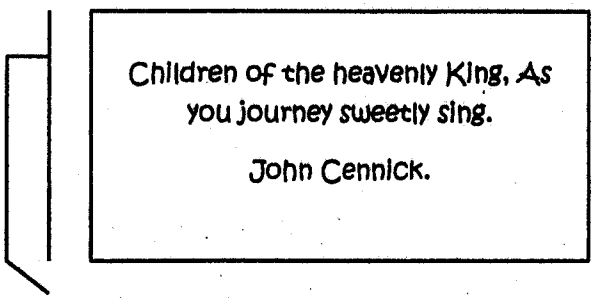
**QUESTION 3**

With the recent ENRON debacle, the issue of auditors' liability has become even more topical. In this connection:

(a) List and briefly describe the circumstances when an auditor may be liable for damages for material misstatements in published accounts on which has expressed an audit opinion and the circumstances when he may avoid liability.
(b) List the persons who may make a successful legal claim against an auditor and state the basis a court of law would use to assess the value of damages.
(c) Briefly state the ways the liability of auditors could be limited and consider the practicality of these methods of limiting an auditor's liability.
(d) Consider the effect the limiting of an auditors liability is likely to have on:
   i) The investor's view of the reliability of the audit opinion:
   ii) The amount of work an auditor will perform (compared with the work he would perform if his liability was unlimited) and the effect this will have on the reliability of the audit opinion.

(e) Briefly come to a conclusion on:
   i) Whether you consider it practicable for an auditor's liability to be limited:
   ii) Whether limiting auditor's liability will affect the reliability of the audit opinion and
   iii) Whether you would agree with the proposal that an auditor's liability should be limited.

*JUNE 2002 QUESTION FIVE*



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# TOPIC 4

## RISK ASSESMENT

### QUESTION 1

a) Discuss the audit risk that auditors face in the course of the audit of financial statements of entities with material assets stated at fair values instead of historical costs.

### QUESTION 2

*DECEMBER 2011 QUESTION THREE*

Chai Bora Ltd. is a tea growing and processing company. In addition to producing its own raw tea leaves, the company buys raw tea from farmers in the neighbouring environs.

As the manager in charge of the external audit of the company for the year ended 31 December 20 1 0, you gathered the following facts about the company's operation:

- The company has its own free nurseries whose tea seedlings are raised for establishing new plantations. In addition, there are blue gum tree nurseries for establishing wood fuel plantations for factory boilers.
- The tea grown by the company and that from out growers is weighed and graded for quality compliance. It is then processed at the factory.
- Processed tea is graded and kept in a large store in readiness for sale. Thereafter the tea is either exported or sold locally at the factory retail shop situated near the factory gate and other local outlets.
- The company has rented five shops in different towns to boost local sales. Each of the shops is a profit centre and has a shop manager. All cash collections from each shop are banked daily in the main bank account of the company.

The company's turnover for the year amounted to Sh.400 million of which Sh.360 million were export sales. All exports are zero rated with respect to Value Added Tax (VAT). The company claimed VAT refunds estimated at Sh12 million each quarter in the year 2010. Your firm certified the claims as required by the tax authorities.

Tea for export is sold by brokers at the auction who later transfer the sales proceeds electronically to the bank account of the company usually in US dollars.

The company maintains a US dollar account and a shilling account. Dollars are from time to time converted to shillings using negotiated rates.

**Required:**

Evaluate the risks posed to you as the auditors of Chai Bora Ltd. In expressing your audit opinion and outline the measures you would take to minimise the risks in the course of your audit.

*JUNE 2011 QUESTION TWO*





### QUESTION 3

Your firm, PLC & Associates Certified Public Accountants have recently been appointed the auditors of Plastic Manufacturing Limited (PML). The Company manufactures jugs and other kitchen ware and has a workforce of 100 employees.

The products are predominantly sold to local retailers and distributed countrywide. The company has a small accounting unit which consists of the chief accountant, Mr.Mwendapole and an accounts clerk Miss Kazungu the Chief Accountant reports directly to the managing director and the major shareholder Mr.Makanyaga.

The company uses a simple personal computer based accounting system. Miss Kazungu enters invoices into the computer and maintains the manual cash book. Mr.Mwendapole is in charge of preparing management accounts on a monthly basis and the payroll, which is approved monthly by Mr.Makanyaga controls purchasing and sales although he has a personal assistant who performs the paperwork in liaison with Miss Kazungu.

The previous auditors did not offer themselves for re-election due to dispute with Mr.Makanyaga, but have stated that they are not aware of any ethical reason which bars your firm from undertaking the audit. They have passed over some relevant working papers to your firm and have met with you to give some background information on the audit. One of the things they mentioned about the audit was that they have always assessed the internal controls of PMl as poor.

**Required:**

a) Discuss the term "audit failure" and it's probable causes.
b) With respect to PML identify and briefly explain three types of each of the following risks:

i. Audit risks
ii. Business risks

*DECEMBER 2010 QUESTION FIVE*

### QUESTION 4

You are the audit manager at Shabir & Associates, a firm of Certified Public Accountants. One of tile clients assigned to you as the audit partner is Zep Engiering Ltd, a company engaged in oil and gas exploration. The audit partner has indicated that Zep Engineering Ltd, could be a high risk company with respect to social and environment obligations.

**Required:**

a) Identify four possible areas that might lead to the risk of material misstatements in the financial statements of Zep Engineering Ltd.
b) Describe any six substantive procedures that you could carry out to detect material misstatements in the financial statements of ial p Engineering Ltd. with respect to social and environmental matters.
c) Highlight four main components that should be included in an independent verification report on environmental matters of the organisation.

*DECEMBER 2010 QUESTION TWO*



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**QUESTION 5**

a) Your client, Island Ltd. manufactures machines for use in coal extraction. Your audit firm was appointed as the auditors of the company in June 2009.This is your first audit engagement by Island Ltd.

You are planning the audit of the financial statements for the year ended 31 October 3009.The draft financial statements show revenue of Sh.125 million (2008 - Sh 103 rnillion). The reported profit before tax is Sh 5.6 million (2008 - Sh5.1 million) while total assets are reported as Sh.95 million (2008 - Sh.90 million).

Island Ltd. has five main customers who pay for supplies in three instalments; 50 % on confirmation of order,25 % on delivery and 25% on the installation of machinery. It takes, on average, six months from the time of confirmation of an order to the installation of machinery.

You have established the following:

1. There is an outstanding amount of Sh.2.85 million from Jack Mine Ltd.jack Mine Ltd. has disputed payment of the amount due, claiming the machinery installed was not operating efficiently.
2. One customer, Wyne Ltd. claimed for damages for injuries suffered by their employee when a machine malfunctioned in August 2009.The company has a poor safety record. Island Ltd. has informed Wyne Ltd. that they would not pay for the damages claimed by the company. Subsequently, Wyne Ltd. has cancelled two orders placed in October 2009.
3. Work in progress is valued at Sh.8.5 million as at 31 October 2009.A physical inventory count was carried out on 17 October 2009.The company's chief engineer estimated the stage of completion of each machine on 17 October 2009.
4. One of the major components used in manufacturing the machinery for coal extraction is sourced from an overseas supplier, Locks Ltd. and is invoiced in Euros. There is a trade payable of Sh.1.5 million owed to Lock Ltd. as at 31 October 2009.
5. All machine are supplied with a warrant; of one year. An allowance of Sh 2.5 million (2008 - Sh 2.4 million) in respect of warranties is recognised in the statement of financial position as at 31 October 2009. The Chief executive as Island Ltd.,Ms.Kate Collins estimates the cost of repairing defective machinery reported by customers which is used as the basis for making the allowance in the financial statements.
6. Ms. Kate Collins owns 60 % of the shares of Island Ltd. She also owns 55 % of the shares in Pacific Ltd. The premises where the head offices if Islannd Ltd. are situated are owned by Pacific Ltd.Ms.Kate Collins is considering selling part of her shareholding in February 2010 and would like the audit completed by 15 January 2010.

Required:

i) Discuss the audit risks and any other matters to be considered when planning the final audit of Island Ltd. for the year ended 31 October 2009.
ii) Explain the audit procedure that could be used in verifying the allo ance for warranties included in the statement of financial position as at 31 October 2009.

*DECEMBER 2009 QUESTION ONE A*



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**QUESTION 6**

i) Citing the components of each risk, differentiate between "business risks "and audit risks".

*DECEMBER 2009 QUESTION THREE A*

**QUESTION 7**

You have been appointed the auditor of Chapa Kazi Ltd., a limited liability company. The company has 150 employees and deals in the manufacture of household goods including glasses.

The glassware is sold predominantly to a large distributor and retail store in an affluent market. The glassware sold to the distributor and retail store in the affluent market are designed to the store's specification and cannot be sold to anyone else.

Chapa Kazi Ltd. also sells household goods to a number of retailers operating in the low income market segment. The accounting function of Chapa Kazi Ltd. consists of the chief Accountant, Mr.Mhasibu, who reports directly to the managing director who is also the major shareholder Mr. Egeza and an accounts assistant Mr.Karani.

There is a simple personal computer (PC) based accounting system. Mr.Karani enters invoices into the computer and maintains the manual cash book Mr.Mhasibu is in charge of preparing the management accounts on a monthly basis and the payroll which is approved monthly by Mr.Egeza.Mr,Mhasibu also manages the tax affairs of the company and the tax affairs of Mr. Egeza.

Mr.Egeza controls purchasing and sales, although he has an assistant who produces the paperwork and liaises with Mr.Karani the accounts assistant from time to time on matters relating to accounts payable.

Arising from disputes between the previous auditors and Mr.Egeza, the auditors did not offer themselves for re-election .Mr.Egeza has requested your firm of auditors 10 undertake the audit of Chapa Kazi Ltd. for the current financial year ending 31 December 2009.

You have met the previous auditors who have provided YOLI with some background information on their audit of Chapa Kazi Ltd. The auditors also provided you with their working papers and inform you that they are not aware of any ethical reason which may prevent your firm from accepting the audit appointment

However, the previous auditors have disclosed that they have always assessed the internal control systems of Chapa Kazi Ltd. as ineffective to be relied upon in their previous audits.

**Required:**

a) Explain the term professional scepticism and comment on its role in the detection of fraud
b) Describe the key audit risks and business risks of Chapa Kazi Ltd.

*AUGUST 2009 QUESTION TWO*

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**QUESTION 8**

You are the audit supervisor on the audit of RS Ltd., a company listed on the Nairobi Stock Exchange. RS Ltd. sells building materials, plumbing supplies and ceramic tiles through its home improvements retail outlets.

The results of operations and the financial position of RS Ltd. for the previous financial year as well as the current financial year are summarized as follows:

| | **Actual Year ended 31 December 2003** | **Budget Year ended 31 December 2003** |
|---|---|---|
| | Sh. Million | Sh. Million |
| Turnover | 11,480 | 13,780 |
| Profit before interest and tax | 1,270 | 1,500 |
| Profit before tax | 920 | 1,200 |
| Profit after tax | 630 | 800 |
| Ordinary shareholders' funds | 3,240 | 3,640 |
| Total assets | 5,500 | 6,000 |

You are currently planning the audit for the year end 31 December 2004. The following matters have come to your attention during your review of last year's working papers and the most recent management accounts and during discussions with the financial director of RS Ltd.

1. MPH Ltd., the holding company of RS Ltd. is in financial difficult. MPH Ltd. holds 50% of the ordinary shares in issue.
2. RS Ltd. also has retail outlets in Tanzania, Uganda, Ethiopia and Sudan.
3. The managing director of RS Ltd., Mr. Peter Rush, has acquired an interest in a national car hire business. It appears from discussions with the financial director of RS Ltd. are encouraged to use this car hire company at all times. Car hire expenditure is a material component of the operating costs of RS Ltd.
4. The RS Ltd.'s pension fund has a large surplus. During the current financial year, the company has temporarily suspended its contributions to the pension fund.
5. RS Ltd. made a loan to Mr. Peter Rush to purchase shares in the company. The financial director intends to obtain repayment of the loan before the financial year end and to re-advance the funds from the RS Ltd. share trust.
6. RS Ltd. is currently involved in a dispute. A customer is alleging that certain building supplies purchased from the company were sub-standard and the customer is claiming damages of Sh.50 million. RS Ltd. has rejected this claim. A preliminary trial date has been set for February 2005.

During a discussion with Mr. Peter Rush he offered to supply, free of charge, the bathroom tiles and plumbing materials for the house you are in the process of building.

**Required:**

(a) Outline the potential audit risks apparent from the above matters and state briefly the audit procedures necessary to address the risks you have identified. Detailed audit programme steps are not required. You simply need to set out each of the issues that will need to be covered by your audit procedures.





(b) Indicate what matters you need to consider, what steps you should take before responding to the offer from Mr. Peter Rush. In addition, state what you believe to be the appropriate response to Mr. Peter Rush

*JUNE 2004 QUESTION TWO*

**QUESTION 9**

Twenty Second Century Ltd, a large company was founded and controlled by Mr. J.Presscot. The principal business of the company was to develop derelict land in city and town centers into office accommodation. In 1999, Kenya Revenue Authority became suspicious of the nature of the operations being carried out by the company and an investigation into its affairs commenced. The resultant report stated that the company's internal controls were weak and non-existent in many cases. The investigators found payments to unknown persons and fictious consultancy firms. In addition Mr. Prescott had maintained a secret expense account that was used to disburse funds to himself. The board of directors of Twenty Second Century Ltd did not know of the existence of this account. This expense account was maintained by the partner firm of accountants responsible for the audit of the company. The auditors were heavily criticized in the report of the investigators.

The firm of auditors A to Z & Co. had an aggressive marketing strategy and had increased its audit fees by 100% in two years. The audit firm had accepted the appointment in 1997 after the previous auditors had been dismissed. The audit report for the year ended 1996 had been heavily qualified by the previous auditors on the grounds of poor internal control and lack of audit evidence. Mr. J.Presscot has approached several firms of auditors in order to ascertain whether they would qualify the audit report given the present systems of control in Twenty Second Century ltd. A to Z & co ltd has stated that it was unlikely they would qualify their report. They realized that Mr. J. Prescott was "opinion shopping" but were prepared to give an opinion in order to attract the client to the firm.

Twenty Second Century Ltd was subsequently put under receivership and liquidation and A to Z & Co were sued for negligence by the largest loan creditor, its bankers.

**Required:**

(a) Describe the procedures, which an audit firm should carry out before accepting a client with potentially high audit risk such as Twenty Second Century ltd
(b) Discuss the ethical problems raised by the maintenance of the secret expense account for Mr. J.Presscot by the audit partner.
(c) Suggest measures that audit firms might introduce to try and minimize the practice of "opinion shopping" by the prospective audit clients.
(d) Explain how audit firms can reduce the risk of litigation and its effects upon the audit practice

*DECEMBER 2001 QUESTION FIVE*

**QUESTION 10**

(a) State the objective of the statutory audit and explain how carrying out the audit in accordance with ISAs helps the auditor to achieve that objective.
(b) ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment sets out matters that should be documented during the planning stage of an audit,



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**Required**
List six matters that should be documented during audit planning.

(c) ISA 230 Audit documentation provides guidance to auditors in respect of audit working papers.
**Required**
List six factors which affect the form and content of audit working papers.

**QUESTION 11**

(a) Explain the term 'audit risk' and the three elements of risk that contribute to total audit risk.

(b) The EuKaRe charity was established in 1960. The charity's aim is to provide support to children from disadvantaged backgrounds who wish to take part in sports such as tennis, badminton and football.

EuKaRe has a detailed constitution which explains how the charity's income can be spent. The constitution also notes that administration expenditure cannot exceed 10% of income in any year.

The charity's income is derived wholly from voluntary donations. Sources of donations include:

(i) Cash collected by volunteers asking the public for donations in shopping areas,
(ii) Cheques sent to the charity's head office,
(iii) Donations from generous individuals. Some of these donations have specific clauses attached to them indicating that the initial amount donated (capital) cannot be spent and that the income (interest) from the donation must be spent on specific activities, for example, provision of sports equipment.

The rules regarding the taxation of charities in the country EuKaRe is based are complicated, with only certain expenditure being allowable for taxation purposes and donations of capital being treated as income in some situations .

**Required;**

i. Identify areas of inherent risk in the EuKaRe charity and explain the effect of each of these risks on the audit in approach.
ii. Explain why the control environment may be weak at the charity EuKaRe.

**QUESTION 12**

a) ISA 315 Identifying and assessing the risks of material misstatement through understanding the entity and its environment requires the auditor to perform risk assessment procedures which include obtaining an understanding of the entity and its environment, including its internal control.

**Required**
(i) Explain the purpose of risk assessment procedures.
(ii) Outline the sources of audit evidence the auditor can use as part of risk assessment procedures.

b) Mal & Co, an audit firm, has seven partners. The firm has a number of audit clients in different industrial sectors, with a wide range of fee income.

An audit partner of Mal & Co has just delegated to you the planning work for the audit of Serenity Co. This company provides a range of mobile communication facilities and this will be the second year your firm has provided audit services.

You have just met with the financial controller of Serenity prior to agreeing the engagement letter for this year. The controller has informed you that Serenity has continued to grow quickly, with financial accounting; systems changing rapidly and appropriate control systems being difficult to maintain. Additional services in terms of review and implementation of control systems have



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been requested. An internal audit department; has recently been established and the controller wants you to ensure that external audit work is limited by using this department.

You have also learnt that Serenity is to market a new type of mobile telephone, which is able to intercept messages from law enforcement agencies. The legal status of this telephone is unclear at present and development is not being publicized.

The granting of the license to market the mobile telephone is dependent on the financial stability of Serenity, The financial controller has indicated that Mal & Co may be asked to provide a report to the mobile telephone licensing authority regarding Serenity's cash flow forecast for the year ending December 20x7 to support the license application. .

**Required**
As part of your risk assessment procedures for the audit of Serenity Co for the year ending 31 December 20x6, identify and describe the issues to be considered when providing services to this client.

c) When reporting on a cash flow forecast, explain the term 'negative assurance and why this is used.

Remember that even if you haven't been audited in the past, it doesn't mean you won't be audited in the future. And it takes only one audit to ruin your day.

Kathy Burlison.

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# TOPIC 5

## CONDUCT OF AN AUDIT

**QUESTION 1**

Abdul Yego is the stores supervisor of Lobeke Ltd. He is responsible for creating a summary of the stores transactions at the end of each day. Abdul is also responsible for checking the register tape against the credit slips and cash in the register. Every morning he banks the cash receipts of the previous day.

Abdul Yego was promoted to head book-keeper and also continued to carry out his store keeping responsibilities. Occasionally he inflates the payables and also records fictitious accounts payables. The owner of Lobeke Ltd. does not verify invoices before making payment to the respective suppliers. He simply issues cheques as per the billing indicated on the invoice by Abdul Yego,

The cash received from accounts receivables is either never recorded or recorded at a later date. This enables Abdul Yego to misappropriate the cash from debtors or delay to record the receipt.

At the end of the year when the stores manager goes on holiday, Abdul writes off the amounts he received and misappropriated as bad debts. Alternatively, he credits money he receives from another debtor to the accounts he had misappropriated.

Abdul Yego has been following this practice for long and he feels confident that he has developed a fool proof method to earn extra income.

**Required:**

(a) Discuss the respective responsibilities of the auditors and management in detecting the type of fraud committed by Abdul Yego.
(b) Describe the audit tests that the auditor for Lobeke Ltd. could perform to detect the fraud.

*JUNE 2012 QUESTION FOUR*

**QUESTION 2**

(c) Describe the audit procedures required in respect of accounting

*JUNE 2012 QUESTION THREE C*

**QUESTION 3**

(a) Mulo Hotels Ltd. is a listed company which has a chain of 20 hotels in the East African region. The company has established an internal audit department which is based at the head office and which makes regular visits to the hotels.

The hotels provide business and tourist class accommodation. They also provide restaurants, bars, conference and leisure facilities which are open to the general public. The company operates a





computerised central booking and billing system and an inventory and asset control system, both of which can be accessed via terminals in the hotels.
Access to the system is restricted by the use of passwords and all significant expenditure is authorised by the head office. The payroll is operated at the head office. Hotel and regional managers are actively involved in the setting of budgets and cash flow forecasting. On average, throughout the year, the hotel chain has a 60% occupancy rate.

**Required:**

(i) Describe the areas in which the internal audit department of Mulo Hotels Ltd. could check detailed transactions and balances.
(ii) Explain areas in which the internal audit department of Mulo Hotels Ltd. could perform reviews of system or operational performance.

*JUNE 2012 QUESTION TWO A*

**QUESTION 4**

You are the audit manager in charge of the audit of Subira Limited, a local distributor of fast moving consumer goods. You are also the auditors of Sifa Limited which imports goods from a neighbouring country and sells all the goods to Subira Limited. The two companies have common shareholders and directors including the managing director.

Subira Limited also buys from three other local suppliers.

Whereas all purchases by Subira Limited from Sifa Limited are paid for promptly, Subira Limited extends sixty days credit to its customers.

The managing director expresses doubt on the reliability of the inventories control system.

Sifa Limited owns some trucks which it uses to ferry goods from the neighbouring country. The trucks have a computerized mechanism for monitoring fuel consumption which is the basis of determining their transport costs which includes drivers allowance for upkeep while ferrying the goods.

In addition, Sifa Limited hires trucks from third parties which it pays for at agreed rates. These costs are categorized as transport expenses in the income statements of Sifa Limited.

The managing director is apprehensive about the inventory management system especially with regard to damaged packages, regular stock takes, adequate documentation of stock movements and slow moving goods.

**Required:**

a) Describe the audit procedures you would undertake to verify the occurrence, completeness and validity of:

i) Sifa Limited's sales
ii) Subira Limited's purchases
iii) Subira Limited's receivables

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iv) Subira Limited's inventories
v) Sifa Limited's transport costs

b) Summarise the challenges you might face as an auditor in carrying out the audit.

*DECEMBER 2011 QUESTION FOUR*

**QUESTION 5**

b) You are audit manager responsible for the audit of Rura Manufacturing Ltd for the year ending 31 December 2011. During the year ended 31 December 2010, the company purchased several investment properties utilizing its surplus funds to generate rental income. The properties were revalued at the year end in accordance with IAS 40, Investment Property, and recognised in the financial statements at a fair value of Sh. 1.2billion.The total assets of the company were valued at Sh.24million as at 31 December 2010. The company hired an external valuer to provide the fair value for each property.

Required:

i) Citing reasons indicate the enquiries that you would make before placing reliance on the work of the valuers.
ii) Explain the audit procedures you would carry out on the valuation of the investment properties.

*DECEMBER 2011 QUESTION THREE*

**QUESTION 6**

You are the audit manager in charge of the audit of Karibu Furniture Ltd (KFL) a listed company, for the year ended 31 July 2011. KFL buys domestic furniture from manufacturers for sale to the general public. The company's head office and main warehouse are located at the same site. There are various sales branches and warehouses situated in different parts of the country.

Your firm Stephenson & Gerald, Certified Public Accountants was engaged as the auditors of the company five years ago.

All the accounting records of the company are maintained in the computer at the head office. When an order is received at the branch, the salesmen check whether the items of furniture are in the inventory. If available, the customer pays in cash, cheque or credit card before the items are released from the warehouse. If the items are not available in the branch the salesman confirm whether the items are available from the other local branches and thereafter place an order for the items.

In the previous years' audits, your firm has raised concern relating to actual inventory at the branches being less than the computer book inventory quantities. There have also been other concerns relating to identifying and valuing damaged inventory and goods returned by customers.

The company has a small internal audit department and their work includes periodic visits to branches.

The company was subject to a management buy-out in February 2009 which resulted in high gearing. You also understanding that the company has liquidity problems and that it is negotiating with its



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bankers for additional finances

**Required;**

(a) Explain the meaning of the term "opinion shopping" in auditing and indicate how audit firms should deal with opinion shopping.
(b) Discuss the matters you would consider and the work you would carry out in planning the audit.
(c) Analyse the important matters considered during the overall review of an audit and their significance.

*DECEMBER 2011 QUESTION TWO*

**QUESTION 7**

The following is the statement of comprehensive income of Loko Ltd. For the year ended 31 October 2010:

| | 2010 shs '000' | 2009 shs '000' |
|---|---|---|
| Revenue | 1,911,600 | 1,923,000 |
| Cost of sales | 833,400 | 823,060 |
| Gross profit | 1,078,200 | 1,099,940 |
| Expenses( including loan interests) | 1,046,400 | 1,020,000 |
| Profit on ordinary activities before taxation | 31,800 | 79,940 |
| Exceptional Income | | |
| Evaluation on non-current assets | 53,000 | - |
| Profit before tax | 84,800 | 79,940 |
| Income tax expense | (9,540) | (23,982) |
| Profit after taxation | 75,260 | 55,958 |
| Dividends | (119,000) | (66,000) |
| Retained profit for the year | (43,740) | (10,042) |

**Required:**

a) Assuming that reliance can be placed upon the company's internal control procedures, list the substantive testing procedures which should be carried out by the auditor when examining the above draft statement of comprehensive income of Loko Ltd.(You are not required to calculate accounting ratios)
b) Discuss the appropriateness of the company's decision to include the gain on the revaluation of non-current assets as an exceptional income item in the statement of comprehensive income.
c) Describe the audit implications of the directors' decision to pay a dividend, assuming that the audit report expresses an "except for" qualified opinion on the grounds the company is not a going concern.
d) Describe the audit procedures which should be carried out to verify the gain arising on the revaluation of non-current assets.

*DECEMBER 2010 QUESTION ONE*

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**QUESTION 8**

Your firm has recently been appointed as auditors of Super Toys Ltd a manufacturer of children toys. Super Toys Ltd designs all of its products. The products are made of up of separate components

which the company sources from companies based overseas, primarily in Taiwan and China. Super Toys Ltd then assembles these components in to a finished product at its own Kenyan based factory. Components sourced from overseas are sent by sea and can take up to three months to reach Super Toys Ltd. The suppliers of the components invoice in their own local currency. Terms with these supplier stipulate a 50% deposit to be paid when the goods leave the exporting country, and the final 50 % to be paid when the goods arrive in Kenya.

Super Toys Ltd's customers are toy stores, both independent outlets and the major supermarket chains based in Kenya.

Your audit manager has asked you to assist with the audit planning for the year ended 31 March 2010.The specific area that she has asked you to look at is current liabilities and the comparatives from the previous year.

The current liabilities are shown as follows:

| | As at 31 March 2010 Sh' 000' | As at 31 March 2009 Sh '000' |
|---|---|---|
| Trade payables | 73,710 | 27,820 |
| Accruals | 17,420 | 63,700 |
| Provisions | | |
| Legal claim | 63,570 | |
| Warranty claims | 15,730 | 34,710 |

**Additional Information**

1. Legal claim

This relates to a claim made by a competitor that super Toys Ltd. has copied the designs for a range of toys that was introduced during the year. Super Toys Ltd. has denied the claim but has made a provision equal to 50 % of the amount claimed by their competitor.

2. Warranty claims

The company offers a limited 90-day warrant on all its products. Warranty costs have in the past represented a fairly constant percentage of annual sales. The warranty period starts from the date when the end consumer buys a product frorn one of Super Toys Ltd's customers. The average inventory holding period of Super Toys Ltd's customers is three months. The management of Super Toys Ltd. use the above information to calculate their year end warranty provision.

During the year, Super Toys Ltd. introduced a new design of skateboard, sales of which started in April 2010. On 1 June 2010 Super Toys Ltd. started to receive reports from a number of customers about a defect in the skateboard which causes some models to break when ridden over a certain speed. Super Toys Ltd.'s management have made provision for all known claims received by the year end.





**Required:**

a) Explain why the audit of made trade payables, accruals and provisions is normally more demanding to the auditor than the audit of trade receivables, prepayments and other receivables.
b) Describe the audit procedures that you would undertake in order to gain assurance that trade payables, accruals and provisions are fairly stated in the financial statements of Super Toys Ltd. for the year ended 31 March 2010.

*JUNE 2010 QUESTION THREE.*

**QUESTION 9**

The activities of the Pesa Mingi Business Group (PMBG) comprise retailing of general merchandise and luxury goods. PMBG has developed an internal audit function over many years. In the recent past, employee turnover in the internal audit department has risen, with high performing employees moving to other departments and less successful employees leaving the company.

The external audirors, Weru & Co. have suggested that PMBG outsources its internal audit function to experienced auditors. Your firm.Mulzin & Co. has been invited to tender for the provision of the internal audit services to PMBG for three years up to 31 December 2011.The appointment will include an evaluation of organisation risk, financial compliance, information technology controls, systems audit and fraud investigation.

As the prospective assignment manager in Mulzin & co. you have been asked to identify the principal matters to be presented in your firm's written submission for the tender. The invitation to tender indicates that written submissions will be used as a means of shortlisting candidates to make a detailed presentation to PMBG's Audit rind Risk Management Committee.

You have obtained the following information from PMBG:

1. The Audit Risk Management Committee receives annual reports from the head of internal audit on the controls over operational, financial and compliance risks.
2. PMBG has a comprehensive system of budgetary controls including monthly performance reviews of both financial and non-financial indicators.
3. Financial extracts

| | Six months to 30 June 2009 Draft Sh'million' | Year to 31 December 2008 Actual Sh 'million' |
|---|---|---|
| Revenue | 387 | 751 |
| Profit before tax | 46 | 83 |

4. A substantial proportion ofPMBG's revenue is generated through retail outlets in departmental stores and shopping centres. Many of tile rents payable for these premises are contingent on revenues earned by the retail outlets.

**Required:**

a) Briefly describe potential advantages and disadvantages to PMBG of outsourcing its internal audit function.
b) Describe the principal matters that should be included in your firm's submission to provide internal audit services to PMBG.



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c) Explain the possible impact of PMBG outsourcing its internal audit functions to Mulzin & Co. on the audit of the financial statements by Weru & Co.

*AUGUST 2009 QUESTION ONE*

**QUESTION 10**

Keen Sankori and Company are the auditors of JS Foundation, a charity formed many years ago from a large gift by JS Mkarimu. The income from the charity is used to pay school fees for needy students. The original gift has been invested in fixed interest bonds and shares in listed (quoted) companies. The trustees manage the charity and a full-time administrator keeps the accounting and other records and also pays the school fees by cheque.

The draft summarized income statement for the year ended 30 June 2005 and an extract from the balance sheet together with the comparative audited figures for 2004 are given below:

**Income statements for the year ended 30 June:**

| | 2005 | 2004 |
|---|---|---|
| | Sh. | Sh. |
| **Income:** | | |
| Fixed interest investments | 3,536,000 | 3,352,000 |
| Shares in listed companies | 9,912,000 | 9,880,000 |
| | 13,448,000 | 13,232,000 |
| | | |
| **Expenditure:** | | |
| Payments for fees | 11,304,000 | 11,544,000 |
| Administration costs | 1,728,000 | 1,640,000 |
| Audit and accountancy | 376,000 | 360,000 |
| Sundry expenses | 224,000 | 208,000 |
| | 13,632,000 | 13,752,000 |
| Net deficit for the year | (184,000) | (520,000) |

| **Balance sheet extracts as at 30 June** | | |
|---|---|---|
| | 2005 | 2004 |
| | Sh. | Sh. |
| **Cost of investment** | | |
| Fixed interest investments | 40,896,000 | 40,896,000 |
| Shares in listed companies | 115,648,000 | 101,016,000 |
| | 156,544,000 | 141,912,000 |

The following additional information has been provided:

1. During the year, some shares were sold at a profit of Sh.14, 632,000 and the proceeds were re-invested in shares of other listed companies.
2. There were not purchases or sales of fixed interest investments in the year ended 30 June 2005. In the year ended 30 June 2004 some of the fixed interest investments were sold and others purchases using the proceeds from the sale.
3. The charity is managed by voluntary trustees who meet four times a year, and the administrator keeps the minutes of the meetings.



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4. The trustees receive application for school fees, and approve them if they are suitable and there is sufficient income from the investments.
5. The auditors of the charity prepare the financial statements from the accounting records kept by the administrator and audit those financial statements. Their audit report is addressed to the trustees of the charity.

**Required:**

Describe the audit work the auditors should carry out in order to:

(a) Verify that school fees are paid to authorised schools. You should consider how the auditors would verify the existence of the students.

(b) Verify income from investments. The audit tests should verify that all the income from the investments has been received by the charity and included in the financial statements, including dividends from the shares in listed companies bought and sold during the year ended 30 June 2005.

(c) Verify the ownership of the fixed interest investments and the shares in listed companies.

*DECEMBER 2005 QUESTION THREE*

**QUESTION 11**

You are the manager responsible for the audit of BCD Stores Ltd. which has a number of stores which sell household products to the general public, including furniture, electrical equipment, cooking equipment and carpets. The company has annual sales of about Sh.1,600 million. In previous years' audits, there have been problems with:

1. Misappropriations of inventory by employees and customers.
2. Slow moving and damaged goods which are worth less than cost, and
3. Incomplete recording of sales when the customers pay by cash (these represent 55% of all sales)

The company has a small internal audit department, the staff of which visit branches and perform appropriate audit work at the head office.

**Required:**

(a) Describe the work you will carry out and the matters you will consider in planning the audit prior to the commencement of the detailed audit work, including consideration of the timetable for the audit.

(b) Describe the procedure you will carry out to control the audit including reviewing the work of the audit staff.

*DECEMBER 2005 QUESTION FOUR*

**QUESTION 12**

(a) Systems Technologies Limited, a listed company, deals in computer accessories. The company reported a significant decline in profits, for the year ended 31 December 2004. This decline was attributed to increased competition due to the entry of new dealers into the market.

The directors of Systems Technologies Limited project an improved performance for the year ending 31 December 2005. The annual accounts for the year ended 31 December 2004, which were signed on 24 April 2005, included a profit forecast of Sh.260 million for the year ending 31 December 2005. This contrasts with realized profit of 80 million for the year ended 31 December

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2004 Sh.190 million for the year ended 31 December 2003. In order to realize the forecast profits, the directors intend to increase turnover by 7 per cent and to reduce overheads by 7 per cent.

To give assurance to shareholders and other investors, the directors have requested Kilonzo and Associates, the auditors of the company, to report on the profit forecast.

**Required:**

i) Define the term "prospective financial information" and identify the main challenge which reporting on such information poses to auditors.
ii) Summarise the procedures that Kilonzo and Associates should carry out in order to be in a position to report on the profit forecast for the year ending 31 December 2005.

(b) The question of the auditor's responsibility for the detection and prevention of fraud is highly contentious. The past few years have seen an increase in both the incidence and scale of corporate fraud, while the question of third party liability has also not be conclusively settled by case law.

**Required:**
Explain the procedure you would follow as an auditor in a fraud investigation.

*JUNE 2005 QUESTION THREE*

**QUESTION 13**
You have recently been appointed auditor of UPS Hotels Ltd., a company which owns and runs a number of hotels. The company has an established internal audit department whose staff operate form the head office and visit the hotels.

Each hotel has a computer which records the bookings of rooms for overnight accommodation and produces the billing account for each guest.

**Required:**
(a) List and briefly describe the work you would expect to be carried out by the internal audit staff of UPS Hotels Ltd.
(b) Describe the factors you would consider and the work you would perform to enable you assess the extent to which you could rely on the work of the internal auditors.
(c) Assuming that you conclude that the work of the internal audit department's reliable, describe the effect this would have on your audit work.

*JUNE 2005 QUESTION FIVE*

**QUESTION 14**
You are the audit manager at Zainabu and Associates responsible for the audit of the books of account of Ziwani Spares Ltd. in the course of the audit of the financial statements for the year ended 30 June 2004, your preliminary evaluation of the internal controls indicated that reliance could be placed on the system. However, compliance tests carried out during the audit disclosed that the system was not operating effectively. This situation has necessitated various amendments and additions to your original audit plan.

**Required:**
Describe the changes to be effected:
a) During the interim audit.
b) After the end of the financial year.

*DECEMBER 2004 QUESTION TWO*



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**QUESTION 15**
Mwebeni Manufacturing Ltd. which has several branches in Kenya is proposing to install a new computer system. The finance director has asked you to suggest the controls which should be exercised over access to the computer system from remote terminals. All accounting data will be input into the computer from terminals and data from the branches transmitted to the main computer through the national telephone system.

**Required:**
a) Describe the general controls which may be established to prevent unauthorized access to the computer system from the remote terminals. Your answer should consider the effectiveness and limitations of each type of control.
b) Describe the additional procedures which could be exercised to prevent unauthorized access to the computer system through the national telephone system.
c) Briefly describe the controls which should be implemented in the accounts payable and payroll systems over:
   i) Retrieval of information.
   ii) Input of transaction data.
   iii) Updating of standing data files.

*DECEMBER 2004 QUESTION ONE*

**QUESTION 16**

Your firm is responsible for auditing the financial statements of HK manufacturing Ltd., a privately owned incorporated business, for the year ended 31 May 2004. The company operates from a single site. Its sales are Sh.380 million and the profit before tax is Sh.8,360,000. There are no inventory records so the inventory counts at the year end will be used to value the inventory in the financial statements. As Monday 31 May 2004 is a normal working day, it has been decided that the inventory should take place on Sunday 30 May 2004 when there is no movement of inventory.

The company has produced the following schedule to determine the value of inventory at 31 May 2004 from that counted on 30 May 2004.

| | Sh. | Sh. |
|---|---|---|
| Value of inventory – 30 May 2004 | | 44,326,772 |
| Add: Cost of goods received on 31 May 2004 | 833,644 | |
| Production ;labour on 31 May 2004 | 247,760 | |
| Overheads relating to labour at 120% | 297,312 | |
| | | 1,378,716 |
| | | 2,792,240 |
| Less: Cost of goods sold on 31 May 2004 | | 42,913,248 |
| Value of inventory at 31 May 2004 | | |

The company keeps basic accounting records on a microcomputer using a standard software package. The accounting procedures for sales, purchases and wages comprise:

1. Dispatch notes are raised by the shipping department when the goods are sent to customers. Sales invoices are produced from dispatch notes. Sales invoices are input into the computer which posts them to the accounts receivable ledger and the general ledger.

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2. When goods are received, a goods received note (GRN) is prepared, purchase invoices are matched with GRNs and purchase orders are authorized by the chief executive officer. After the purchase invoices have been authorized, they are input into the computer which posts them to the accounts payable ledger and the general ledger.
3. For the wages system, the hours worked by each employee are input into the computer which calculates the gross wage and deductions; PAYE, NSSF, NHIF and the net pay. All employees are paid weekly.

**Required:**

(a) The audit procedures you should perform to verify the accuracy of the inventory count:
(i) Before the inventory count, and
(ii) On the day of the inventory count
Your answers to parts (i) and (ii) above should include details of the matter you should record in your working papers for follow-up at the final audit.

(b) The substantive procedures you should perform to check the company's schedule as shown above which adjusts the value of inventory at 30 May 2004 so that at the company's year end of 31 may 2004.

You are required to verify the total value of inventory of Sh.42,913,248 at 31 May 2004. You are not required to describe the procedures necessary to verify the accuracy of the individual values of raw materials, work in progress and finished goods, as required on IAS 2 – inventories.

(c) The substantive procedures you should perform to check the purchases cut off at the year end.

*JUNE 2004 QUESTION THREE*

**QUESTION 17**

(a) The partner in charge of your audit firm has asked your advice on frauds which have been detected in recent audits.

The audited financial statements of a client, Lam Trading Ltd., were approved by shareholders at the Annual General Meeting on 3 June 2004. On 7 June 2004 the managing director of Lam Trading discovered a petty cash fraud by the cashier. Investigation of this fraud has revealed that it has been carried over a period of one year. It involved the cashier making out, signing and claiming petty cash expenses which were charged to motor vehicle expenses. No receipts were attached to the petty cash vouchers. The managing director signs all cheques for reimbursing the petty cash float. Lam Trading Ltd. has sales of about Sh.160 million and the profit before tax is about Sh.12 million. The accountant has prepared the draft financial statements for audit.

The partner in charge of the audit decided that no audit work should be carried out on petty cash. He considered petty cash expenditure was small, so the risks of a material error or fraud was small.

**Required:**

(i) Briefly state the auditor's responsibilities for detecting fraud and error in financial statements
(ii) Consider whether your firm is negligent if the fraud amounted to Sh.400,000
(iii) Consider whether your firm is negligent if the fraud amounted to Sh.1,600,000



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(b) The audit of directors' remuneration at Wick Enterprises Ltd., a limited company has confirmed that the managing director's salary is Sh.18 million per annum and that he is the highest paid director. However, a junior member of the audit team asked you to look at some purchase invoices paid by the company. Your investigations have revealed that the managing director has had work amounting to Sh.8 million carried out in his home, which has been paid by Wick Enterprises Ltd. The managing director has authorized payment of these invoices and there is no record of authorization of this work in board minutes. The managing director has refused to include the Sh. 8 million in his remuneration for the year, and to charge the financial statements. If you insist on qualifying your audit report on this matter, the managing director says he will get a new firm to audit the current year's financial statements. The company's profit before tax for the year is Sh.640 million.

Assuming the managing director refuses to amend the financial statements, you are required to:

(i) Consider whether the undisclosed remuneration is a material item in the financial statements
(ii) Describe the matters you will consider and the action you will take:
- To avoid replaced auditor, and
- If you are replaced as auditor, assuming the managing director owns 60% of the issued shares of Wick Enterprises Ltd.

(iii) Describe the matters you will consider and the action you will take to avoid being replaced as auditor assuming Wick Enterprises Ltd. is a listed company with an audit committee, and the managing director owns less than 1% of the issued shares.

*JUNE 2004 QUESTION FOUR*

**QUESTION 18**

You have been the auditor of Nairobi Super Furniture Ltd. for the last ten years. The company manufactures furniture for the local and export markets. The shares in Nairobi Super Furniture Ltd. whose year end is 31 December changed hands during the year, resulting in 74% of the shares now being owned by a company in Vienna (Austria).

The directors of Nairobi Super Furniture Ltd. have informed you that the audited financial statements must be delivered to the holding company in Vienna by 15 January 2004 for consolidation purposes. The year end of the holding company in Vienna is also 31 December. You are currently planning your audit.

**Required:**
State the actions to be taken to perform the assignment within the time restriction. Discuss this in terms of:
(a) Steps to be taken by the client
(b) Steps to be taken by the auditor

*DECEMBER 2003 QUESTION ONE*



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**QUESTION 19**

Your friend Cosmas Chege was recently appointed managing director of Triple M. Ltd. Cosmas is a marketing specialist and has frequently requested for your assistance in regard to financial matters. He is aware of the importance of sound internal controls and has asked you to advise him in regarding the internal controls at Triple M. Ltd.

He has provided you with the following details:

1. The company purchases and sells various consumer products which are stored at its warehouse in Athi River town.
2. The warehouse is surrounded by an electric fence with only one entrance which is permanently manned by a security guard.
3. All sales are on credit and are made by sales representatives who travel throughout the country.
4. Goods are delivered by the company's own fleet of vehicles.
5. The company employees the following staff
   - A sales director and his assistant
   - 14 sales representatives
   - A stores manager and 10 stores assistant
   - 7 drivers
   - A credit controller and her assistant
   - 2 invoicing clerks
   - A financial director and 3 accounting staff
   - An operations director and 3 buyers
   - A security manager and 6 security personnel
6. All transactions are recorded on the following pre-printed, pre-numbered documents
   - Sales orders
   - Delivery notes
   - Credit notes
   - Sales invoices
   - Purchase orders
   - Goods received notes
7. Monthly management accounts incorporating comprehensive financial reports are presented by the financial director.

You have agreed to assist Cosmas and have decided to commence with the sales system. You have already explained:

(i) The necessity for proper segregation of duties, and
(ii) That the accounts receivable ledger and general ledger should be properly controlled, monthly statements should be sent out timeously, and proper financial reports including age analyses, relating to accounts receivable should be prepared regularly and circulated properly.

**Required:**
Describe a suitable system of interest control over credit sales. Do not deal with the aspects dealt with in (i) and (ii) above.

*DECEMBER 2003 QUESTION TWO*





**QUESTION 20**

Your staff have recently completed the fieldwork in respect of the audit of Craig Ltd. for the year ended 30 September 2003. You have been the company's auditors since inception.

The entire share capital has been held by Mr. G. Craig since incorporation. While working on the audit of your assistant discovered a file which appeared to indicate that substantial money in respect of cash sales had not been recorded in the accounting records and were also not included in turnover per the company's VAT returns.

Your assistant found this quite disturbing as, in addition to the audit, your firm assists Mr. Craig with the VAT returns and completes both the company's tax returns and Mr. Craig's personal returns.

Mr. Craig admitted to your assistant that he has for some years followed the practice of 'pocketing' most of the cash sales of the company. Mr. Craig was reluctant to discuss the matter in detail although he did not make it clear that he felt that Craig Ltd. was his company and that the auditors should not 'dig too deeply'. Besides the 'company makes a healthy profit and already pay too much tax'.

**Required:**
(a) Discuss the attitude you could adopt and the action, if any, you would take in the circumstances.
(b) Explain how your answer in (a) above would differ if your firm was doing the audit for the first time
(c) Explain your response if Mr. Craig were to ask for your immediate resignation

*DECEMBER 2003 QUESTION FIVE*

**QUESTION 21**
The Chief Executive of Modern Supermarkets Ltd., a large supermarket chain, is concerned about the controls in the company's computerized purchases ledger by the purchases accounting department, and the computer automatically raises the cheque when the invoice is due for payment. The relevant information with regard to payment by cheque is as follows:

1. For payment under Sh.5,000 per printed cheques are used and no further authorization of the cheque is required, as the authorized signature is included in the preprinted cheque.
2. For payments above Sh.5,000 but below Sh.50,000 an authorized person is required to initial the cheque.
3. For payments over Sh.50,0000 an authorized signatory must sing the cheque.

**Required:**
Describe the controls which should be in operation to prevent fraud and error in the company's purchases system in relation to:
(a) Controls to ensure that only authorized purchase invoices and credit notes are posted to the purchase ledger.
(b) Controls over the addition, amendment and deletion of suppliers from the suppliers' list and ensuring that only authorized suppliers are on the standing data file.
(c) Controls over the cheque payments and the custody of the cheques.

*JUNE 2003 QUESTION FIVE*

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**QUESTION 22**

Your firm is the external auditor of Highland Tea Growers Company Ltd, one of the largest tea growing and manufacturing companies in Kenya and indeed, in Africa, Highland Tea Growers Company Ltd does not have an internal audit department.

At the interim audit you have been assigned to the audit of the wages system. This will involve obtaining an understanding of the wages system, testing the controls and performing substantive procedures in order to verify wages transactions.

The wages records are maintained on a computer and all the wages information is processed at the head office. Some of the employees are paid in cash and all other employees have their wages paid directly into their bank accounts.

Head office and manufacturing employees are paid their wages a week in arrears. All other employees are paid at the end of each week or month.

There is a personnel department, which is independent of the wages department. The personnel department maintains records of the employees including their start date, grade, current wage rate and leaving date (if appropriate.

Previous year's audits have revealed frauds by the wages department staff, which have been facilitated by weaknesses in controls in the wages system. These frauds have included:

1. Paying employees after appointment but before they commenced work.
2. Paying employees after they have left employment, and
3. Paying fictitious employees.

A check of current controls in the wages system has revealed that the company has failed to institute controls to prevent these types of fraud recurring. So the audit programme requires extensive substantive procedures to be carried out to ensure that recorded wages transitions have not been mis-stated by similar frauds taking place in the current year.

The existence of employees at the head office site can be verified by physical inspection. From a cost effectiveness point of view, only a small sample of plantations will be visited. The audit manager has asked you to consider the audit procedures you would carry out to obtain sufficient and appropriate evidence of the existence of employees at the plantations not visited by the audit staff.

The audit manager has explained that "unclaimed wages" (in part (c) below) arise when employees are not present to collect their wages at the time of payment. The unclaimed wage packets are given to the cashier who records their details in the unclaimed wages book and is responsible for their custody. Any employees who have not received his/her wage packet at the payout can obtain it from the cashier. You have ascertained that there is no system of checking the operation of the unclaimed wages system by a person independent of the cashier and the wages department.

You are required to describe:

(a) How you would verify that employees are not paid before they have commenced employment or after they have left (a starters and leavers test).
(b) The audit procedures you would carry out in connection with attending a payout of wages in cash to the employees.
(c) The substantive checks of transactions you would carry out on the unclaimed wages system.





(d) The evidence you would obtain to verify the existence of employees whose wages are paid directly into their bank accounts.

*DECEMBER 2002 QUESTION ONE*

**QUESTION 23**

AZ Ltd is a large public construction company with annual sales of Sh 25 billion and its draft income statement shows a profit from operations for the year-ended 30 September 2002 of Sh 3 billion. This is the first audit by your audit firm. Inquiry of the previous auditors revealed no reasons for concern. On completing the audit work at the company's premises, the audit senior has drafted a memo extracts from which are reproduced below:

**1. Inventory valuation**

Inventories include Sh 525 million at cost of scrap rubber. This material is widely used as a road surface in other countries. Contracts for road building with this country's Ministry of Construction, the state authority for road construction does 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. AZ Ltd speculated on a favorable outcome of the review and purchased the material. In November 2002, shortly before the financial statements were approved by the directors, the ministry of construction reported that it would not currently accept the use for this material. If used on non-ministry of construction contracts, the materials net realizable value would not exceed Sh150 million. The chief financial officer maintains that as the Ministry of Construction's report was issued after the balance sheet date, the write down of the inventory should be reflected in the next period's financial statements.

**2. Depreciation**

In 1998, the company purchased two computer controlled earthmovers at a cost of Sh188 million each and a further two at the same price in 1999. Depreciation has been provided at 10% per annum straight line, the same basis as it previously depreciated conventional earthmovers.

This year, 2002, the company decided that improvements in technology made it worthwhile scrapping the first two computer controlled earthmovers and replacing them with the latest model at a cost of Sh 300 million each. 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. The chief financial officer claims that the depreciation rate of 10% is in the line with industry standards and reflects the physical life of the machines. He argues that continued improvements in technology cannot be foreseen and that there is no justification for increasing deprecation to 20% per annum because of the possibility of technological obsolescence.

**3. Contingent liability**

The company is being sued for Sh 4 billion by the Ministry of Construction for defective work on a recently completed road. The company maintains that it met the ministry's construction's specifications and that it is the Ministry's engineers who are at fault in drawing up the specifications. AZ ltd 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 chief executive officer has admitted that the company's road



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building techniques are under investigation by the Ministry of construction. If the company were to lose the case, its future as a going concern would be threatened.

**Required:**
Explain the effect of each of the three matters, namely: inventory valuation, depreciation and contingent liability (i) on the financial statements and (ii) if the company were to refuse to amend the financial statements on the auditor's report.

*DECEMBER 2002 QUESTION FOUR*

**QUESTION 24**

You are the auditor of Fixit Ltd. The company consists of a head office and a chain of 200 shoe repair and key-cutting kiosks. These kiosks are located in supermarkets and shopping centers and each is run by a single staff member who repairs shoes and cuts keys while customers wait.

In an attempt to increase turnover, Fixit Ltd recently advertised that all workmanship in the kiosks would be guaranteed for three months. However, this additional service has not resulted in the expected additional sales. Management believe incremental revenue is being misappropriated by certain kiosk operators.

In addition, it has come to your attention that various components, namely heels, soles and keys are being removed from kiosks by certain operators and sold to competitors. Instances have also been found where operators regularly repair shoes for friends without charging them.

Although each kiosk has a register, controls and procedures in the chain are currently weak and head office management has asked for your advice on desirable internal control procedure.

**Required:**

Detail the internal control procedure you would expect to find that would provide adequate control over:
(a) Cash sales
(b) Stock

*JUNE 2002 QUESTION ONE*

**QUESTION 25**

Rural and Urban Housing Ltd is a large company whose main activities relate to the house building market. Your firm has audited Rural Urban Housing Ltd for several years. During the audit for the year ended 30 September, the audit manager has come across two items he feel require discussing with the audit engagement partner. Details of the relevant items are:

During statistical testing of delivery notes, an observant audit assistant had noticed that the delivery address of several items of purchased materials was that of the managing director. Using the costing records, these materials were traced to Job Spoo l which was the construction of a swimming pool. No sales invoice had been raised for this job. On investigation the audit manager discovered that the job was the construction of a "demonstration" swimming pool which prospective purchasers could view. It





had been included in Rural and Urban Housing Ltd's balance sheet as a fixed asset. The maintenance and running costs of the pool have been charged to the profit and loss account as promotion and selling costs.
Several large payments have been made to unidentified agents and described as commissions in respect of obtaining building contracts. Most of these payments have been made in cash, some of which were in foreign currencies. However, the name of a nominee and the beneficiary cannot be identified. There is no supporting documentation for any of the payments. The finance director of Rural and Urban Housing Ltd has said that such commissions are common practice and the agents represent valuable contacts whose identity must be kept confidential as otherwise Rural and Urban Housing Ltd's competitors would be able to "poach" work from them.

**Required:**
As the engagement partner for the audit of Rural and Urban Housing Ltd, discuss the matters you would consider including any further inquiries you would make in determining the appropriate treatment of:
a) Job Spoo l
b) The payments of the commissions

*DECEMBER 2001 QUESTION ONE*

**QUESTION 26**
Your firm is the auditor of Global foods ltd, which supplies a wide range of imported foods to supermarkets and stores from two large depots in Nairobi. The company employs 300 people and has a turnover of Sh 3 billion. The accounts department uses a maintenance computer for all the accounting records except for stock control, which is maintained manually on a card system at each depot. Deliveries are made to customers by the company's fleet of lorries and vans.

After ascertaining and recording the system of internal control you have decided that you wish to place reliance on the controls in many areas. The results of your substantive tests on the system of controls on purchases and stocks reveal that:

1. Out of 100 purchase invoices selected for inspection, 2 could not be found and 2 were not initialed as checked and approved for payment.
2. Out of 120 stock cards inspected, 4 contained an instance where the delivered quantity had been altered by a significant amount.
3. One supplier is regularly paid before supplies are delivered on the basis of pro forma invoices, which are processed through the purchase ledger system on receipt so as to initiate the necessary payments.

No other exceptions were noted.
**Required:**
(a) Specify what further procedures you would adopt in order to be able to reach a conclusion on whether the company's system of control can be relied upon, indicating what factors you would consider in reaching your conclusion.
(b) State the reasons why you would report to management, in writing, significant weakness in internal control and the principal limitations on the use of such a report.

*JUNE 2001 QUESTION ONE*

**QUESTION 27**
You are the auditor of Nairobi Motor spares ltd, a private company which wholesales parts for cars and vans. You have completed the fieldwork for the year onded 30 April 2001 and have identified the following three outstanding issues.



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1. Nakuru Motor Spares Ltd has been a customer of Nairobi Motor Spares Ltd. At 30 April 2000, the previous year-end, the amount due from Nakuru Motor Spares Ltd was Sh 22,400,000 out of total trade debtors of Sh 145,600,000. Nakuru Motor Spares Ltd is slow payer but places frequent orders with Nairobi Motor Spares Ltd. Although the amounts due at 30 April 2002 were settled in the year to 30 April 2001, further supplies have increased the balance on Nakuru Motor Spares ltd's account to Sh 35,840,000 at 30 April 2001. Nairobi Motor Spares ltd informs you that it has recently obtained a floating charge on the stock of Nakuru Motor Spares ltd and the client therefore believes no provision is required at 30 April 2001.
   On comparison of the physical count with computerized book stock records at 30 April, many individual unders and overs have been identified, some of which are large in terms of quantities and values. The client has explained, that because there are several thousand limes and many parts are similar in description and size, mistakes easily occur and the unders and overs are, therefore, the result of errors in description or categorization. Accordingly, the client is satisfied that this is not a matter of concern and proposes to make adjustment to the book stock figure.

3. Stock has risen substantially over the 12 months to 30 April 2001 and the client is unable to provide a satisfactory overall explanation. An analysis of the increase would require an extensive line-by-line review, which the client is unwilling to do because of the number of lines in stock. The managing director suggests that bulk-buying opportunities offered at attractive prices account for a good part of the stock increase. The client's computer system generates a document called an "old stock listing" which the audit staff has used to assess stock provisions. It is produced annually at the year-end by a special software routine. The old stock listing identifies only those stock lines not moving at all during the last six months of the year and shows a 25% increase on the previous year in the total value of such items. No further ageing information is produced. The client has based the stock provision on items included in the "old stock listing".

**Required:**
In respect of each of the above three issues, state what further evidence you would seek in order to reach a conclusion upon the accounting treatment to be adopted in the financial statements of Nairobi Motor Spares ltd at 30 April 2001.

*JUNE 2001 QUESTION TWO*

**QUESTION 28**
Commercial Sales Ltd. was a growth-oriented company that was dominated by its managing director, Mr. A Chongo. The company sold quantity music systems direct to the public. A large number of sales person were employed on a commission only basis. The music systems were sent to the sales agents who then sold them direct to the public using telephones sales techniques. The music systems were sent to the sales agents on a sale or return basis and commercial sales ltd. recognized the sale of the equipment when it was received by the sales agents. Any returns of the music systems were treated as repurchases in the period concerned.

The company enjoyed a tremendous growth record. The main reasons for this expansion were as follows:
Mr. A Chongo falsified the sales records. He created several fictitious sales agents who were responsible for 25% of the company's turnover.
At the year end, Mr. Chongo dispatched nearly all of his stock of music systems to the sales agents and repurchased those that they wished to return after the year end.





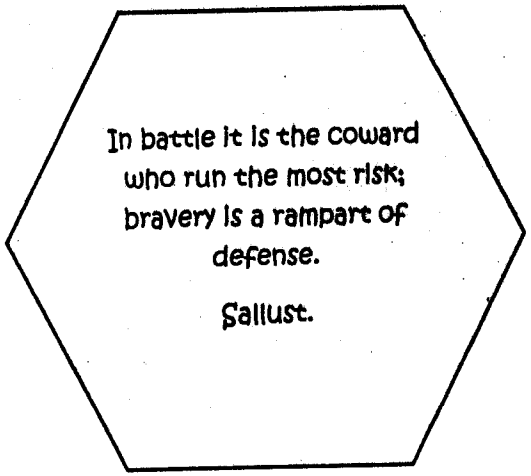
Twenty percent of the cost of sales were capitalized. This was achieved by the falsification of purchase invoices with the co-operation of the supplier company. Suppliers furnished the company with invoices for fixed assets but supplied music systems.
The directors of the company enjoyed a bonus plan linked to reported profits. Executives could earn bonuses ranging from 50% to 75% of their basic salaries. The directors did not query the unusually rapid growth of the company and were unaware of the fraud perpetrated by Mr. A Chongo.

Mr. A Chongo spent large sums of money in creating false records and bribing accomplices in order to conceal the fraud from the auditors. He insisted that the auditors should sign a 'confidentiality' agreement which effectively precluded the auditors from corroborating sales with independent third parties and from examining the service contracts of the directors. This agreement had the effect of preventing the auditors from discussing the affairs of the company with the sales agents.

The fraud was discovered when a disgruntled director wrote an anonymous letter to the Nairobi Stock Exchange concerning the reasons for Commercial Sales Ltd.'s growth. The auditors were subsequently sued by a major bank that had granted a loan to Commercial Sales Ltd. on the basis of interim accounts. These accounts had been reviewed by the auditors and a review report issued.

**Required:**
a) Explain the key audit tests would normally ensure that such a fraud as that perpetrated by Mr. A Chongo would be detected.
b) Discuss the implications of the signing of the 'confidentiality' agreement by the auditors.
c) Explain how the 'review report' issued by the auditors on the interim financial statement differs of its level of assurance from the auditors' report on the year end financial statements.
d) Discuss whether you think that the auditor is guilty of professional negligence in not detecting the fraud

*DECEMBER 2000 QUESTION THREE*



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# TOPIC 6

## REVIEW OF AN AUDIT

**QUESTION 1**

(b) International Standard on Auditing (ISA) 570: 'Going Concern' provides examples of events that, individually or collectively, may cast significant doubt on the going concern assumption.

Summarise the possible financial indicators of going concern problems.

*JUNE 2012 QUESTION FIVE B*

**QUESTION 2**

You are the engagement partner responsible for the audit of Newton Company Ltd (NCL), a company whose financial year end is 31 July. The company is a private owned entity and has been in operation for over five years. The company has been profitable except for the last two years when it began incurring losses as well as high interest costs. The losses were due to increased borrowing to finance additional assets. The company has continued to incur operating losses during the current year.

The extract from the May 2011, management account and the 2010 audited annual financial statements are as follows:

| Income statements for | 10 months to 31" May 2011 | 12 months ended 31st July 2010 (Audited) |
|---|---|---|
| | Shs. "000" | Shs. "000" |
| Operating loss before interest | 96,000 | 50,400 |
| Interest expenses | 38,400 | 28,800 |
| Net loss | 134,400 | 79,200 |
| Accumulated loss brought forward | 91,200 | 12,000 |
| Accumulated loss carried forward | 225,600 | 91,200 |

| Statements of financial position for: | Notes | 10 months to 31" May 2011 Shs. "000" | 12 months ended 31st July 2010 (Audited) Shs. "000" |
|---|---|---|---|
| Non-current assets | 2 | 264,000 | 300,000 |
| Current assets: | | | |
| Inventory | | 96,000 | 84,000 |
| Accounts receivable | | 72,000 | 60,000 |
| | | 168,000 | 144,000 |
| Current liabilities | | | |
| Bank overdraft | 3 | 72,000 | 67,200 |
| Accounts payable | | 225,600 | 108,000 |
| | | 297,600 | 175,200 |





| | | | |
|---|---|---|---|
| Net current liabilities | | (297,600) | (31,200) |
| Total assets | | 134,400 | 268,800 |
| Equity and liabilities: | | | |
| Ordinary share capital | | 240,000 | 240,000 |
| Accumulated loss | | (225,600) | (96,200) |
| | | 14,400 | 148,800 |
| Loss term borrowings | 1 | 120,000 | 120,000 |
| | | 134,400 | 268,800 |

Notes:

1. Long term borrowings are from Equality Bank Ltd. And are secured by a mortgage over land and building and a pledge of book debts. Interest is charged at 22% per annum. These borrowings fall due for repayment on 31st January 2012. The company is currently negotiating with Equity Bank Ltd to replace the borrowing with a five-year loan.
2. Non-current assets comprise:
   (i) Land and buildings purchased in J 990 at a cost of Shs. 36 million (2011: Shs 36 million).
   (ii) Plant and machinery with a net book value of Shs. 228 million (2011: Shs264 million).
3. The bank overdraft is unsecured. On 1June 2011, the directors sold under-performing plant and machinery with a net book value of Shs. 108 million for shs. 48 million. The loss of sh60 million on the sale of the plant and machinery resulted in a shareholder's deficit at 1st June 2011 of Shs. 45,600,000.
   The managing director is confident that although it is unlikely that there will be any material change in the financial position of the company before the financial year end, the company will return to profitability in the new financial year as certain large new contracts have been secured. In addition, interest payable will be reduced by the injection of the Shs, 48 million from the sale of the assets. The managing director is however concerned about the shareholder's deficit and requests your opinion on the matter.

**Required**

(a) Advise the management NCL on the measures that could be taken to improve the financial position of the company.
(b) Evaluate the additional information you would require to support the managing director's comment that the company will return to profitability.
(c) Consider the form of audit opinion you would issue on the financial statements of NCL if you conclude that the company is experiencing going concern problem under the following circumstances.
   (i) The financial statements give sufficient disclosure of the going concern problems
   (ii) There is no disclosure of the going concern problem in the financial statements and you believe there is a serious risk that the company will fail in the foreseeable future.

*DECEMBER 2011 QUESTION FIVE*

**QUESTION 3**

Your client Birnba Ltd. Sells machines subject to a warranty of one year included in the statement of financial position of Bimba Ltd. as at 30 April 20 II is a warranty provision of Sh 300,000,000 (20 10:



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Sh 290,000,000 the managing director who owns 60% of the shares of the company estimates the cost of repairing detective machinery reported by customers. The estimates from the managing director form the basis of the warranty provision.

This is your first year as the auditors of Bimba Ltd whose turnover is Sh 15 billion for the year 2011 compared to Sh 13 billion for the year 2010.

**Required:**

Explain the audit procedures that should be performed during the final audit in respect of the estimated warranty provision included in the statement of financial position of the company as at 30 April 2011.

*JUNE 2011 QUESTION FOUR A*

**QUESTION 4**

You are the audit manager at Niche Electronics Limited (NEL), a local private company which sells television sets, fridges, digital video disks (DVDs) and similar products through its two division mail order division and on-line ordering on the internet division. Nelia a new audit client of your firm of auditors

You are commencing the planning of the audit for the year ended 31 October 2009. In an initial meeting with the directors of the company you have been provided with the following information:

1. The directors plan to expand the range of goods sold through the internet division to include toys and fashion clothes. The directors believe that when one product has been sold on the internet, then any other product could also sell through the internet.
2. The company's turnover is in excess of Sh.96 million with net profits ofSh.8.2 million. All profits are currently earned in the mail order division, although the internet division is expected to return a small profit during the year ending 31 October 2010. Sales revenue is growing at the rate of 15 % per annum. However, the net profit has remained almost the same for the last four years.
3. The accounting systems used in recording sales by the mail order division is relatively old.
4. It relies heavily on manual input to transfer orders received into NEL's computer systems. Recently errors have occurred in the input of orders and in invoicing of goods following dispatch. The directors maintain that the errors were negligible and the information produced by the current accounting system is reliable. The company has not employed a qualified accountant.
5. The directors estimate that their expansion plans will require a bank loan of approximately Sh. 16 million partly to finance the enhanced website and also to provide working capital to increase inventory levels. A meeting with the bank has been scheduled for three months after the year end. The directors expect an unqualified auditor's report to be signed prior to this meeting.

**Required:**

Explain the audit procedures you would perform in order to form an opinion on whether Niche Electronics Limited was likely to remain a going concern.

*DECEMBER 2009 QUESTION THREE B*



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**QUESTION 5**

The International Auditing Practices Committee requires that doubts about the going concern presumption be detected and adequately disclosed in the financial statements and auditors' reports.

**Required:**

a) Explain the term "going concern" ill relation to the preparation of financial statement.
b) Describe the audit procedures the auditor should undertake in order to obtain sufficient audit evidence to be able to form an opinion on the going concern status of the company.
c) List six factors which might cast doubt on the going concern status of a company.
d) Discuss briefly how the present responsibilities of the auditor regarding the going concern status of company could be extended.

*DECEMBER 2004 QUESTION THREE*

**QUESTION 5**

You are auditing the financial statements of Twendelee Trading Co Ltd., a listed company, for the year ended 31 October 2002. The audit assignment partner has asked you to consider the auditors responsibilities for identifying subsequent events. Also, he has asked you to describe the audit procedures, which examine subsequent events. He has suggested that an example of one point in answer to part (b) below would be:

"Checking accounts receivable cash, received after the year-end to determine the realizability of accounts receivable balances at the year-end and highlight doubtful balances on the accounts receivable ledger".

The detailed audit work was completed on the morning of Friday 6 December 2002. It is proposed that:

1. The audit report is signed on Friday 20 December.
2. The financial statements are sent to shareholders on Monday 6 January 2003.
3. The company's annual general meeting will be held on Wednesday 29 January 2003. At this meeting the shareholders will vote to approve the financial statements.

**Your are required to:**

(a) Consider the auditor's responsibilities for detecting material subsequent events in the periods:
i) 31 October to 6 December 2002.
ii) 6 December to 20 December 2002
iii) 20 December 2002 to 6 January 2003
iv) 6 January 2003 to 29 January 2003
v) After 29 January 2003.

(b) List and briefly explain audit procedures, which involve examination of subsequent events.
(c) Describe the work you will carry out in period (a) (ii) above

*DECEMBER 2003 QUESTION THREE*

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**QUESTION 7**

(a) List the factors and explain reasons why these factors may indicate that a company may not be going concern
(b) Describe any further investigations you would carry out to decide:

(i) Whether the company is a going concern and
(ii) Whether it has a reasonable chance of recovering from the going concern problems.

Your answer should include details of checks you would carry out in verifying the company's profit and cash flow forecasts

*JUNE 2002 QUESTION TWO*

**QUESTION 8**

"The management letter is a form of report by external auditors to the management. This report which in some respects is a report on the ability and effectiveness of management is useful to shareholders as the financial statements and should be distributed to the shareholders not just to management themselves."
**Required:**

Discuss the merits and demerits of this proposition. How does it compare to the current practice?

*JUNE 2001 QUESTION FIVE*

**QUESTION 9**

Vintage Villas Ltd. operates five holiday centers on freehold sites in Kenya. The company's financial statements for the year ended 30 April 2000 disclose total turnover of 456 million and net profit before taxation of Sh.50,400,000. The following matters have arisen for your audit work on these financial statements:
Costs of brochures and advertising of Sh.15,840,000 relating to the year ended 30 April 2000 for the peak season have been carried forward in the balance sheet as a prepayment.
Bar stocks at one of the holiday centers were not physically counted on 30 April 2000 but were estimated by the bar manager at Sh.840,000 based on the previous physical stocktaking at 31 March 2000 which disclosed a value of Sh.768,000. Sales during the month of April amounted to Sh.1,320,000. The subsequent physical stocktaking took place on 31 May 2000. using the estimated value on 30 April 2000, a review of the trading results for the month of April and May disclosed a gross profit percentage of 60% and 39% respectively, compared with an average of 46% for the other eleven months of the year.
The manger of each holiday center is responsible for paying casual labour employed during the six peak holiday weeks and for the shorter periods at other times of the year. These payments are made in cash and amount to approximately Sh.4,800,000 per center for the year, but no receipts or vouchers are available apart from the weekly lists of payments signed by each manager. However all necessary PAYE and NSSF requirements have been complied with in respect of such payments.
Provisions for liabilities and charges include a provision for future maintenance of Sh.24.000,000 representing one third of the estimated cost of totally renovating all building in the holiday centers. During February each year, one third of the properties on each side is fully renovated.





**Required:**
Comment on the further considerations required of each of the above matters in order to conclude the audit and to indicate the possible effects on the audit report.

*JUNE 2000 QUESTION THREE*

**QUESTION 10**

a) ISA 570 going concern provides guidance to auditors in respect of ensuring that an entity can continue as a going concern.

**Required**
Explain the actions that an auditor should carry out to try and ascertain whether an entity is a going concern.

**QUESTION 11**

a) ISA 580 Subsequent Events explains the audit work required in connection with subsequent events.
**Required**
List the audit procedures that can be used prior to the auditors report being signed to identify events that may require adjustment or disclosure in the financial statements.
b) You are the auditor of OilRakers, a limited liability company which extracts, refines and sells oil and petroleum related products.
The audit of OilRakers for the year ended 30 June 20X5 had the following events:

| Date | Event |
|---|---|
| 15 August 20x5 | Bankruptcy of major customer representing 11% of the trade receivables on the statement of financial position. |
| 21 September 20x5 | Financial statements approved by directors. |
| 22 September 20x5 | Audit work completed and auditors' report signed. |
| 1 November 20x5 | Accidental release of toxic chemicals into the sea from the company's oil refinery resulting in severe damage to the environment. Management had amended and made adequate disclosure of the event in the financial statements. |
| 23 November 20x5 | Financial statements issued to members of OilRakers. |
| 30 November 20x5 | A fire at one of the company's oil wells completely destroys the well. Drilling a new well will take ten months with a consequent loss in oil production during this time |

**Required**
For each of the following three dates:
- 15 August 20x5
- 1 November 20X5; and
- 30 November 20x5.

(i) States whether the events occurring on those dates are adjusting or non-adjusting according to IAS 10 Events after the reporting period, giving reasons for your decision.
(ii) Explain the auditor's responsibility and the audit procedures that should be carried out.



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## QUESTION 12

(a) Define the going concern assumption.
(b) Medimade Co is an established pharmaceutical company that has for many years generated 90% of its revenue through the sale of two specific cold and fl n remedies. Medimade has lately seen a real growth in the level of competition that it faces in its market and demand for its products has significantly declined. To make matters worse, in the past the company has not invested sufficiently in new product development and so has been trying to remedy this by recruiting suitably trained scientific staff, but this has proved more difficult than anticipated.
In addition to recruiting staff the company also needed to invest $2m in plant and machinery. The company wanted to borrow this sum but was unable to agree suitable terms with the bank; therefore it used its overdraft facility, which carried a higher interest rate. Consequently, some of Medimade's suppliers have been paid much later than usual and hence some of them have withdrawn credit terms meaning the company must pay cash on delivery: As a result of the above the company's overdraft balance has grown substantially.
The directors have produced a cash flow forecast and this shows a significantly worsening position over the coming 12 months.
The directors have informed you that the bank overdraft facility is due for renewal next month, but they are confident that it will be renewed. They also strongly believe that the new products which are being-developed will be ready to market soon and hence trading levels will improve and therefore that the company is a going concern. Therefore they do not intend to make any disclosures in the accounts regarding going concern.

**Required:**
i) Identify any potential indicators that the company is not a going concern and describe why these could impact upon the ability of the company to continue trading on a going concern basis.
ii) Explain the audit procedures that the auditor of Medimade should perform in assessing whether or not the company is a going concern.
iii) The auditors have been informed that Medimade's bankers will not make a decision on the "overdraft facility until after the audit report is completed. The directors have now agreed to include going concern disclosures.

**Required:**
Describe the impact on the audit report of Medimade if the auditor believes the company is a going concern but a material uncertainty exists.

## QUESTION 13

Smithson Co provides scientific services to a wide range of clients. Typical assignments range from testing food for illegal additives to providing forensic analysis on items used to commit crimes to assist law enforcement officers.
The annual audit is nearly complete. As audit senior you have reported to the engagement partner that: Smithson is having some financial difficulties. Income has fallen due to the adverse effect of two high-profile court cases, where Smithson's services to assist the prosecution were found to be in error. Not only did this provide adverse publicity for Smithson, but a number of clients withdrew their contracts.


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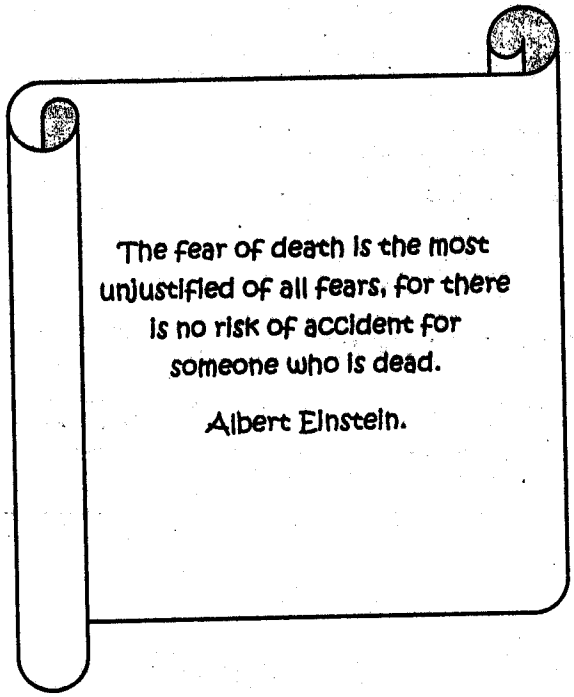
A senior employee then left Smithson, stating lack of investment in new analysis machines was increasing the risk of incorrect information being provided by the company
A cash flow forecast prepared internally shows Smithson requiring significant additional cash within the next 12 months to maintain even the current level of services. Smithson's auditors have been asked to provide a negative assurance report on this forecast.

**Required**
(a) Define going concern and discuss the auditor's responsibilities in respect of going concern.
(b) State the audit procedures that may be carried out to try to determine whether or not Smithson Co is a going concern.
(c) Explain the audit procedures the auditor may take where the auditor has decided that Smithson Co is unlikely to be a going concern.
(d) In the context of the cash flow forecast, define the term 'negative assurance' and explain how this differs from the assurance provided by an audit report on statutory financial statements.





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# TOPIC 7

## AUDITORS REPORT

**QUESTION 1**

You are the audit manager assigned to the audit of Plasma Industrial Products Limited. You are reviewing the working papers with respect to the financial statements of the company for the year ended 31 March 2011, including the directors' report and the chairman's statement.

Meanwhile, on 15 April 2011, one of the customers of the company who owed Sh.3.6 million as at 31 March 2011 was adjudged bankrupt.

The reported profit before tax for the company for the year ended 31 March 2011 was Sh.IS million while trade receivables as at 31 March 2011 amounted to Sh.84 million.

The directors of the company have advised you that they would not amend the financial statements to provide for bad debts of Sh 3.6 million.

**Required:**

a) Explain the responsibilities of the auditors with respect to:

i) Financial statements of Plasma Industrial Products Limited.
ii) Information contained in the directors' report and the chairman's statement.

b) Discuss the actions that the auditors should take if they consider the financial statement to be inconsistent with directors' report and the chairman's statement.
c) Justify the form of audit report you would issue to the members of Plasma Industrial Products Limited for the year ended 31 March 2011.

*JUNE 2011 QUESTION FIVE*

**QUESTION 2**

c) With reference to International standard on Auditing 700, The Auditor's Report on Financial Statements:

i) Explain two circumstances under which an auditor may not be able to express an unqualified opinion on a matter whose effect is or may be material to the financial statement.
ii) Describe the two types of audit reports that may be expressed by the auditor in each of the circumstances explained in (c) (i) above.

*DECEMBER 2009 QUESTION THREE C*





**QUESTION 3**

a) You are the Audit manager of Mariana and Associates, a firm of Certified Public Accountants. You are reviewing the proposed audit reports for two of your clients, alpha Ltd. and Deema Ltd. whose financial year end was 30 June 2009, submitted by the Audit Senior.

The following are some matters relating to the two clients:

**Alpha Ltd**

Alpha ltd., a company listed on the stock exchange, permanently closed several factories in May 2009, with all costs of closure finalised and paid in June 2009 all the Factories produced the same item, which contributed 10 % of Alpha ltd. 's total revenue tor the year ended 30 June 2009(2008 - 23%).The closure has been disclosed accurately and fully in the chairman's statement and directors report. However the disclosure is not mentioned in the notes to the financial statements nor separately disclosed in the financial statements.

The audit senior has proposed an unmodified audit opinion for Alpha Ltd. as the matter has been fully addressed in the chairman's statement and directors' report.

**Deema Ltd.**

In July 2009, a legal claim was filed against Deema ltd. a retailer of toys. The claim is from a customer who slipped on a greasy step outside one of the retail outlets. The matter has been fully disclosed as a material liability in the notes to the financial statements. The audit working papers provide sufficient evidence that no provision is necessary as Deema Ltd., have stated in writing that the likelihood of the claim succeeding is remote. The amount of the claim is fixed and is adequately covered by cash resources.

The Audit senior proposes that the audit opinion for Deema Ltd. should not be qualified, but that an emphasis of matter paragraph should be included after the opinion to highlight the situation.

**Required:**

i. Explain the circumstances under which an auditor may issue a qualified opinion.
ii. Describe the various types of qualified audit opinions.
iii. With respect to the proposed audit reports for Alpha Ltd and Deema Ltd., discuss the appropriateness of the proposed report and recommend amendments as appropriate.

*AUGUST 2009 QUESTION FOUR A*

**QUESTION 4**

Reports produced by internal auditors are different from audit reports produced by external auditors performing audits under international Standards on Auditing. The reports are produced for different purposes, and are directed at different users. They differ substantially in both lot.in and content. Internal audit reports often comprise the following:



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(i) A cover page;
(ii) Executive summary
(iii) The main report contents;
(iv) Appendices.

**Required**

a) List and briefly describe the general categories of information that you would expect to find in an internal audit report under each of the four headings above
b) List the main contents of most external audit reports. Note. You are not required to reproduce a full external audit report.
c) Explain why the contents of external audit reports prepared under International Standards on Auditing and internal audit reports are different

**QUESTION 5**

(a) ISA 210 Agreeing the terms of audit engagements explains the content and use of engagement letters.
**Required;**
State six items that could be included in an engagement letter
(b) ISA 500 Audit evidence explains types of audit evidence that the auditor can obtain.
**Required**
State, and briefly explain four types of audit evidence that can be obtained by the auditor.
(c) ISA 705 Modifications to the opinion in the independent auditor's report sets out the different types of modified opinions.
**Required**
State three ways in which an auditor's opinion may be modified and briefly explain each modification.



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**QUESTION 6**

You are the audit manager, of Hood Enterprises a limited liability company. The company s annual revenue is over $ 10 million.

**Required:**

a) Compare the responsibilities of the directors and auditors regarding the published financial statements of Hood Enterprises.
b) Extracts from the draft audit produced by an audit junior are given below:
We have audited the accompanying financial statements of Hood Enterprises Limited which comprise ..... We have also evaluated the overall adequacy of the presentation of information in the company's annual report.

**Auditor's responsibility**

.....We conducted our audit in accordance with Auditing Standards, Those standards require that we comply with ethical requirements and plan and perform the audit so that we can confirm the financial statements are free from material misstatement. The directors however are wholly responsible for the accuracy of the financial statements and no liability for errors can be accepted by the auditor.
An audit involves performing procedures to obtain as much audit evidence as possible in the time available about the amounts and disclosures in the financial statements.
An audit also includes evaluating the appropriateness of accounting policies used and the reasonableness of all accounting estimates made by management as well as evaluating the presentation of the financial statements

**Required**
Identify and explain the errors in the above extract.
Note. You are not required to redraft the report.

c) The directors of Hood Enterprises have prepared a cash flow forecast for submission to the bank. They have asked you as the auditor to provide a negative assurance report on this forecast.

**Required**
Briefly explain the difference between positive and negative assurance, outlining the advantages to the directors of providing negative assurance on their cash flow forecast.

**QUESTION 7**

(a) ISA 700 Forming an opinion and reporting on financial statements indicates the basic elements that will ordinarily be included in the audit report.

**Required:**
List six basic elements of an auditor's report. Briefly explain why each element is included in the report.
(b) You are the audit manager in charge of the audit of MSV Co for the year ended 28 February 20x7. MSV Co is based in a seaside town and hires motor boats and yachts to individuals for amounts of time between one-day and one week. The majority of receipts are in cash, with a few customers paying by debit card. Consequently, there are no trade receivables on the statement of financial



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position. The main non-current, assets are the motor boats and yachts. The company is run by four directors who are also the major shareholders. Total income for the year was about $10 million.

The following issues have been identified during the audit.

**Issue 1**

Audit tests on sales indicate a deficiency in the internal control system, with a potential understatement of income in the region of $500,000. The deficiency occurred because sales invoices are not sequentially numbered, allowing one of the directors to remove cash sales prior to recording in the sales day book. This was identified during analytical procedures of sales, when the audit senior noted that on the days when this director was working, sales were always lower than on the days when the director was not working.

**Issue 2**

During testing of non-current assets, one yacht was found to be located at the property of one of the directors. This yacht has not been hired out during the year and enquiries indicate that the director makes personal use of it. The yacht is included In the non-current assets balance in the financial statements.

Required

For each of the issues above:

i) List the audit procedures you should conduct to reach a conclusion on these issues;

ii) Assuming that you have performed all the audit procedures that you can, but the issues are still unresolved, explain the potential effect (if any) on the audit report.

**QUESTION 8**

a) You are the audit manager in JonArc & One of your new clients this year is Galartha Co, a company having net assets of $15 million. The audit work has been completed, but there is one outstanding matter you are currently investigating; the directors have decided not to provide depreciation on buildings in the financial statements, although international Financial Reporting Standards suggest that depreciation should be provided.

Required

State the additional audit procedures and actions you should now take in respect of the above matter.

b) Unfortunately, you have been unable to resolve the matter regarding depreciation of buildings; the directors insist on not providing depreciation. You have therefore drafted the following extracts for your proposed audit report..

1. ...We conducted our audit in accordance with International Standards on Auditing. Those Standards require that we comply with ethical requirements and plan and perform the audit to obtain reasonable assurance about whether the financial statements are free from material misstatement (remaining words are the; same as a normal unmodified report).
2. As discussed in Note15 to the financial statements, no depreciation has been provided in the financial statements which practice, in our opinion, is not in accordance with International Financial Reporting Standards.
3. The provision for the year ended 31 September 20X7, should be $420,000 based on the straight-line method of depreciation using an annual rate of 5% for the buildings.
4. Accordingly, the non-current assets should be reduced by accumulated depreciation of $1,200,000 and the profit for the year and accumulated reserve should be decreased by $420,000 and $1,200,000, respectively.





5. In our opinion, except for the effect on the financial statements of the matter referred to in the preceding paragraph, the financial statements present fairly, in all material respects ... (remaining words are the same as for an unmodified opinion paragraph).

The extracts have been numbered to help you refer to them in your answer.

**Required**

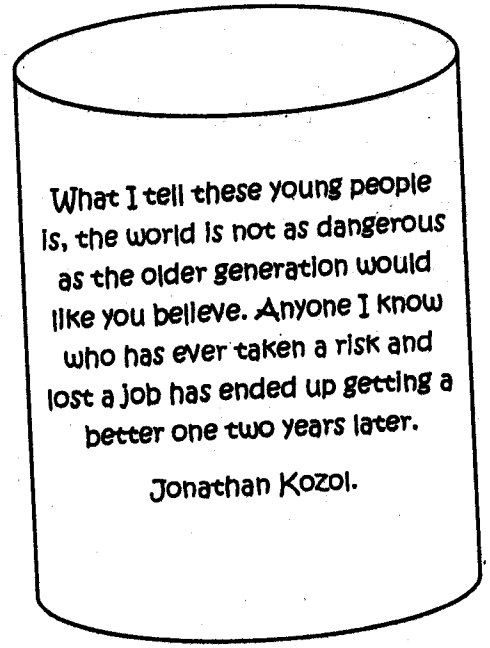
Explain the meaning and purpose of each of the above extracts in your draft audit report.

c) State the effect on your audit report of the following alternative situations:

(i) Depreciation had not been provided on any non-current asset for a number of years, the effect of which if corrected would be to turn an accumulated profit into a significant accumulated loss.

(ii) JonArc & Co were appointed auditors after the end of the financial year of Galartha Co. Consequently, the auditors could not attend the year end inventory count; inventory is material to the financial statements.

(Note. You are not required to draft any audit reports.



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# TOPIC 8

## GROUP AUDITS

**QUESTION 1**

(a) You are the audit manager in K & Associates, a lm of certified public accountants and you are reviewing the working papers completed on the final audit of Ban Limited and the Bane Group for the year ended 31 December 2011. Bane Group consists of four wholly owned subdiaries and the holding company Bane Limited.

**Required:**

Describe the principal audit procedures to be performed on the consolidation schedule of the Bane Group.

*JUNE 2012 QUESTION THREE A*

**QUESTION 2**

(a) According to International Standard on Auditing (ISA) 550: 'Related panics' where the financial reporting frameworks establish specific accounting and disclosure requirements for related party transactions relationships and balances to enable users of the financial statements to understand their nature, the auditor has a responsibility to perform audit procedures to identify, assess and respond to the risks of material misstatement arising from the entity's failure to appropriately account for or disclose related party relationships transactions or balances.

The auditor should therefore place emphasis on testing material transactions with panics he knows are related to the reporting entity. Certain relationships such as parent-subsidiary or investor - investee, may be clearly evident. However, determining the existence of other related party relationships requires the application of specific audit procedures.

The auditor could also devise detailed procedures intended to provide guidance for identifying material transactions with parties known to be related and for identifying material transactions that may be indicative of the existence of previously undetermined relationships.

**Required:**

(i) Design the specific audit procedures that could be relied upon to ascertain the existence of related parties.
(ii) Describe the detailed procedures an auditor could perform to identify transactions with related parties.

*JUNE 2012 QUESTION ONE A*



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**ESTION 3**

auditor needs to examine investments held by the parent company to determine whether an estment constitutes an associate company or a subsidiary company. In most cases, the auditor will have a problem in identifying subsidiary companies.

owever, the process by which the auditor obtains sufficient evidence to confirm the position taken a client company to determine whether or not the investment constitutes a subsidiary undertaking of major concern to the auditor.

he precise shareholding can be ascertained from the register of members of the potential subsidiary dertaking. Examination is then required of the particular circumstances against the relevant efinition.

Once the group members have been identified, the auditor will be particularly concerned with the accounting treatment and accounting policies of the group companies.

**Required:**
Discuss the matter an auditor would consider when auditing the financial statements of group companies with respect to the following:
a) Accounting policies
b) Consolidation Adjustments
d) Loss making subsidiaries
e) Contingent liabilities and events after the reporting period.

*JUNE 2010 QUESTION FOUR*

**QUESTION 4**

(a) With reference to International Standard on Auditing 550 (Related Parties), discuss the responsibility of an auditor with regard to related party transactions.

(b) You are a partner in ABC Associates, a firm of Certified Public Accountants (CPAs) specializing in the audit of group accounts. One of your clients, Excel Ltd., is the parent company of a number of subsidiary companies. Some of these subsidiary companies are audited by other audit firms.

Your firm is in the process of determining the extent to which the work of these subsidiary company auditors can be relied upon in the audit of the accounts of the parent company.

**Required:**
i) Explain the factors you would consider in deciding on the extent to which you could rely on the work of the auditor of a subsidiary company. Your answer should include a consideration of the size of the subsidiary.
ii) Analyse the matters you would consider in deciding whether you should qualify your audit report on the parent company's accounts given that the audit report on the accounts of a subsidiary company is qualified.

*JUNE 2005 QUESTION FOUR*



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## QUESTION 5

Hydrasports, a limited liability company and national leisure group, has sixteen centers around the country and a head office. Facilities at each centre are of a standard design which incorporates a heated swimming pool, sauna, air-conditioned gym and fitness studio with supervised childcare. Each centre is managed on a day-to-day basis, by a centre manager, in accordance with company policies. The centre manager is also responsible for preparing and submitting monthly accounting returns to head office.
Each centre is required to have a licence from the local authority to operate. Licences are granted for periods between two and five years and are renewable subject to satisfactory reports from local authority inspectors. The average annual cost of a licence is Kshs.90,000.
Members pay a Kshs.1,000 joining fee, plus either Kshs.500 per month for 'peak' membership or Kshs.300 per month for 'off-peak', payable quarterly in advance. All fees are stated to be non-refundable.

The centre at Verne was closed from July to September 2003 after a chemical spill in the sauna caused a serious accident. Although the centre was re-opened, Hydrasports has recommended to all centre managers that sauna facilities be suspended until further notice.
In response to complaints to the local authorities about its childcare facilities, Hydrasports has issued centre managers with revised guidelines for minimum levels of supervision. Centre managers are finding it difficult to meet the new guidelines and have suggested that childcare facilities should be withdrawn.

Staff lateness is a recurring problem and a major cause of 'early bird' customer dissatisfaction with sessions which are scheduled to start at 07.00. New employees are generally attracted to the industry in the short-term for its non-cash benefits, including free use of the facilities – but leave when they require increased financial rewards.
Training staff to be qualified life-guards is costly and time-consuming and retention rates are poor. Turnover of centre managers is also high, due to the constraints imposed on them by company policy.

Three of the centres are expected to have run at a loss for the year to 31 December 2003 due to falling membership.

Hydrasports has invested heavily in a hydrotherapy pool at one of these centres, with the aim of attracting retired members with more leisure time. The building contractor has already billed twice as much and taken three times as long as budgeted for the work. The pool is now expected to open in February 2004.
Cash flow difficulties in the current year have put back the planned replacement of gym equipment for most of the centres.

Insurance premiums for liability to employees and the public have increased by nearly 45%. Hydrasports has met the additional expense by reducing its insurance cover on its plant and equipment from a replacement cost basis to a net realisable value basis.





**Required:**
(a) (i) Identify and explain the business risks which should be assessed by the management of Hydrasports.
(ii) Explain how each of the business risks identified in (i) may be linked to financial statement ris
(b) Describe the principal audit work to be performed in respect of the carrying amount of the following items in the balance sheet of Hydrasports as at 31 December 2003:
(i) deferred income; and
(ii) Hydrotherapy pool.
(c) Suggest performance indicators that could be set to increase the centre managers' awareness of Hydrasports' social and environmental responsibilities and the evidence which should be available to provide assurance on their accuracy.

## QUESTION 6

You are an audit manager in Riebect & Co. a firm of Chartered Certified Accountants. One of your audit clients, Amber Pan Europe ('Amber') a listed company with a 30 June accounting year end, provides wirefree communications services in a rapidly growing market.
In August 2001 Amber purchased Talc, a competitor group of companies. Significant revenue, cost and capital expenditure synergies are expected as the operations of Amber and Talc are being combined into one group of companies.
The following financial and operating information consolidates the results of the enlarged Amber group:

| | Year end 30 June | |
|---|---|---|
| | 2002 (Estimated) Shs 'million' | 2001 (Actual) Shs 'million' |
| Revenue | 7,585 | 4,893 |
| Cost of sales | (3,454) | (2,212) |
| Distribution and administrative costs | (3,184) | (1,889) |
| Research and development costs | (28) | (24) |
| Depreciation and amortisation | (1,030) | (735) |
| Finance cost | (296) | (224) |
| Loss before taxation | (407) | (191) |
| Customers (in thousands) | | |
| Contract (Note 1) | 8,861 | 5,914 |
| Prepaid (Note 2) | 6,084 | 1,688 |
| Average revenue per user (APRU) | | |
| Contract | 655 | 714 |
| Prepaid | 241 | 283 |

**Notes:**

1. Contract customers have specified minimum terms and monthly subscription charges.
2. Prepaid customers have no monthly subscription charges and pay for airtime through refill cards/vouchers

In may 2002 Amber purchased Socolla, a large mobile phone network operntor in East Africa, where your firm has no representation. The financial statements of Socolla for the year ended 30 June 2002 will continue to be audited by a local firm of Chartered Certified Accountants. Socolla's activities have



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not been reflected in the above estimated results of the group. Amber is committed to introducing its corporate image into Africa.
In order to sustain growth, significant costs are expected to be incurred as operations are expanded, networks upgraded and new products and services introduced.

**Required:**

a) Identify and describe the principal business risks for the Amber group
b) Explain what effect the acquisitions will have on the planning of Riebeck's audit of the consolidated financial statements of Amber for the year ending 30 June 2002.
c) Describe how analytical procedures may be used in the audit of Amber for the year ending 30 June 2002.

**QUESTION 7**

(b) Kite Associates is an association of small accounting practices. One of the benefits of membership is improved quality control through a peer review system. Whilst reviewing a sample of auditor's reports issued by Rook & Co, a firm only recently admitted to Kite Associates, you come across the following qualified opinion on the financial statements of Lammergeier Group:

'Qualified opinion arising from disagreement about accounting treatment relating to the non-adoption of IAS

'The management has not prepared a group cashflow statement and its associated notes. In the opinion of the management it is not practical to prepare a group cashflow statement due to the complexity involved. In our opinion the reasons for the departure from IAS 7 are sound and acceptable and adequate disclosure has been made concerning the departure from IAS 7. The departure in our opinion does not impact on the truth and fairness of the financial statements.
'In our opinion, except for the non-preparation of the group cashflow statement and associated notes, the financial statements give a true and fair view of the financial position of the Company as at 31

December 2003 and of the profit of the group for the year then ended, and have been properly prepared in accordance with ...'
Your review of the prior year auditor's report has revealed that the 2002 year-end audit opinion was identical.

**Required:**

Critically appraise the appropriateness of the audit opinion given by Rook & Co on the financial statements of Lammergeier Group for the years ended 31 December 2003 and 2002.

**QUESTION 8**

Your audit client, Alakazam, sells and distributes telecommunications equipment and accessories to retail outlets. The company has expanded rapidly since the appointment of a new chief executive, Leon Izzardo, in September 2000.

In October 2000, the company purchased exclusive national distribution rights to an imported WAP phone for a two year period. During 2001, the company has doubled its customer base and is close to achieving national coverage with its distribution network. Employee numbers have increased rapidly from 36 to 103. Head office administrators, including accounts staff, have risen from 10 to 25.



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In October 2001, the central distribution and servicing department was moved away from the head office into larger premises. This was necessary to handle not only the increased inventory levels and pre-delivery checks necessary, but also the rising level of after sales warranty work caused by manufacturing defects in the WAP phones. Sales of the WAP phone, which now account for 80% of Alakazam.s turnover, have recently started to fall. You have been assigned the task of planning the audit of the financial statements of Alakazam for the year ended 31 March 2002.

**Required:**

a) Describe the principal audit risks arising and how the audit strategy will be directed to take account of them inthe overall audit plan.
b) Mr Izzardo has now targeted Neodex, a private limited company, for acquisition by Alakazam in early 2002. Your firm has just completed a review of Neodex.s published financial statements for the year to 31 December 2000 and held brief discussions with its two directors. The main findings were as follows:
   1) Shares in Neodex are owned equally by the technical director, Stefan Koyla, and marketing director, Georgio Neratu, who set up the company three years after graduating from university.
   2) Neodex has successfully developed a small range of specialised data interface network servers (DINS) which significantly reduce the costs of communication systems. Each unit sells for Kshs.3,500 . Kshs.5,000. Monthly sales are increasing slowly but steadily since Georgio presented the products at an IT exhibition earlier this year.
   3) Between them, Stefan and Georgio assemble and package DINS in a small rented office. The manufacture and assembly of the principal component (a circuit board) is outsourced. Stefan would like to recruit an assistant so that he has time to prototype his new design for the Virtual Private Network (VPN) market.
   4) Neodex has only one employee who acts as telephonist, receptionist, secretary and bookkeeper.

**Required:**

(i) Outline the principal matters to be considered by Alakazam in deciding whether or not to acquire Neodex
(ii) Explain the implications of the acquisition for the conduct of your audit of Alakazam for the year to 31 March 2002.



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# TOPIC 9

## ACCOUNTING AND AUDITING STANDARDS

**QUESTION I**

a) Corporate governance has become an issue of world wide importance. In furtherance to corporate governance, audit committees have been established by various companies.

**Required:**

Explain six ways in which the establishment of an audit committee would assist in improving the effectiveness of external audit work.

b) The ban on advertising of accountancy services in Kenya is not sustainable. Discuss.
c) The auditors have a legal duty to their clients. This legal duty appears to have, of late, been extended to cover third parties not in direct contractual relationship with the auditors.

State specific actions an auditor or an audit firm should take to minimise liability deriving from audit risk.

*DECEMBER 2004 QUESTION FOUR*

**QUESTION 2**

In an attempt to improve Corporate Governance of companies in Kenya banks and listed companies are now required to have audit committees.

Explain the composition and the role of audit committees and offer suggestions as to how their role can be strengthened.

*DECEMBER 2000 QUESTION FIVE*

**QUESTION 3**

**Auditors and Auditing standards are controlled and regulated in a number of different ways.**

**Required**

a) Explain how international Standards on auditing (ISAs) are developed by IAASB and explain the role and authority of ISAs.
b) Explain the role of professional bodies in the regulation of auditors
c) Describe how ISAs and national auditing standards in some individual countries influence each other.





**QUESTION 4**

International Standards on Auditing-(ISAs) are produced by the International Auditing and Assurance Standards Board (IAASB), which is a technical committee of the International Federation of Accountants (IFAC). In recent years, there has been a trend for more countries to implement the ISAs rather than produce their own auditing standards.
A school friend who you have not seen for a number of years is considering joining ACCA as a trainee accountant. However, she is concerned about the extent of regulations which auditors have to follow and does not understand' why ISAS have to be used in your country.

**Required**
Write a letter to your friend explaining the regulatory framework which applies to auditors.
Your letter should cover the following points:
(a) The due process of the IAASB involved in producing an ISA.
(b) The overall authority of ISAs and how they are applied in individual countries.
(c) The extent to which an auditor must follow ISAS.
(d) The extent to which ISAS apply to small entities.

When one door closes, another opens; but we often look so long and so regretfully upon the closed door that we do not see the one that has opened for us.

Alexander Graham Bell.



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# TOPIC 10

## CORPORATE GOVERNANCE

**QUESTION 1**

(b) Analyse the factors affecting the evolution of the role of the audit committee from traditional financial review towards oversight responsibilities.

*JUNE 2012 QUESTION TWO B*

**QUESTION 2**

You are the audit manager in the audit firm of Turu & Feya Associates, Certified Puhlic Accountants One of your clients is Sipoting Ltd, a company specialising in the manufacture and supply of spoting equipment. The company has been your audit client for several years and you have been the audit manager for the past four years. The audit partner who reviews the audit working files of Sipoting Ltd. has remained unchanged.

You are now planning the audit for the year ended 31 December 20 I O. Following an initial meeting with the directors of Sporting Ltd, you have obtained the following information:

1. The company is attempting to obtain a listing on the stock exchange. The directors have established an audit committee, as required by the corporate governance regulations issued by the Capital Markets Authority. However no further action has been taken in this respect. Meanwhile, the information on the listing has not yet been made public.
2. You have been assigned to prepare the company's financial statements as in previous years.
3. As the company's auditors, you and the partner have been invited to attend an evening reception in an upmarket hotel where Sipoting Ltd. will present its listing arrangements to banks and existing major shareholders.
4. Your firm also acts as tax advisors to Sipoting Ltd. You have been advising the company regarding the legality of certain items as "allowable" for taxation purposes. The revenue Authority is disputing these items.
5. Finally, you have just inherited 6 % of Sipoting Ltd 's issued share capital on the death of a close relative.

**Required:**

a) Explain why your audit firm will need to communicate with the audit committee of Sipoting ltd. for the current and future audits.
b) Explain the actions that the board of directors of Sipoting Ltd. must take in order to meet corporate governance requirements for the listing of the company.
c) Identify and explain the releyance of any five factors which might threaten the independence of Turu & Feya's audit of Sipoting Ltd.'s financial statements for the year ending 31 December 2010 and suggest how the auditors could mitigate against each of the threats.

*DECEMBER 2010 QUESTION THREE*





**QUESTION 3**

a) You are the internal auditor of Katumani Contractors Ltd,a construction company with large scale contracts in Eastern Africa including some parts of Southern Sudan.The company has recently established an audit committee, whose members are very concerned about meeting corporate governance "best practice "particularly because the company is considering listing on the stock exchange.

You have been asked to conduct a review of how well the company is meeting relevant corporate governance requirement.

**Required:**

i) Briefly explain the term "Corporate governance"
ii) Describe the respective roles of the audit committee and the internal auditor with respect to corporate governance in organisation.

*JUNE 2010 QUESTION FIVE A*

**QUESTION 4**

You are the audit manager in the audit firm of Dark and company. One of your audit clients is Notary Ltd., a company specialising in the manufacture and supply of sporting equipment. Notary Ltd. has been an audit client of Dark and Company tor four years and you have been the audit manager for the last two years. The partners of Dark and Company have not changed in the four years.

You are planning the audit for the year ending 3 i October 2009.you held an initial meeting with the directors of Notary Ltd. The following matters are relevant to the audit or Notary Ltd.

1. Notary Ltd. is attempting to obtain a listing on the stock exchange. The directors have established an audit committee as required by the corporate governance regulations, although no further action has been taken in this respect. The information on the listing is not yet public knowledge.
2. You have been requested to continue to prepare the company's financial statements as in the previous years.
3. As the company's auditors, Notary Ltd. would like you and the audit partners to attend an evening reception in a hotel where Notary Ltd. will present their listing anangements to the banks and the existing shareholders.
4. Notary Ltd. has indicated that the fee for taxation services rendered in the financial year ending 3 J October 2009 will be paid as soon as the tax authorities have confirmed the company's taxation liability. You have been advising Notary Ltd. regarding the legality of certain items as "allowable deductions" for taxation purposes and the tax authority is disputing these items.

Meanwhile, YOLI have just inherited about 5 % of notary Ltd.'s share capital as an inheritance in the death of a distant relative who owned shares in Notary Ltd.



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**Required:**

a) Explain threats to the independence of Dark and Company in auditing the financial statements of Notary Ltd. for the year ending 31 October 3009 and suggest how the audit firm may mitigate against each threat.
b) Recommend the actions that the board of directors of Notary Ltd. should take in order to meet the corporate governance requirements for the listing of Notary Ltd.
c) Explain why it would be necessary for the audit firm to liaise with the audit committee of Notary Ltd.

*AUGUST 2009 QUESTION THREE*

**QUESTION 5**

You are the internal audit manager of Faida Investment Ltd, a large company dealing in real estate and equity investment. The company has four executive directors and seven non-executive directors. The chairman of the hoard of directors of the company is keen to establ ish an audit committee in order to enhance corporate governance in the management of the company. The chairman has requested the managing director of the company to prepare a report on audit committees for presentation to the board of directors in their meeting.

**Required;**

Prepare a report to the managing director which should contain the following details;

a) The objectives of an audit committee and the recommended composition of the audit committee of the company.
b) The functions of an audit committee
c) The advantages and potential pitfalls of an audit committee
d) The working relationship between an audit committee and the external auditors of a company

*JUNE 2008 QUESTION TWO*

**QUESTION 6**

a) Corporate governance has become an issue of world wide importance. In furtherance to corporate governance, audit committees have been established by various companies.

**Required:**
Explain six ways in which the establishment of an audit committee would assist in improving the effectiveness of external audit work.
b) The ban on advertising of accountancy services in Kenya is not sustainable. Discuss.
c) The auditors have a legal duty to their clients. This legal duty appears to have, of late, been extended to cover third parties not in direct contractual relationship with the auditors.

State specific actions an auditor or an audit firm should take to minimise liability deriving from audit risk.

*DECEMBER 2004 QUESTION FOUR*





**QUESTION 7**

In an attempt to improve Corporate Governance of companies in Kenya banks and listed companies are now required to have audit committees.

Explain the composition and the role of audit committees and offer suggestions as to how their role can be strengthened.

*DECEMBER 2000 QUESTION FIVE*

**QUESTION 8**
If there is a need for a uniform set of international accounting standards and international auditing standards, there is also a need for global corporate governance standards.

**Required:**

Discuss and reach a conclusion.

**QUESTION 9**
**Becher Construction**

Becher are a major independent construction company, dealing with large scale contracts throughout Kenya and with some international interest in Africa, particularly in Uganda. Becher have recently established an audit committee whose members are very concerned about meeting corporate governance 'best practice', particularly since they are currently looking at obtaining a stock exchange listing. You are an internal auditor with the company and have been asked to conduct a review of how well the company are meeting requirements.
You are required to prepare a report that addresses:
(a) What is corporate governance and why are corporate governance requirements important?
(b) What are the key issues for Becher to address to achieve effective corporate governance?
(c) What is the role of internal audit in achieving corporate governance compliance?
(d) What should the role of the audit committee be in demonstrating corporate governance.
(e) List the types of regular reporting that would be useful for Becher

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# TOPIC 11

## CURRENT ISSUES AND DEVELOPMENTS

**QUESTION 1**

b) Social and environmental issues could have a direct impact on the statutory audit because non-compliance with social and environmental legislation might have an impact on the financial statement

**Required**
Citing suitable examples explain cases where financial statements might be materially affected by social and environmental issues.

*JUNE 2012 QUESTION ONE*

**QUESTION 2**

Six months ago, Shupavu Ltd, shut down one of its four factories as a result of deteriorating market conditions. All staff at the factory were declared redundant on the date of closure.

While monitoring the monthly management accounts, John Muga, the internal auditor performed analytical procedures on salary expenses and established that the monthly total payroll expenses had reduced by 3% in the months following the closure of the factory. This was lower than the expected reduction given that 25% of the total staff of the company had been declared redundant.

Initial investigations by the internal auditor revealed that many of the employees who had been declare redundant had actually remained on the payroll records and salary payments in respect of these individuals were still being made every month. All the payments were being credited into the same bank account.
As soon as the internal auditor realized that there was a possibility of fraud, he informed the managing director who immediately stopped any further payments in respect of the redundant employees.
Shupavu Ltd has contacted your audit firm to conduct an investigation.

You are further informed that the senior accountant has been absent from work and has not been traced since the commencement of the initial investigations. It is believed that he might have been involved in the suspected fraud.

Shupavu Ltd. Are not audit clients of your firm of auditors. They have enquired whether your firm could provide a forensic investigation

**Required**
(a) Describe three objectives of a forensic investigation.
(b) Using examples of procedures that could be used to gather evidence, explain the: steps you would follow in undertaking the forensic investigation.
(c) Assess how the code of ethics for professional accountants could be applied in the provision of the above forensic investigation services.

*DECEMBER 2011 QUESTION ONE*





N 3

cribe the concept of value for money auditing.
plain the approach that an auditor would follow in undertaking value for money audit in ic sector organisation.

irm of auditors has been requested to carry out a forensic assignment for an existing lient. The assignment requires your firm to provide litigation support and entails tion of possible financial outcome on amounts and disclosures to be reflected in the ial statements.

he threats that the forensic assignment may pose to your audit firm and suggest the s that your firm may implement to mitigate those threats.

*DECEMBER 2009 QUESTION FIVE*

ON 4

forensic auditing and describe its application to fraud investigations.

*AUGUST 2009 QUESTION FOUR B*

ION 5

st, the accountancy profession has been criticised for its role in monitoring and reporting corporate failure. Radical reforms have been called for in the way the accountancy profession ted. There have been calls for legislation in the following areas:

diting standards:
diting standards should be set and enforced independent of the accounting profession.
ud:
diting firms should have a duty to detect and report fraud.
n-audit services:
ditors should not provide their clients with non-auditing services.
uration of auditors appointment:
he appointment of auditors should be for a maximum period of seven years.

ired:
escribe the current regulatory and professional requirements relating to each of the main issues sted above.
With reference to current regulations in the above areas, discuss the reasons why the accountancy profession has been criticised.

*DECEMBER 2004 QUESTION FIVE*



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**QUESTION 6**

(a) Explain the purpose of the three 'Es' in relation to a value for money audit.
(b) You are an audit manager in the internal audit department of KLE Co. The internal audit department is auditing the company's procurement system in the company. Extracts from your system notes which are correct and contain no errors, are provided below.
Details on ordering department:
- Six members of staff-one buyer and five purchasing clerks.
- Receives about 75 orders each day, many orders for duplicate items come from different departments in the organization.
- Initial evaluation of internal controls is high

**Procurement systems**

**Ordering department**
All orders are raised on pre-numbered purchase requisitions and sent to the ordering department.
In the ordering department, each requisition is signed by the chief buyer. A purchasing clerk transfers the order information onto an order form and identities the appropriate supplier for the goods.
Part one of the two part order form is sent to the supplier and part two to the accounts department. The requisition is thrown away.

**Goods inwards department**
All goods received are checked for damage. Damaged items are returned to the supplier and a damaged goods note completed.
For undamaged items a two-part pre-numbered Goods Received Note (GRN) is raised.
- Part one is sent to the ordering department with the damaged goods notes.
- Part two is filed in order of the reference number for the goods being ordered (obtained from the supplier's goods dispatched documentation), in the goods inwards department.

**Ordering department**
GRNs are separated from damaged goods notes, which are filed. The GRN is forwarded to the accounts department.

**Accounts department:**
GRNs matched with the order awaiting the receipt of the invoice.

**Required,**

Using the system notes provided
(i) Identify and explain the internal control deficiencies and provide a recommendation to overcome each deficiency
(ii) Identify and explain the additional deficiencies that should be raised by a value for money audit and provide a suitable recommendation to overcome each deficiency.





# SOLUTIONS

## TOPIC 1

## ASSURANCE SERVICES AND NON ASSURANCE SERVICES

**QUESTION 1**

**(c) IFAC's first international standards on Assurance engagements**

The statutory audit of historical financial statements is an example of a traditional assurance service which has been provided by auditors for many years. Factors which have contributed to a growing demand for different assurance services by accountants include:

- Business expansion.
- Developments in information technology and communication networks.
- Greater accountability of corporate managers.

In the public sector, assurance is increasingly sought on information concerning the performance of National Health Service department and education providers.

In the private sector, there is an increasing demand for large companies to assess the quality of their management and communication systems, whilst consumers demand assurance that e-commerce, data integrity and confidentiality.

Professional accountants bring independence to assurance services because they are bound to adhere to an ethical code. Such codes require that other fundamental principle be observed. The term professional accountant includes auditor.

The objective of an assurance engagement is to enhance credibility of information. Thus assurance services improve the quality or context of information- for decision makers to use.

Types of assurance services include:

- Risk assessments.
- Performance measurement.
- Information systems.
- E-commerce.

Subject matter, which may be as at a point in time or for a period of time, must be identifiable and in a form which allows evidence to be gathered. For example:

- Data (for example prospective financial information).
- Systems (for example internal controls).
- Behaviour (for example corporate governance).

An engagement which seeks to provide a "high" (but not absolute) level of assurance (for example an audit) is concluded by the expression of an opinion on whether the subject matter (for example financial



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statements) conform, in all material respect to suitable criteria (for example financial statement assertions). This is called "positive assurance".

*JUNE 2012 QUESTION FIVE*

**QUESTION 2**

a) **Matters relating to the assurance engagement that would be discussed at the meeting include.**

1. Details of the business plan information relating to past business performance.
2. Availability of market for the new product
3. Availability of evidence
   In this case evidence will include discussions with key management and written representations of these discussions may be required. Mbao ltd should be notified that audit opinion will be based on the information they provide to the auditor.
4. Cashflow projections
5. The intended recipient of the report
   The auditor should clarify the name and address of the recipient at Mpesha Bank Ltd.
   For the limitation of professional liability, it should be clarified that Mpesha Bank Ltd, will be the only recipients and that the assurance opinion is being used as part of the bank's overall lending decision.
6. Liability
   To mitigate against audit liability the auditors may want be provided with a written statement saying that the report is for information purposes only, and does not give rise to any responsibility, liability, duly or obligation from the firm to the lender.
7. Timing
   The deadline of the report should be discussed. This in turn will be influenced by when Mbao Ltd. needs the requested financing ofSh.200 million. The bank may need a considerable period of time to assess the request for financing prior to advancing the finance.
8. Procedures and regulations
   The auditors need to discuss the kind of procedures that will be undertaken and confirm that they will be complying with relevant professional guidance, for instance ISAE 3000 Assurance engagement other than audits of reviews of historical financial information.
9. Fees and billing arrangements must be agreed before any work is carried out.
10. The engagement letter
    The engagement letter should be disclosed and signed at the meeting before any assignment work is conducted.
11. Assurance report

b) The enquires will include the following:

- Forecast preparation
  The experience and competence of the preparer of the forecast should be evaluated. Previous forecasts should also be reviewed to determine if they were accurate and reliable.
- Internal financing
  Does the firm have surplus cash to cover for any shortfall, if there is cash within the firm then the bank should not meet the full cost of the project.
- Whether the cost of finance has been included in the forecast.
- Forecast operating cycle of the new project.

*JUNE 2011 QUESTION THREE*





**QUESTION 3**

a) i) ISA 220 Quality Control for Oil audit financial statement specifies the quality control procedures that should be applied by the engagement team in audit assignments..
These procedures include:

- **Competence of engagement team**
  There should be procedures in place to ensure that the engagement team has the skills and expertise required to perform the audit engagement. The engagement partner should assess that the auditor for technical knowledge, ability to apply professional judgment and experience of audit engagements
- **Planning and direction**
  The engagement team should be directed by the engagement partner. Procedures should be undertaken to ensure that the team understands, the objective of the work they are to perform, their responsibilities approach to the performance of the audit etc.
- **Client acceptance procedures**
  There should be full documentation and conclusion on ethical and client acceptance issues in each audit assignment. The engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the audit team are independent of the client.
- **Arrange for consultation**
  When faced with difficult matters the engagement partner should consult. This is done where a matter is discussed with a professional outside the engagement team and the audit firm's consultations must be documented.
- **Supervision**
  It is critical that supervision should be continuous during the engagement. The main objective for this is to ensure that members of the audit team are carrying out their work in accordance with the planned approach to the engagement.
- **Review of audit work**
  All work performed must be reviewed by a more senior member of the audit team. This is one of the key quality control procedures

ii) Challenges faced by small firms in implementing quality control procedures and measures to address the same

| CHALLENGES | MEASURES TO ADDRESS |
|---|---|
| 1. Lack training on quality procedures. Small firms may find it hard to establish and in-house training function. | 1. Small firms may find it affordable to rely on external training consortia to provide training for its staff |
| 2. Independent review of audit engagement within small firms may not be possible because there are few experienced auditors | 2. Use external review service. |
| 3. Consultations on specialist areas within small firms may not be possible due to shortage of specialist professionals. | 3. Make arrangements with other practices for consultation |
| 4. Most small firms lack resources to establish adequate and standard working papers. | 4. In this case documentation can be provided by external firms or professional bodies |
| 5. Lack of specialist experience | 5. Bring in the special skill or subcontract to another practice |

*JUNE 2011 QUESTION FOUR B*



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QUESTION 4

(b) Quality control procedures (ISA 220)

Review of work performed

Proper review procedures should be instituted. All working papers must be independently reviewed to ensure that work has been performed in accordance with the audit plan, that the appropriate risks have been identified and that the evidence supports the conclusions. The manger or partner should also review the audit file and final accounts before the audit report is finalised.

Organisation

Responsibilities and duties of staff should be clearly shown in an organization chart.

Their job description should also be spelt out. These will be maintained and updated as appropriate.

The audit plan and resource/time allocation schedule will be used effectively to ensure that all team members should clearly understand their assignments by the help of the audit plan and the time allocation schedule.

The organization should keep records of assignments performed.

Assignment

Assignments should be performed in accordance with standardized documentation.

Assignment control and review procedures will ensure that individual audits are completed to a high standard, using the right skills and resulting in a report that reflects the underlying facts.

Supervision

Supervision and review of work should be carried out at all levels so that work performed meets appropriate standards of quality. Supervisors will receive appropriate training in the conduct of this supervision and be appraised against the relevant management competencies.

*DECEMBER 2009 QUESTION ONE B*

## QUESTION 5

(a) **The five key elements of an assurance engagement are:-**

i) A three party relationship involving a practitioner, a responsible party and intended users.
ii) An appropriate subject matter
iii) Suitable criteria
iv) Sufficient appropriate audit evidence and
v) A written assurance report in the form appropriate to a reasonable assurance engagement or limited assurance engagement.





(b) **Engagement risks that face a professional accountant who accepts an assurance engagement.**

Assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusions. In reasonable assurance engagements, the practitioner reduces the risk to an acceptably low level in the circumstances of the engagement to obtain assurance as the basis for a positive form of expression of the practitioner conclusion.

In general, assurance engagements can be represented by the following components, although not all of these components will necessarily be present or significant for all assurance engagements

i) The risk that the subject matter information is materially misstated which in form consists of
- Inherent risk
- Control risk

ii) Detection risk: the risk that the practitioner will not defect a material misstatement that exists.

The degree to which the practitioner considers each of these components is affected by engagement circumstances, in particular by the nature of the subject matter and whether reasonable assurance or a limited assurance is being performed.

(c) **Why absolute assurance may not be given and circumstances in which reasonable assurance can be given.**

ISA 200 (objective and general principles governing an audit of financial statements) states that an auditor can not give or obtain absolute assurance because there are inherent limitations in an audit that affects the auditors' ability to detect material misstatements. These limitations result from factors such as;

- the use of testing
- the inherent limitations of internal control
- the fact that audit evidence is persuasive rather than conclusive.

An auditor's work is also permeated by judgement regarding gathering of audit evidence and drawing conclusions.

Reasonable assurance is a concept relating to the accumulation of audit evidence necessary for the auditor to conclude that there are no material mistatements in the financial statements taken as a whole.

Therefore an auditor provides reasonable assurance when circumstances allow him/her to gather sufficient appropriate audit evidence.

(d) **Potential to the independence of a firm involved in assurance engagements.**

Independence requires independence of mind and independence in appearance according to the IFACs code of ethics for professional accountants.

Independence is threatened by self-interest, self-review, advocacy, familiarity and intimidation threats.

i) Self-interest threat occurs when a firm or member of assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client



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Example;
- A direct financial interest or material indirect financial interest in an assurance client
- A loan or guarantee from an assurance client or any of its directors and officers.

ii) Self review threat occurs when any product or judgement of previous AE, or NAE needs to be re-evaluated in reading conclusions on the assurance engagements or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct or significant influence over the subject matter of the assurance engagement.

iii) Advocacy threat – occurs when a firm or member of the assurance team, promotes or may be perceived to promote an assurance clients position or opinion to the point that objectivity may or may not be perceived to be compromised.

iv) Familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or member of the assurance team becomes too sympathetic to the client's interests.

v) Intimidation threat occurs when a member of the assurance team may be deferred, from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

*DECEMBER 2005 QUESTION TWO*

## QUESTION 6

**(a) Respective responsibilities of directors and management of a company and its external auditors with respect to financial statements.**

ISA 200, explains the respective responsibilities.
The responsibility for the preparation and presentation of the financial statements in accordance with the applicable financial reporting framework is that of the management of the entity with oversight from those charged with governance.

The auditor is responsible for forming and expressing an opinion on the financial statements.

The audit of financial statements does not relieve management or those charged with governance their responsibility.

**(b) The inherent limitations facing auditors in undertaking their work;**

The inherent limitations in an audit of financial statements that affect the auditor ability to detect material mistatements include:-
i) The use of testing
ii) The inherent limitations of internal control (for example, the possibility of management override or collusion)
iii) The fact that most audit evidence is persuasive rather than conclusive
iv) The work is also permeated by judgement
v) Assessing the reliability of estimates made by management





**Significant types of judgements made by auditors in:**

i) Gathering audit evidence
The work undertaken by the auditor to form an audit opinion is permeated by judgement in particular regarding the gathering of audit evidence, for example in deciding the nature, extent and timing of audit procedures. Also the drawing of conclusions based on the audit evidence gathered for example, assessing the reasonableness of the estimates made by management in preparing the financial statements.

**ii) Arriving at an opinion in the financial statements**

In expressing an audit opinion, the auditor provides uses of financial statements with reasonable assurance that the financial statements are free from material mistatements. In other words, the engagement risk has been minimized to acceptable level. It implies that sufficient appropriate audit evidence has been obtained.
The auditor makes judgements regarding matters affecting or not affecting his audit opinion and also decides on the appropriate forms of the report.

He also considers compliance with laws to satisfy regulatory requirements in a given jurisdiction.

*DECEMBER 2005 QUESTION FIVE*

## UESTION 7

**) Definition of assurance engugement and its purpose.**

The International framework for assurance engagements defines assurance engagement as an engagement in which a practitioner expressed a conclusion designed to enhance the confidence of the intended users other than the responsible party about the outcome of the evaluation or measurement of a subject matter against criteria.

The outcome of the evaluation or measurement of a subject matter is the information that results from applying the criteria to that matter.

According to the framework, an assurance engagement has the following elements;
i) A three party relationship involving a practitioner, a responsible party and intended users.
ii) An appropriate subject matter
iii) Suitable criteria
iv) Sufficient appropriate evidence and
v) A written assurance report in the form appropriate to a reasonable assurance engagement or a limited assurance engagement.

(b) Engagement risk that faces a practitioner who accepts an assurance engagement. According to the framework on AE, an assurance engagement risk is the risk that the practitioner expresses an inappropriate conclusion when the subject matter information is materially misstated.

(c) Forms of reports that a firm involved in assurance engagements may give to minimise its assurance engagement risk.



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The forms of reports given for assurance engagements include reasonable assurance reports and limited assurance reports conveying different levels of assurance in the opinion of the auditor on the subject matter.

In these reports, the responsibilities of the parties should be clearly delineated and the auditor may consider a disclaimer with respect to the inappropriate use of the reports.

**(e) Potential to the independence of a firm involved in assurance engagements.**

Independence requires independence of mind and independence in appearance according to the IFACs code of ethics for professional accountants.

Independence is threatened by self-interest, self-review, advocacy, familiarity and intimidation threats.

i) Self-interest threat occurs when a firm or member of assurance team could benefit from a financial interest in or other self-interest conflict with an assurance client

Example;
- A direct financial interest or material indirect financial interest in an assurance client
- A loan or guarantee from an assurance client or any of its directors and officers.

ii) Self review threat occurs when any product or judgement of previous AE, or NAE needs to be re-evaluated in reading conclusions on the assurance engagements or when a member of the assurance team was previously a director or officer of the assurance client or was an employee in a position to exert direct or significant influence over the subject matter of the assurance engagement.

iii) Advocacy threat – occurs when a firm or member of the assurance team, promotes or may be perceived to promote an assurance clients position or opinion to the point that objectivity may or may not be perceived to be compromised.

iv) Familiarity threat occurs when, by virtue of a close relationship with an assurance client, its directors, officers or employees, a firm or member of the assurance team becomes too sympathetic to the client's interests.

v) Intimidation threat occurs when a member of the assurance team may be deferred, from acting objectively and exercising professional skepticism by threats, actual or perceived, from the directors, officers or employees of an assurance client.

*JUNE 2005 QUESTION TWO*

## QUESTION 8

**(a) Preliminary Considerations**

**Acceptance of Engagement**
The International Standard on Assurance Engagements no. 3400 states that before accepting an engagement to examine prospective financial information, the auditor would consider, amongst other things:
- The intended use of the information;





- Whether the information will be for general or limited distribution;
- The nature of the assumptions, that is, whether they are best-estimate or hypothetical assumptions;
- The elements to be included in the information; and
- The period covered by the information.

ISA 3400 adds that the auditor should not accept, or should withdraw from, an engagement when the assumptions are clearly unrealistic or when the auditor believes that the prospective financial information will be inappropriate for its intended use.

**(b) The main points to be considered in conducting the review**

**(i) Nature and background of the company's business**
Establish its activities, products, customers, markets, labour force, prospects, and the trends of its financial results.

**(ii) Accounting polices**
Establish the accounting policies adopted for interim and final accounts and forecasts. Ensure that they are reasonable and are consistently followed especially in the forecasts. Special areas to be watched include stock and work in progress valuations, depreciation, the method of taking profit on long term contracts, exceptional and extraordinary items and deferred tax.

**(iii) The assumptions**
- These should be stated
- The forecast should be consistent with the assumptions which may be economic (e.g. growth in G.N.P.), financial (e.g. interest rate movement), marketing (e.g. market share), industrial (e.g. output potential), labour relations (e.g. strike free periods) etc.

The accountant is not concerned with the correctness of these assumptions although he should be sure the directors are responsible for them and that they are reported on by the advisers.

**(iv) The procedures adopted by the company to prepare the forecasts**
The accountant should investigate:
- Whether forecasts are regularly prepared for management or prepared only for this occasion
- Whither the recasts are best estimates, honestly believed to be achievable, or simply targets
- The extent to which forecasts for wholly or partly expired periods are covered by reliable interim accounts.
- The extent to which the forecasts are built up form detailed divisional or activity based sectional accounts, distinguishing those woith steady performance foam those with more volatile results
- The treatment of material, extraordinary, and exceptional items
- The adequacy of provisions for future losses and contingencies
- The adequacy of working capital. If finance will be required to fulfill the forecast, this should have been arranged and confirmed.



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**The report**

**This will be addressed to the directors and will contain:**

(i) A statement that the reporting accountants have carried out a review of the accounting bases and calculations on which the profit forecasts have been based.

(ii) Specific identification of the forecasts and documents to which the report refers.

(iii) If, as likely, the accountant have not carried out an audit of the results of expired periods, a statement to that effect.

(iv) Whether in the opinion of the reporting accountants the forecasts have been properly compiled on the basis of the assumptions made by the Board of Directors, as set out in the prospectus or circular, and are presented on a basis consistent with the accounting practices normally adopted by the company.

(v) If the accountant has material reservations about any part of the forecast they should qualify their report.

c. When the auditor believes that one or more significant assumptions do not provide a reasonable basis for the prospective financial information prepared on the basis of best-estimate assumptions or that one or more significant assumptions do not provide a reasonable basis for the prospective financial information given the hypothetical assumptions, the auditor should either express an adverse opinion in the report on the prospective financial information, or withdraw from the engagement.

*JUNE 2003 QUESTION ONE*

QUESTION 9

(a) **Profit and loss account**

1. Carry out ratio analysis. I would compare the following ratios and compare the rations with previous years ratios and the industry average: -

- Gross profit margins
- Other operating ratios such as mark up.

2. Review the accounting policies used in preparing the profit and loss account and assess whether:

a. They are consistent with the International Accounting Standards and the generally acceptable accounting policies (GAAPS)
b. They are applied consistently from year to year.

3. Inspect the items within the profit and loss account to determine their identity for example:

Sales - search for fictitious sales. Review of the sales daybook and cashbook and cash sales will identify fictitious sales.
Expenses or purchases -review suppliers statement and trend of payments made.

4. Visit a number of the business premises to assess the volume of business actually being achieved.





(ii) **Balance sheet**

1. Carry out ratio analysis. I would compute the following ratios.

- Fixed assets turnover ratio
- Current ratio
- Acid test ratio
- Stock turnover ratio
- Debtors average collection period
- Creditor's payment period.

2. Consider the validity of the entries in the balance sheet for example: -
Stock- assesses the existence and conditions of stock (by carrying out a stock take) and its apparent value.

Debtors - circularize debtors to assess their existence value

Creditors - circularize them to identify any unrecorded liabilities.

Fixed assets - inspect them to confirm their existence and condition and determine whether they have been denied necessary repairs and maintenance.

3. Review the accounting policies adapted for these items to determine their suitability and consistency of application.

The factors to consider on whether: -

i. To purchase all the shares are:Is the company well known by its given name and is his significant businesses derived from the use of the name? If so, then shares should be purchased.

- The quality of the company's assets
- Contractual arrangement of Nathoo with third parties.

ii. To purchase assets, goodwill, and liabilities: -

- Level of liabilities. If high, then it's better to purchase only the assets.
- If there is no goodwill, because the company's reputation is poor, it is better to buy the assets and operate under a new name.
- Continuity of trading arrangements. Some contracted arrangements lapse or need to be renegotiated when ownership of the company changes. As such, the name of the company has no real value and the assets and goodwill can be bought without the name.

*JUNE 2002 QUESTION THREE*

**QUESTION 10**

The engagement described has aspects of an investigation as well as a review engagement. Matters that require particular attention include procedural as well as subject matter issues.



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This being an investigation and review of valuation of shares the procedure will be as follows:

1. Receive instructions from the clients and confirm the specific terms of reference
2. Communicate with other auditors as a matter of professional courtesy if the investigating accountant is not the auditor of the entity.
3. Discuss with the client and make logistical arrangements for the investigation
4. Obtain background information on the investigation including understanding the entity including its internal control and assess the risk of material misstatement in the financial statements.
5. Gathering of preliminary information with regard to the business and the valuation of shares
6. Prepare the report outline and discuss with the client so that the terms of reference and client expectations are confirmed
7. Carry out the investigation and review in detail according to the clients instructions and other professional or statutory requirements
8. Prepare my draft report and discuss it with the client
9. Finalise the report and deliver it to the client
10. Be available for further discussions, inquiries or other investigations.

Taking the above procedures ensures that the clients and the investigating accountant understand their specific roles and expectations and thus minimizes disagreements, and protects the auditor from litigation.

With regard to the financial statements and the valuation of shares, matters to pay particular attention to include:

- After observing the above procedures, normal courtesies, obtain copies of the audited accounts of the previous years (say three years) and critically analyse them
- Whether the accounting policies adopted are suitable and have been consistently applied over the years
- Perform analytical review of the figures and whether the figures and rations make sense
- Whether there were any qualifications in the auditors reports for the previous years and the nature of the qualifications

The audited accounts for the current period will be reviewed including:-

- Tests of controls over the controls relevant for the preparation of reliable financial statements
- Search specifically for any evidence of creative accounting such as fictitious sales, over valuation of assets, understatement of liabilities, big bath provisioning, impairment of assets and vice versa.

After the above, I would then pay particular attention to the basis of the valuation of shares.

In general, the value of equity shares are determined by the expected performance of the business and current financial performance, position, cashflows and the perceived economic environment.

In particular, attention will be focused on:-
The relevance and reliability of forecast performance and economic benefits inflow. The benefits expected to be derived from continuing to hold the shares such as expected dividends, capital gains and control of the resources of the company. Historical figures are important as a basis for forecasts.

Evaluate the methods of share valuation and ensure the accuracy of the computations.

There are two main bases;

1. Earnings basis
2. Assets basis





The earnings basis has two approaches;

1. Dividend yield method
2. Earnings yield method

The assets basis has two approaches also

1. Going concern basis
2. Break up value basis

- Since the company is a going concern and the shareholding to be disposed off is significant, the methods of dividend yield and break up value is not relevant.
- In my procedures, I will ensure that they have not been used.
- I would review the computations obtained using any of the other two methods and ensure that the value is reasonable, taking into consideration the nature of the business.

*JUNE 2000 QUESTION FIVE*

**QUESTION 11**

a) **The elements of an assurance engagement**

An assurance engagement performed by a practitioner will consist of the following elements:

i) **A three party relationship.** The three parties are the intended user requiring the assurance report, the responsible party (responsible for preparing the subject matter) and the practitioner, who will review the subject matter and provide assurance.

ii) **A subject matter.** This is the data to be evaluated that has been prepared by the responsible party.

iii) **Suitable criteria.** The subject matter is evaluated or measured against criteria in order to reach an opinion.

iv) **Evidence.** Sufficient appropriate evidence needs to be gathered to support the level of assurance.

v) **An assurance report.** A report containing the practitioner's opinion is issued to the intended user.

b) **Materiality**

Materiality for the financial statements as a whole (referred to from now on as 'overall materiality') and performance materiality must be determined for all audits.
In the context of the financial statements, a matter is material if its omission or misstatement would reasonably influence the economic decisions of users taken on the basis of the financial statements.

Performance materiality is a materiality level set by the auditor for particular transactions, account balances and disclosures.
Ultimately, both overall and performance materiality are determined using the auditors judgment as to how the users will be affected by misstatements for a particular area. However it is useful to use benchmarks as a starting point, such as 5% of profit before tax, or 1% of total assets.

When setting performance materiality, the possibility of a number of misstatements with a low value aggregating to high overall value must be considered. This results in it being lower than overall material



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# TOPIC 2

## MANAGEMENT OF PROFESSIONAL ACCOUNTING FIRMS

**QUESTION 1**

**(a) The independence of the auditor might be strengthened and improved in the following ways:**

- Provision of other services which could include accountancy, consultancy and taxation. Such services should be charged separately from audit work.
- The rotation of auditors on, say, a three-year cycle
- The compulsory peer review of the work of one audit firm by another audit firm,
- Compulsory audit committees for every company subject to audit
- Where the auditor provides other services their involvement must be advisory only. He must not perform executive functions or take executive decisions.

*JUNE 2012 QUESTION FIVE A*

**QUESTION 2**

**(a) Matters to consider and procedures to be done before accepting appointment**

1. Quality control procedures.
Quality control procedures should be in place so as to be able to guarantee the new client quality service.

2. Communication with outgoing auditor
The firm should request for permission to communicate with the outgoing auditors to confirm whether there are any matters that may make the auditor not accept appointment.

3. Statutory requirements.
Confirm whether there are statutory or regulatory requirements to be met before undertaking the audit.

4. Competence.
The staff should not only ensure that it has enough staff but also they are adequately trained with the relevant skill and expertise in this particular field and in audit in general.

5. Ethical requirements
The firm should ensure that all the professional requirements are adhered to including and especially matters of independence.

6. Timing.
The audit firm should consider whether the timing requirements of the client are realistic?

**(b) Reasons not to commence the audit before the above procedures are done**

1. The matters enables the auditors obtain an initial understanding of the client and as a





result the auditor is able to know what to expect during the audit and hence plan his audit accordingly, which is critical to the successful conduct of the audit.
2. If the auditor performs an audit contrary to this then he may be liable for negligence because the above matters are in accordance with ISAs and other standards that govern the conduct of an audit.
3. Failure to adhere to the above matters may attract penalties because the auditor will be in breach of professional conduct and the rules that govern the accountancy.
4. These matters and procedures are meant to safeguard the interests of the client and the auditor. Furthermore the matters provide a basis for which the auditor can negotiate terms with the client.

**(c) Purpose of an engagement letter and its contents**

Contents

According to ISA 210, the principal contents of an engagement letter include reference to:-

a) The objective of the audit of financial statements.
b) Managements responsibility for the financial statements
c) The scope of the audit, including reference to applicable legislation, regulations, or pronouncements of professional bodies to which the auditor adheres.
d) The form of any reports or other communication of results of the engagement.
e) The fact that because of the test nature and other inherent limitations of an audit together with the inherent limitations of any accounting and Internal Control System, there is an unavoidable risk that even some material misstatement may remain undiscovered.
f) Unrestricted access to whatever records, documentation and other information requested in connection with the audit.

The auditor may also wish to include in the letter:

- Arrangement regarding the planning of the audit
- Expectation of receiving from management written confirmation concerning representations made in connection with the audit
- Request for the client to confirm the terms of the engagement by acknowledging receipt of the engagement letter
- Description of any other letters or reports the auditor expects to issue to the client
- Basis on which fees are computed and any billing arrangement.

When relevant the following points could also be made:

- Arrangements concerning the involvement of other auditors and experts in some aspects of the audit.
- Arrangements concerning the involvement of internal auditors and other client staff
- Arrangements to be made with the predecessor auditor, if any, in the case of an initial audit.
- Any restriction of the auditor's liability when such possibility exists.
- A reference to any further agreements between the auditor and the client.



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**The engagement letter serves the following purposes-**

i) The letter defines the scope of work to be carried out and the respective responsibilities of the auditor and the client under the engagement. This helps in avoiding misunderstandings between the client and the auditor as regards to the scope of the work to be carried out and the respective responsibilities of both parties.
ii) The letter documents and confirms the auditor's acceptance of the appointment
iii) It explains the forms of any reports to be issued under the engagement
iv) To educate the client on: -
- His duty to maintain proper hooks of accounts and to prepare financial statements that show a true and fair view.
- His duty to prevent errors and frauds.
- His duty to provide all the necessary information
- That the audit should not be relied upon to detect errors and frauds.
To explain that the audit will be carried out on a test basis.
- Basis of charging his fees.
v) Minimize auditor's liability to third parties. The auditor may include a clause in the engagement letter limiting the client from distributing the audit report to parties other than those agreed on an identified in the engagement letter.

*DECEMBER 2009 QUESTION TWO*

## QUESTION 3

**Independence of the internal auditor**
The internal auditor will be independent in a situation where he is to reporting directly to the audit committee or director

**Qualification and experience**
The external auditors should consider the professional qualifications of the internal auditor

**Quality of their work**
The report made by the internal auditor can be assessed by the external auditor to evaluate their quality. Where reports portray high quality then external auditor can place reliance on the work of the internal auditors.

**Training program**
If the organization remind the internal auditor for training courses such as those organized by ICPAK then their work is likely to be more reliable than if they are not trained.

**Scope of the internal audit function together with their objective**
The scope of work refer to the nature and extend of the work and testimony done by the internal auditor if the extend of work and testing differs from that that would otherwise be done then the external auditor will be less on the

**Level of business risk**
If the overall and it risk is assessed to one higher than the audit will place less reliance or the work of the internal auditor





**Resources available in the internal audit function**
The level of resource will relate to staffing, finance, equipment etc.

**Professional due care.**
In assessing professional the cars check whether the internal auditor have property planned reviewed and document their work.

*JUNE 2009 QUESTION FOUR B*

## QUESTION 4

(a) The first matter for the auditor to quantify the total costs of this type of expenditure. This would be done by examining the costing records of job SPOO1 and checking the accuracy of the attributed costs to underlying documentation. This will involve the cost of the materials, used labor, time and appropriate rates and testing the accuracy and reasonableness of the overhead allocation to the job. Similar work would be required to determine the running costs that have been incurred since the building of the pool.

A further issue raised by this situation is whether there are any other transactions of a similar nature, which need similar consideration. For example, have any of the directors had any building work or house improvements made that have in effect been paid for by the company? Managements written assurances should be sought on this matter and the locations at which Rural Urban Housing work has been carried out during the year should be checked to see if they correspond to the addresses of any of the directors or known related parties.

Assuming the swimming pool is the only example of this type of transaction, the real issue is how it should be treated in the financial statements. The company (presumable through the directors) claims it is used for promotional purposes and the claim must be investigated. The auditor should physically inspect the pool for its existence.

**For example:**

Does the pool have "board" displaying rural and urban housing as the builder, and there is promotional literature at the pool?

Is there evidence of prospective clients visiting the pool?

Does Rural Urban Housing promotional literature mention that a pool is available for viewing? Have any orders for further swimming pools have been obtained from other customers?

Where the answers to these questions support the claims of management then the company's accounting treatment may be correct. The auditor would however have further issues to consider:

Who is the legal owner of the pool? It is claimed to be a company asset, however, if it is on land owned by the managing director (which presumably it is) then in law he would (probably) own the pool and it would be difficult to recognize it as a company asset; and

Whether the managing director could be assessed as having a personal benefit that should be disclosed as part of his remuneration (with possible taxation implications).



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Where there is little or no evidence that the pool is being used for promotional purposes, the company's treatment of the pool is incorrect. Neither the capital cost of the pool nor the running costs should appear (as such) in the financial statements. These costs should be treated either as remuneration of the managing director (which would have implications) or they should be reimbursed immediately. Treating them as a loan would be unacceptable as this would probably be in contravention of the Companies Act.

**(ii) Commission payments:**

- The issues raised by these payments could be summarized as:
- They may be genuine payments of commission that are unusual in the method of payment
- They may be a form of bribery, which are unlikely to be common practice, and are both unethical and illegal.
- They may not be payments to third parties at all and represent defalcations of cash by directors.

Given the information in the question, the auditor's suspicions must have been aroused and the matter should be probed to the bottom.. The appendix of ISA 240 The Auditors duty to consider Fraud in an audit of financial statements contains examples of 'unusual transactions' and 'problems in obtaining sufficient and appropriate audit evidence. Reference is made to inadequate supporting documentation and authorization of transactions and evasive responses by management. These examples appear to describe the commission payments and the existence of these factors increases the likelihood of fraud. The question implies that the management of Rural Urban Housing is reluctant to identify the recipients on the basis that doing so would increase the risk that these valuable contacts may be disclosed to competitors. This is an inadequate response. The auditor has a duty of confidentiality to the client and would not reveal commercially sensitive information of any kind. The auditor should seek written representations from management as to the nature of these of payments. However ISA 580 management representations say such representations cannot be a substitute for other audit evidence where the auditor could reasonably expect it. It seems unlikely that the auditor will be able to discover the true nature of these transactions. In these circumstances the auditor should express a qualified opinion or a disclaimer in his report on the basis of the limitation of scope of the audit. If the auditor is able to conclude that there is a fraud and its effect is material and has not been properly reflected in the financial statements this could lead to an 'adverse' audit report.

Where fraud involves senior management including members of the board, the auditor should consider reporting to an audit committee, if one exists, or taking legal advice. As the last resort the auditors should consider withdrawing from the audit, as there could be no reliance on managements representations.

*DECEMBER 2000 QUESTION TWO*

**QUESTION 5**

a) **Situations where an auditor may disclose confidential information about a client**
Auditors have a professional duty of confidentiality and this is an implied term of the agreement made between the auditor and the client.
However there may be a legal tight or duty to disclose confidential information or it may be in the public .interest to disclose details of clients' affairs to third parties.
Also the client may have given the auditor consent to disclose, confidential information. These are general principles only and there is more specific guidance which is discussed below.



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**Obligatory disclosure**
If the auditor knows or suspects that his client has committed money-laundering, treason, drug-trafficking or terrorist offences then he is obliged to disclose all the information he has to a competent authority.

Under ISA 250 Consideration of laws and regulations in an audit of financial statements auditors must also consider whether non-compliance with laws and regulations may affect the accounts. They might have to include in the audit report a statement that non compliance with laws and regulations has led to significant uncertainties (in an emphasis of matter paragraph), or may consider modifying the audit opinion if there is a disagreement over the way specific items have been treated in the accounts.

**Voluntary Disclosure**
Voluntary disclosure may be applicable in the following situations:

- Disclosure is reasonably necessary to protect the auditor's interests, for example to enable him to sue for fees or defend an action for, say, negligence
- Disclosure is authorized by statute
- Where it is in the public interest to disclose, say where an offence has been committed which is contrary to the public interest.
- Disclosure is to non-governmental bodies which have statutory powers to compel disclosure.

If an auditor is requested to assist the police, the taxation or other authorities by providing information about a client's affairs in connection with enquiries being made, he should first enquire under what statutory authority the information is demanded.
Unless the auditor is satisfied that such statutory authority exists he should decline to give any information until he has obtained his client's authority. If the client's authority is not forthcoming and the demand for information is pressed, the auditor should not accede unless advised to do so by his legal advisor.
If an auditor knows or suspects that a client has committed a wrongful act he must give careful thought to his own position. The auditor must ensure that he has not prejudiced himself by, for example, relying on information given by the client -which subsequently proves to be incorrect or unreliable.
However, it would be a criminal offence for a member to act positively, without lawful authority or reasonable excuse, in such a manner as to impede with intent the arrest or prosecution of a client whom he knows or believes to have committed an 'arrestable offence.'

b. **Risks to independence**
**Audit Partner**
Mr. Grace has been the audit partner on the audit of Ancients for the last eight years, His independence and ; objectivity are likely to be impaired as a result of this close relationship with a key client and its senior management. The ACCA Code of ethics and conduct requires key audit partners to be rotated after seven years and Mr. Grace's involvement for eight years already contravenes this rule.
This threat could (and should) be addressed by appointing another audit partner to the audit of Ancients and rotating partners at suitable intervals thereafter.

**Tax Fees Outstanding**
There are taxation fees outstanding from Ancients for work that was done six months previously. In effect, McKay £ Co are providing an interest-free loan to Ancients. This can threaten independence



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and objectivity of the audit firm as it may not want to modify the audit opinion in case the outstanding fees are not paid.
This can be addressed by discussing the issue with the directors of Ancients and finding out why the fees have not been paid. If the fee is still not paid the firm should consider delaying the start of the audit work or even the possibility of resigning.

**Fee Dependence**
Ancients is one of McKay & Co's most important clients and the firm provides other services to this client as well as audit, including taxation services. Also the company is growing rapidly. Objectivity and independence are considered to be threatened to the degree that an independent engagement review is needed by an (external firm or regulator (and disclosure to those charged with governance) if the fees for audit and recurring work exceed 15% of the firm's total fees for a listed client such as Ancient
This threat could be mitigated by reviewing the total of the audit and recurring fee income from Ancients as a % of McKay & Co's total fee income on a regular basis and possibly limiting the provision of the other services if deemed necessary to maintain independence.

**Relationship to financial Director of Ancients PLC**
Allyson Grace, the daughter of Mr. Grace, has recently been appointed the Financial Director of Ancients. The independence of Mr. Grace could be threatened because of their close family relationship. The extent of the threat depends on the position the immediate family member holds with the client and the role of the professional on the assurance team.
As Financial Director, Allyson has direct influence over the financial statements and as engagement partner, Mr. Grace has ultimate responsibility for the audit opinion, so there is a clear threat to objectivity and independence.
This threat to independence could (and should) be mitigated by the appointment of another audit partner to this client.

**Meal**
The fact that Allyson Grace wants to take the audit team out for an expensive meal before the audit commences could be considered a threat to independence as it might influence the audit team's decisions once they start the audit of the financial statements. The ethics rules state that gifts or hospitality from the client should not be accepted unless the value is trivial and inconsequential.
This threat could be mitigated by declining the invitation.

**QUESTION 6**

a) **Threats to independence:**
**Same audit partner and long-standing audit client**
NorthCee has been a client of Dark for seven years, during which time the audit partner has remained the same. This gives rise to a familiarity threat.
The threat can be mitigated by rotating the audit partner. ACCA's Code of ethics and conduct states that for listed companies, the engagement partner (or any key audit partner) should be rotated after no more than seven years and should not return until a period of two years has passed. Therefore, although NorthCee is not yet listed, the firm could consider this. It could also ensure that an independent internal or external quality review of the audit work is undertaken.





**Preparation of financial statements**
The firm has been asked to continue to prepare the financial statements for the company, as well as carry out the audit. This gives rise to a self-review threat, as there could be a perception that the firm will not apply sufficient professional scepticism to its own work.
NorthCee is attempting to obtain a listing. Firms should not prepare accounts or financial statements for listed or public interest clients, unless an emergency arises. Therefore Dark should decline the engagement to prepare the financial statements.

**Attendance at evening reception**
The audit partner and audit manager have been asked to attend an evening reception where NorthCee will present its listing arrangements to banks and existing shareholders. This gives rise to a familiarity threat, as the acceptance of the hospitality could lead to a closer relationship with client management and a risk of placing too much trust in their representations.
This threat can be reduced by the firm declining the invitation to attend the reception.

**Overdue taxation fees**
Dark has provided taxation return preparation services to NorthCee which is generally considered not to pose a self-review threat, However, there are significantly overdue fees which, can be considered as a loan to the client and therefore poses a self-interest threat. There could be a perception that the firm would be reluctant to modify its audit opinion in the face of the risk of not receiving the overdue fees
This threat can be mitigated by firstly discussing the overdue fees with the senior management of NorthCee and, as a last resort, considering resigning if they are not paid.

**Inheritance of share capital**
The audit manager has inherited 5% of NorthCee's share capital as a result of a death in the family. This poses a self-interest threat and ACCA guidance states that a member of the assurance team should not hold direct financial interests in a client

This threat would therefore be mitigated by the audit manager declaring the interest to the firm and then disposing of the shares straightaway. An alternative would be to move the audit manager to another client.

*ACCA*

Promises mean everything,
but after they are broken,
sorry means nothing.

Unknown.



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# TOPIC 3

## LEGAL LIABILITY

**QUESTION 1**

**a) Liability of the auditors**

Decided legal cases have not been consistent on the issue of auditors liability. Discussed below are few, of the decided cases on auditors liability

- **Candler V Crane Christmas & Co.**

Majority (Lord Denning dissenting) decided that there could be no liability in the absence of a contractual relationship. The decision was reached despite Candler having been induced to invest money in the company on the strength of the accounts which were negligently prepared by the company's auditors.

- **Hedley Bryne & Co Ltd V Heller 4 Partners Ltd**

The judges took differed with the above Judgment. They were of the view that the case had been wrongfully decided. They held that a certificate issued in the ordinary course of a bank's business would be relied upon by the party to whom it is issued and the absence of a contract did not constitute a valid defence in negligence claim against the bank.

The Counsel of the Institute of Chartered accountants in England and Wales (ICAEW) on their part maintained that no third party liability would attach auditors if the financial statements they have audited under the Companies Act are used without their knowledge or consent by outsider's ill the investment context.

However it is importance to note that any loss traceable: to negligence of auditors would not be easy to defend .

- **Jeb Fasteners Ltd V Marks Bloom & Co**

In this case it was held that;

- A duty of care was owed by defendant auditors (Marks Bloom & Co.) to the plaintiff.
- The plaintiff in realizing the takeover decision had relied on the financial statements and unqualified report of the auditors.
- The accounts did not show a true and fair view of the company and were negligently prepared.
- Judgment would be given for the defendant auditors, but by reason only of the fact that on the evidence before the court the plaintiff would have acted no differently and would still have gone ahead to take over the company.

- **Caparo Industries Plc. V Dickman & Others**

It was unanimously concluded by the five lords that the question of auditor'~ duty of care to third parties does not extend to investors and individual shareholders acting on Stewardship accounts.





**Conclusion**

The auditors of Pickley Ltd would rely on some of the cases decided by the court while at the same time legal liability may arise based on the interpretation of the case in the question. The auditors can mitigate against legal liability by writing to the potential investor on the issue raised

**b) Contributing factors for increased lawsuits against auditors are:**

i. Regulators such Capital Markets Authority (CMA) have become more conscious of their responsibility in protecting investors interest.
ii. Increasing size of businesses coupled with globalisation has led to complexity of auditing and accounting functions.
iii. Growing awareness of the responsibilities of public accountants by users of financial statements.
iv. Judges encounter hardships in understanding and interpreting technical accounting and auditing matters.
v. Changes in accounting standards and legislation.

**c) Practicing auditors could take the following actions to minimise their liability.**

- Undertaking measures to ensure that all assignments are performed to the highest quality standards. The auditor should ensure that the requirements of the International Standards on Auditing are adhered to in ill assignments;
- Proper planning of the audit work to ensure that all potential risks that could affect the financial statements are identified and appropriate audit procedures performed;
- Be independent
  A lot of litigation has arisen from a too willing acceptance by an auditor of a client's representation or of a client's pressures. The auditor must maintain an attitude of healthy scepticism.
- Putting in place appropriate quality control policies and procedures and monitoring their effectiveness;
- Limit access to his work or reports, where possible;
- Include a disclaimer of liability clause in the relevant document or report. Example of such a clause would be while every care has been taken in the preparation of this document, it may contain errors for which we cannot be held responsible"
- When submitting un-audited accounts or other un-audited financial statements (where the auditor prepares accounts on behalf of the client) the auditor should ensure that the purpose for which the statements or reports have been prepared is properly explained on the face of the report.
- Obtaining proper terms of engagement such that the auditor's roles and responsibilities are clearly bid out and the client understands his role in the engagement.
- Concentrate on clients who have integrity
  There is an increased likelihood of having legal problems when a client lacks integrity ill dealing with auditors, employees, units of government, a firm needs procedures to evaluate the integrity of clients and should dissociate itself from clients found lacking integrity.

*JUNE 2011 QUESTION ONE*



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**QUESTION 2**

Inherent risk is the susceptibility of an account balance or class of transactions to material misstatement, either individually or when aggregated with misstatements in other balances or classes of transactions irrespective of related internal controls.

Therefore, inherent risk is the risk that items will be misstated due to characteristics of those items, such as the fact they are estimates or that they are important items in the accounts.

1. As an audit manager, I will use my own professional judgment and all the available knowledge/information to assess inherent risk.
2. As regards the takeover, I will consider whether the provisions managers' assessment of inherent risk is reasonable regarding the sundry accruals and provisions.If there was information that was not available to the profits manager and is now available, for example provision for management bonuses, I will consider the impact of this information on his assessment of inherent risk. If a lot of information is not available (e.g. as regards provision) this would increase the level of inherent risk.
3. My audit approach would be determined by the extent of reliance that I would be able to place on the work carried out by the previous audit manager. If I am satisfied with his approach, I may continue with it and arrive at a conclusion or I would have to carry out my own tests.

Even if I place reliance on the previous audit manager's work, I would still have to carry out some substantive procedures and compare my results with those of the previous manager. If they agree, I would be persuaded to place reliance on his work.

(b)

1. Accruals have been verified by inspecting supporting documentation of (60% of the value of accruals) accruals over Sh.60, 000. Thus, this is not representative of the accruals figure and further tests need to be done on the other 40% on a test basis. If analytical procedures are carried out, and the 2001 and 2002 figure are compared, it will be seen that there was a significant drop. This could be an indicator that some accruals have been left out. Thus further work should be done to test for completeness of accruals
2. The reason given by Mr. Chege does not seem to be reasonable for the decrease in provision. This is because, even if the employees may not carry forward the leave, they are entitled to their leave pay. Thus, I will ensure that the provision takes into account the unpaid leave pay for the other employees.
3. IAS 37 prohibits, companies from creating a provision for maintenance expenses on the grounds that these expenses are avoidable. Thus, this provision needs to be realized to the profit and loss account by: -

   DR provision for maintenance
   CR profit and loss accounts.

4. I would consider the reasonableness of the estimated costs. If it is an overprovision then I would require the directors to write off the overprovision and set up only the required amount, as prudence would dictate.
5. This provision is not justified. This is because credit notes are accounted for in the period in which they arise and not necessarily the period in which the sales were made. Thus. I need to discuss with the directors the need to reverse this provision by: -

   DR provision for credit notes,
   CR profit and loss account.





6. Mr. Chege's argument that the list of director's bonus is confidential is not acceptable. This is because according to Companies Act, the auditor has a statutory right of access to all books and records of the company. Thus, I would demand from him such a list, which I would use to determine the reasonableness of the provisions. If he refuses to give the list I would seek other evidence.

If not available, I will have to consider whether lack of the list consisting a limitation in the scope of my work and if so, I would give a qualified opinion i.e. a disclaimer.

*DECEMBER 2002 QUESTION TWO*

**QUESTION 3**

(a) An auditor may be liable for damages for material misstatements in published accounts on which he has expressed an audit opinion in the following circumstances: -

1. His failure to detect error and fraud;
2. Carelessness or dishonesty on his part or by his audit assistants.

However, he may avoid liability by;
Planning and carrying out audit procedures that will provide him with a reasonable expectation of detecting all material misstatements.

Again, it may be a defense to show;

1. There was no negligence
2. That no duty of care was owed to the plaintiff in the circumstances
3. In the case of actions in tort, that no financial loss has been suffered by the plaintiff.

(b) **A successful, legal claim be brought against the auditor by: -**

1. His client, whom he owes a primary duty of cane
2. To third parties under the law of tort to assess the value of damages, the tort will consider the following:-

1. It must be proved that the auditor was actually negligent
2. That out of his negligence the plaintiff suffered a financial loss.
3. That the auditor owed a duty of care to the plaintiff.
4. Whether the financial loss is material to warrant redress.

(c) **Ways of limiting an auditors liability; -**

**1. Incorporation of the audit practice**

This has already been done in the United Kingdom. For example, KPMG incorporated its UK practice. However in Kenya, this is prohibited by law.
These arrangements create a "firm within a firm". KPMG audit plc is a limited liability company wholly owned by the partnership. This is done in order to protect partner's from the crushing effects of litigation. Thus, KPMG Audit plc fences the personal assets of each partner [illegible] from the negligence of a colleague working on an audit.

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Under this arrangement, partners involved directly in an audit can still be sued, but incorporation should prevent other partners from losing everything they own simply because they work with someone who has been negligent.

Incorporation will however impose statutory disclosure required on accountancy firms, which have been able in the past to avoid producing published accounts because of their partnership status.

This greater degree of openness can be seen in a more positive light. Clients will be able to see the first position of one of their most important service providers.

**2. Limited liability partnerships**

An alternative means of limiting the risks faced by the accountancy profession is allowing partnerships limited liability.
If such a law is passed, the change in law would protect partners, personal assets from negligence claims against another partner. The firm's assets and those of the allegedly negligent partner would still be exposed to liability.

**3. Avoiding or disclaiming liability to third parties (non statutory works)**

A duty of care to a third party may arise when an accountant does not know that his work will be relied upon by a third party, but only knows that this work of a kind which is liable in the ordinary course of events to be relied upon by a third party.
Conversely, an accountant may sometimes be informed before he carries out certain work that a third party will rely upon the results. An example is a report upon the business of a client, which the accountant has been instructed to prepare for the purpose of being shown to a potential purchaser or potential creditor of
that business. In such a case, an accountant should assume that he will be held to owe the same duty of care to the third party as to his client.
One way that the accountants may seek to avoid liability to third parties is to limit access to his work or reports. For example:

(a) When publishing documents generally an accountant may find it advantageous to include in the document a clause disclaiming liability. For example; "while every care has been taken in the preparation of this document, it may contain errors for which we cannot be held responsible"
(b) When submitting unaudited financial statements or reports to the client, an accountant should ensure that any special purpose for which the statements or reports have been prepared is recorded on their face and in appropriate cases should introduce a clause providing that the report or statement is confidential and has been prepared solely for the private use of the client. For example; - "This report (statement) has been prepared for the private use of X (the client) only and on condition that it must not be disclosed to any other person without the written consent of Y (the accountant)
(c) There are areas of professional work (for example when acting as an auditor under the Companies Act), where it is not possible for liability to be limited, or excluded. There are other areas of professional work (for example when preparing reports on a business for the purpose of being submitted to a potential purchaser) where although such a limitation or exclusion may be included, its effectiveness will depend on the view which a court may subsequently form of its reasonableness.
(d) The investor's view of the reliability of the audit opinion may be attended by the limiting of an auditors liability. The investors may be of the opinion that an auditor's opinion may be given



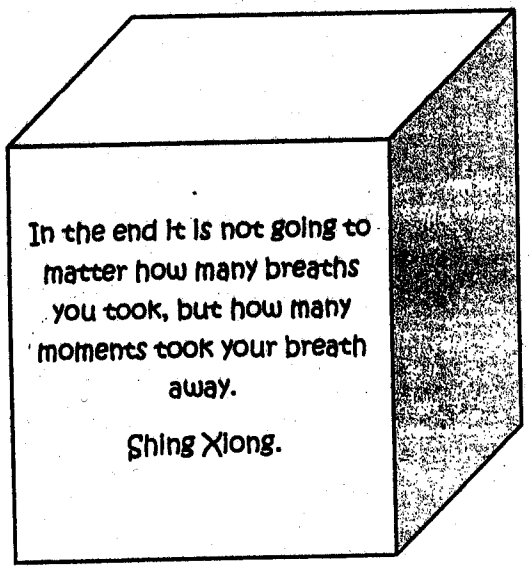


recklessly because his liability is limited, thus, they may not consider it as reliable as when the auditors liability was not limited. There will be no effect on the work to be performed by the auditor. This is because the auditor's work is governed by statutes, auditing standards and professional guidelines that have not changed with the limited auditor's liability.

Therefore the auditor's opinion will still be as reliable as before.

(e)
- Yes. It is practical for the auditor's liability to be limited. However, the extent of liability can only be determined by a court of law in the case of a legal suit.
- There will be not effect see (d) (ii)
- Yes. I agree that the auditor's liability should be limited. Why? Because the public as a result of misunderstanding the role of the auditor have been bringing cases of negligence against them indiscriminately.

*JUNE 2002 QUESTION FIVE*



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# TOPIC 4

## RISK ASSESMENT

### QUESTION 1

**a) Audit risks (ISA 320)**

Audit risk refers to the risk that the auditors will express an inappropriate audit opinion when the financial
statements are materially misstated.

Audit risks facing the auditor when material assets are stated at fair values instead of historical costs include:

- **Inherent risk** is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.
- **Control risk** is the risk that a misstatement that could occur in an assertion and that could be material either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control. Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to the preparation of the entity's financial statements.
- **Detection risk** is the risk that the auditor will not detect a material misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and its application by the auditor.

*DECEMBER 2011 QUESTION THREE A*

### QUESTION 2

**Risks in expressing an opinion**

| Risks posed to the auditor | Measures to minimize the risk |
|---|---|
| 1. Biological assets<br>Since Tea and blue gun trees are biological assets the auditor may be faced with challenges like determining costs incurred to date, economic value mature trees, market value etc. | 1. The auditor may check the industry practice regarding the assets. |
| 2. Collusion between bank staff and company employees in relation to exchange rate negotiations | 2. The auditor should check the reasonableness of exchange rates; he should do so by confirming the exchange rates from relevant authorities such as banks. |
| 3. Since the grading system is manual, it may lead to human error and abuse. | 3. Enter into discussion with management on safeguards against possibility of failure of the system. |





| | |
|---|---|
| 4. The is the risk that brokers can manipulate prices realised at the auction.<br>5. Determination of closing stocks in each of the five shops as well as stocks in transit | 4. Confirm that all charges by the broker are in line with industry practice and legal provisions.<br>5. Check sales receipts, deposit slips and stock take sheets for validity |

### QUESTION 3

**a) Audit failure and probable causes**

-It refers to a situation where the auditor issues an erroneous audit opinion as the result of an underlying failure to comply with the requirements of generally accepted auditing standards. Audit failure frequently related to inadequate industry expertise.

• The causes of audit failure include:-

Failure to-

- Understand the entity's business model.
- Understand changes in the entity's operating environment.
- Fully understand the nature the business purpose of transactions.
- Perform appropriate client acceptance/continuance procedures.
- Reconsider prior year judgment or assumptions.
- Involve specialists.
- Be sufficiently firm with the client,
- Corroborate explanations given by client.
- Consult on issues and judgments.
- Appropriately consider corporate governance.
- Arrange realistic deadlines.

b) Identify the following risks

i) **Audit risk**

Audit risks

This is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a measure of how reliable the information used in the accounting system is that, how much reliance can be put on it. The higher the audit risk, the more evidence must be gathered in order for the auditor to obtain sufficient assurance as a basis for expressing an opinion on the financial statements. Audit risk has three main components.

- Inherent risk-this is the susceptibility of an account balance of class of transactions to misstatements that could be material, individually or when aggregated with misstatements ill other balances or classes, assuming that there were no related internal controls.
- Control risk- This is the risk that could occur in an account balance or class of transactions and that could be material-individually or when aggregated with misstatements in other balances or classes-will not be prevented or detected and corrected on a timely basis by accounting and internal control systems.
- Detection risk-risk that an auditor's substantive procedures will not detect a misstatement that exists in an account balance or class or transactions that could be material individually or when aggregated with misstatements in other balances or classes.



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ii) **Business risks**

They result from significant conditions, events, circumstances or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. Even though such risks are likely to eventually have an impact on an entity's financial statements, not every business risk will translate directly in a risk of a material misstatement in the financial statements, which is often referred to as audit risks. There are 3 categories of business risk.

- Financial risk- this is the risk that the firm will not be able to meet its short term maturing obligations as a when they fall due.
- Operational risk- these are risks arising with regard to operations for instance, the risk that a major supplier will lie longer be able to supply the company with the key raw materials.
- Compliance risk- Risk that arises from non compliance with laws and regulations under which the business operates tor example, environmental issues.

*DECEMBER 2010 QUESTION FIVE*

QUESTION 4

a) **Possible areas that may lead to the risk of material misstatement in the financial statements of Zep Engineering ltd**

- The classification of assets in accordance with the requirements of IAS 16 and IFRS 6.
- Oil and gas valuation: Valuation of oil and gas in accordance with IAS 2
- Valuation of tile property and equipment that firm uses during exploration as provided for under IAS 16 property, land and equipment and I FRS
- The provisions made by the company, contingent liabilities and contingent assets. This may lead to possible litigation as a result of environmental degradation.

b) **Substance procedures to detect material misstatements with respect to social and environmental matters.**

- Obtain a copy of the social and environmental policy of the firm and try to understand its policies concerning the environment and treatment of social ancl environmental Issues.
- Potential impact of the social and environmental issues on the financial statements should be assessed
- Hold discussions with the firm's lawyers to provide more information on litigation matters that may be facing the firm.
- Assess whether the social and environmental policy is likely to achieve its objectives which include, meeting legal requirements, satisfy customers/suppliers and other stakeholders.
- Test the implementations and adherence to the policy by holding discussions with the relevant persons within the firm. Complement the tests by observations and walk through tests where applicable.
- Determine the effect of the social and environmental issues on the overall operations of the firm including the going concern of the firm.





c) **Components of the independent verification report on environmental matters**

- Impact of the firm's activities on the environment
- A statement that management is responsible for the environmental matters and the associated environmental policies.
- An opinion as to whether management has achieved the objectives of the environmental policy.
- The recommendations made by the auditor. The recommendations are with respect to the environmental matters.

*DECEMBER 2010 QUESTION TWO*

QUESTION 5

(a) (i) Audit Risks

Audit risk refers to the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a measure of how reliable the information used in the evidence must gathered .in order for the auditor to obtain sufficient assurance as a basis for expressing all opinion on the financial statements.

**Key audit risks may include**

1. The management should install an internal control system to detect material errors and correct them. In this case management should implement controls around receivables, work in progress and inventory to ensure that any materials errors are detected before they make it to the financial statements.
2. Some material errors may fail to be detected by the controls and others may completely by-pass the controls. The value of inventory depends on the valuation by the chief engineer of the firm, who despite all the controls may under or overstate the value of inventory to suit the management intentions.
3. The auditor is expected to carry out audit procedures to provide reasonable assurance that material errors will be detected and removed from the financial statements. Despite the audit procedures and the controls, there will be the possibility that some misstatements will be undetected. The management makes provisions for warranties based on estimates of the costs incurred in repairing the machines.

**Matters to be considered when planning for the final audit**

ISA 210 provides that when planning and performing audit procedures and in evaluating and reporting the result, auditors should consider the risk of material misstatements in the financial statements resulting in fraud. The auditor must assess the risk that a material fraud or error has occurred.

1. **Knowledge of the business (ISA 310)**

The auditor should obtain a proper understanding of the business to enable the auditor identity and understand the events, transactions and practices in which in the auditor's judgment may have a significant effect on the financial statements or the auditor's report. The auditor needs to obtain sufficient understanding of the firm's clients, the nature of operations of the firm, the industry within which the industry operates.



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**2.Materiality (ISA 310)**

The auditor needs to obtain an understanding of all material items that may affect the reporting in the financial statements and the auditor's report and their impact to the business. The auditor should assess the impact of bad debts and damaged inventory and their overall impact to the financial statements.

**3.Going concern (ISA 570)**

The auditor should obtain all information regarding matters that affect the going concern of the firm. The auditor should assess the impact of the defaulting customers and the effect of cancellation of orders already placed. The auditor should also take into consideration other factors affecting the existence of the firm in the foreseeable future.

**(ii) Audit procedures to be used in verifying the allowance**

i. Obtain a detailed listing of the receivables and a listing of all repairs that have been carried out in the current year and in the previous years.
ii. Obtain the assumptions made by management in the coming up with the provisions and assess thei r reasonableness.
iii. Compute the previous year's provision and re-compute the current years and compare with the management's provisions.
iv. Discuss with management about the provisions they have made and reconcile any differences that may arise and the need to change the provisions where necessary.
v. Compare management's provisions in the previous years and the current year and establish whether the assumptions have been applied consistently over the years.
vi. In case there are any inconsistencies, the same should be resolved with management and adequate explanations provided to that effect.

*DECEMBER 2009 QUESTION ONE A*

**QUESTION 6**

**(a) Business and audit risk**
**i) Business risk**

- They result from significant conditions, events, circumstances, or actions that could adversely affect the entity's ability to achieve its objectives and execute its strategies. Even though such risks are likely to eventually have an impact on an entity's financial statements, not every business risk will translate directly in a risk of a material misstatement in the financial statements. For example, the fact that an engineering firm has difficulty finding sufficient engineers is clearly a business risk, without being an obvious direct link to an audit risk.

ii) **Audit Risk**

- It is risk that the auditor gives an inappropriate audit opinion vhen the financial statements are materially misstated. It is a measure of how much reliable the information used by the accounting system is. The higher the audit risk, the more evidence must be gathered in order for the auditor to obtain sufficient assurance as a basis for expressing an opinion on the financial statements. Audit risk has three components.





1. **Inherent risk (IR):** It is the susceptibility of an account balance or class of transactions to misstatements that could be material individually or when aggregated with misstatements in other balances or classes, assuming that there were no related internal controls.
2. **Control risk (CR.)** Risk that a misstatement that could occur in an account balance or class of transactions and that could be material- individually or when aggregation with other misstatements in order balance or classes will not be prevented or detected and corrected on a timely basis by accounting and internal control systems.
3. **Detection risk (DR):** Risk that an auditor's substantive procedures will not be detect a misstatement that exist in an account balance or class of transactions that could be material, individually or when aggregated with misstatements in other balances or classes.

*DECEMBER 2009 QUESTION THREE A*

**QUESTION 7**

**(a) Professional skepticism and its role in the detection or fraud**

- Professional skepticism recognizes the possibility that circumstances may exist that cause the financial statements to be materially misstated. It is an aspect of rigor that information and explanations obtained are assessed and additional evidence sought as necessary.
- Due to the characteristics of fraud, the auditor's attitude of professional skepticism is particularly important when considering the risk of material misstatement. Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- The auditor must be prepared to consider that a material misstatement due to fraud could exist, notwithstanding the auditor's past experience with the entity and the auditor's belief about the honesty and integrity of management and those charged with governance of the entity
- When making inquiries and obtaining other audit evidence, the auditor exercises professional skepticism so as not to be satisfied with less-than-persuasive audit evidence based on a belief that management and those charged with governance are honest and have integrity.
- An audit of financial statements rarely involves the authentication of documentation, nor is the auditor trained as (or expected to be) an expert in such authentication. However, the auditor considers the reliability of the information to be used as audit evidence including consideration of controls over its preparation and maintenance where relevant. Unless the audit reveals audit evidence to the contrary, the auditor ordinarily accepts records and documents as being genuine.
- An aspect of observing professional level of due care and skill in the planning controlling and documenting the audit work. (ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements, paragraph 24).

**(b) Audit risks and business risks**

- Audit risks (AR=IR x DR x CR)

This is the risk that the auditor gives an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a measure of how reliable the information used in the accounting system is, that is, how much reliance can be put on it. The higher the audit risk, the more evidence must be gathered in order for the auditor to obtain sufficient assurance as a basis for expressing an opinion on the financial statements. Audit risk has three main components.



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i. **Inherent risk** - this is the susceptibility of an account balance or class of transactions to misstatements that could be materials individually or when aggregated with misstatements in other balances or classes assuming that there were no related internal controls.
ii. **Control risk** - this is the risk that a misstatement that could occur in an account balance or class of transactions and that could be material-individually or when aggregated with misstatements in other balances or classes-will not be prevented or detected and corrected on a timely basis by accounting and internal control systems.
iii. **Detection risk** - risk that all auditor's substantive procedures will not detect a misstatement that exists in an account balance or class of transactions that could be material individually or when aggregated with misstatements in other balances or classes.

**The key audit risks include;**

**1. Poor accounting system**
Simple accounting system which the company uses comprises a simple computer and the staff at the accounting department who maintain the books manually. There is a risk that material misstatements may be done since there are no checks and balances in the accounting system.
This in effect makes it hard for the auditor to detect fraud or material misstatements.

**2. Unclear job description**
Responsibilities of staff at the department overlap each other. Employees team up in different jobs meaning that there are no clear job descriptions. Employees can use such confusion as an avenue to perpetuate fraud.

**Business Risk**

There are 3 categories of business risk namely: -

- Financial risk - this is the risk that the firm will not be able to meet its short term maturing obligations as and when they fall due.
- Operation risk - These are risks arising with regard to operations for instance, the risk that a major suppliers will no longer be able to supply the company with the key raw materials.
- Compliance risk - risk that arises from non compliance with laws and regulations under which the business operates for example, environmental issues.

**3. Specialized goods**
The firm deals in specialized stuff that is sold to the affluent market only. This poses a risk to the firm in case the goods do not find any customers and hence the firm may be holding too much high value non-moving stock which is detrimental to the firm.

**4. Inefficient internal controls**
Inefficient internal controls and are not able to detect frauds or other misstatements. The firm's internal controls do not clearly provide procedures and checks and balances to ensure
that there is minimal chance for a fraud to be carried out. There is therefore need for the auditors to carry out more effective substantive procedures.

*AUGUST 2009 QUESTION TWO*



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**QUESTION 8**

| Potential Risk | Audit Procedures |
|---|---|
| 1. Financial reporting risk | 1. Review the transactions between MPH and RS |
| 2. Foreign operations risk | 2. Review currency exchange rates. |
| 3. Exchange risk | 3.Reviewthe translation exercise |
| 4. Related party transactions resulting in misrepresentation | 4. Request for a letter of representation showing details and disclosures are appropriate |
| 5. Pension fund not being able to pay benefits | 5. Review the basis on which the surplus was determined. Consult actuaries |
| 6. Inadequate provisions to boost profits | Review cut off procedures for sales and purchases |

*JUNE 2004 QUESTION TWO*

**QUESTION 9**
1. It should be obvious to any prospective auditor that the management of Twenty Second Century Ltd could lack integrity, given the circumstances of the previous auditors dismissal and the 'opinion shopping' procedures adopted by them. Thus, the quality control procedures adopted by the prospective firm would include the determination of the client's integrity.

The quality control procedures therefore which should be adopted by a firm of auditors when accepting a new client with potentially high audit risk such as Twenty Second Century Ltd are as follows:

(i) Request the client's permission to communicate with the previous auditor. If permission is refused, the auditor should decline the nomination.
(ii) On receipt of permission, the previous auditor should be requested to furnish all information which would enable the prospective auditor to decide whether he is prepared to accept nomination. In the case of Twenty Second Century Ltd, the prospective audit firm may enquire of any reason that the firm might have to question the integrity of the prospective clients management.
Further information would be required about the reasons for the audit qualifications and the dismissal of the previous auditors.
(iii) Enquire informally of the client's business associates whether they feel that the management of the company is competent and trustworthy.
(iv) Contact the regulatory authority with responsibility for overseeing the sector, if this is applicable, in order to see if any disciplinary measures have been taken against the company.
(v) Make a preliminary assessment of audit risk. This would be undertaken by discussing business and economic matters with the client, and by making a preliminary assessment of the internal control structure of the client. In the case of Twenty Second Century Ltd, the previous auditors had qualified the audit report because of poor internal controls and lack of audit evidence. Thus, it would be important for the audit firm to make a preliminary visit to the prospective client in order to gain first hand experience of the management and the accounting system.



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(vi) Assess whether the audit firm has the required expertise to carry out the audit. The audit of land developers is quite specialized and experience in the sector is important if the audit is one of high audit risk.

(vii) Evaluate the costs and benefits of acceptance of the client. The risk of potential legal liability and loss of public image may make the appointment relatively unattractive.

2. There are several ethical issues involved in the maintenance of a secret expense account for the company by the audit partner. First, the audit partner has not behaved with integrity and objectivity. Integrity implies not merely honesty but truthfulness. He has not been open with the board of directors of the company because he concealed the secret expense account from them. Secondly, the audit firm would not be seen to be independent even though in dealing with the transactions in this secret expense account he may have possessed a true mental state of independence. Third parties would doubt the partner's independence irrespective of whether or not the partner acted independently. Objectivity can only be assured if the partner was, and was seen to be independent. Thirdly, in the case of a large public company, a practice should not participate in the maintenance of the accounting records. The auditor should not assume a role equivalent to that of an employee of a client.

   The key consideration in this case is the fact that J.Prescott and the audit partners kept the expense account secret from the management of the company. It would appear to an observer that the two persons were colluding in order to at best, conceal information and at worst defraud the company. From a third party, viewpoint the auditor would not be seen to be independent and it would render the audit opinion somewhat less meaningful.

3. In recent years, many companies, who have disagreed with their auditors over an item in their financial statements, have asked another audit firm for their view on the matter and if the view is sympathetic, then the company invariably has changed its auditors. This practice of 'opinion shopping' could be minimized by adopting the following procedures:

   (i) Where an auditor is dismissed, the company could be required to file a statement to that effect with the Registrar of Companies stating any disagreements with the former audit firm.

   (ii) The audit firm who succeeds the former auditors could be required to disclose also to the Registrar and/or in the first audit report whether or not it agrees with the former audit firm. The above points could deter companies from attempting to find audit firms who are prepared to express a more flexible attitude to accounting issues

   (iii) Where an audit firm is approached by a non-client to give a technical opinion on a matter, it is important that the firm has a clear and comprehensive understanding of the issue prior to giving an opinion.

   Thc audit firm should correspond with the non-clients own audit firm in order to obtain all the information at hand. If it appears that the non-client is 'opinion shopping' then the audit firm should consider its ethical position and possibly refuse to give an opinion.

   (iv) Existing legalization gives auditors the right to present their case to the members against removal either verbally at a general meeting or in writing prior to their removal. Similarly where an auditor resigns from his office, he may make a statement regarding the circumstances of his resignation which must be sent to the registrar and every person entitled to receive a copy of the financial statements. However, auditors seldom publicize their point of view when being dismissed for fear of being branded 'controversial'. However, if audit firms were prepared to publicize their viewpoint more forcibly the adverse publicity might





dissuade company directors from finding a more co-operative audit firm. Also the prospective auditors would possibly be dissuaded from accepting the appointment, if greater publicity was given the circumstances behind the previous auditors dismissal.

4. Audit firms can reduce the risk of litigation and its effects upon the audit practice by adopting the following procedures:

   1. Ensuring that all audit engagements follow Auditing Standards.
   2. Establishing quality control procedures and practice standards of the highest quality.
   3. Adopting rigorous client acceptance procedures.
   4. Ensuring adequate professional indemnity insurance.
   5. Developing a positive litigation strategy. Audit firms often have actions brought against them, which would fail in a court of law. Historically some firms have made nominal 'out of court' settlements in order to avoid publicity but others have refused to deal with this type of lawsuit in this manner choosing to go to court and allegedly this has discouraged potential plaintiffs.

*DECEMBER 2001 QUESTION FIVE*

**QUESTION 10**

**(a) Statutory audit objective**

The objective of the statutory audit is to obtain reasonable assurance about whether the financial statements are free from material misstatement, thereby enabling the auditor to express an opinion on whether the financial statements are prepared, in all material respects, in accordance with an applicable financial reporting framework (such as IFRSs).

There is an International Standard on Auditing that deals with the overall audit objectives (ISA 200), but in, addition each individual ISA has its own objective designed to aid in the achievement of the overall stated above.

Therefore, in most cases fully understanding and complying with the ISAs relevant to the audit will result in the auditor achieving each applicable ISA's objective and the overall objective. To ensure objectives are met, ISA 200 states that the auditor must go beyond the requirements in a particular ISA if it is considered necessary to meet the objective.

The way in the audit is approached is very important, so ISA 200 stresses that in order to achieve the overall objective, auditors also need to plan and perform the audit with professional scepticism and apply professional judgment

**(b) Matters to be documented during audit planning**

- Discussion amongst the audit team about the susceptibility of the financial statements to material misstatements
- Key elements of the understanding gained of the entity
- Identified and assessed risks of material misstatement
- Significant risks identified and related controls evaluated
- Overall responses to address the risks of material misstatement
- Nature, extent and timing of further audit procedures linked to the assessed risks at the assertion level



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- Where reliance is to be placed on the effectiveness of controls from previous audits, conclusions on how this is appropriate

(c) **Factors effecting the form and content of audit working papers**
- The size and complexity of the entity
- The nature of the audit procedures to be performed
- The identified risks of material misstatement
- The significance of the audit evidence obtained
- The nature and extent of exceptions identified
- The need to document a conclusion or basis for a conclusion not readily determinable from documentation of work performed or audit evidence obtained
- The audit methodology arid tools used

**QUESTION 11**

(a) **Audit risk**
Audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk is a function of the risk of material misstatement and the risk that the auditor will not detect such misstatement (detection risk). The risk of material misstatement has two components: inherent risk and control risk. Audit risk can be summarized by the following equation:

Audit risk = Inherent risk x Control risk x Detection risk

**Inherent risk** is the susceptibility of an assertion to a misstatement that could be material, individually or when aggregated with other misstatements assuming that there were no related internal controls.

**Control risk** is the risk that a misstatement that could occur in an assertion and that could be material, individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control.

**Detection risk** is the ii.sk that the auditor's procedures will not detect a misstatement that exists in an assertion that could be material, individually or when aggregated with other misstatements.

(b)
i. **Inherent risk areas**
**Detailed constitution**
The charity has a detailed constitution which sets out how money may be spent. This increases the inherent risk of the audit.
The auditors will need to spend time examining and becoming familiar with the constitution and design their audit procedures with this in mind.

**Limit on administration expenditure**
The constitution states that administration expenditure cannot exceed 10% of Income in any year. This increases inherent risk as management may be tempted to misstate income or administration expenditure so this limit is not breached.
Special attention will need to be devoted to income and expenditure to ensure that the 10% limit is not breached legitimately.





**Uncertainty of future income**
The charity relies wholly on voluntary donations for its income which means that it cannot be assured of receiving a minimum level of income from one year to the next. This increases the risk of it not being able to continue.
The auditors must bear in mind whether the charity can continue as a going concern when carrying out their final review procedures. This will involve discussion with management and examination of budgetary information.

**Cash donations**
Some of the donations received will be in the form of cash collected from the public. There is a risk of misappropriation of cash as a result.
Controls over cash should be examined as this is an area open to misappropriation and theft. Donations from individuals
Some donations have clauses about how the money can be spent. This again increases inherent risk because money may be misspent without regard for the conditions in place.
Where donations have been received with clauses attached, the auditors will need to do detailed work to ensure the conditions have not been breached.

**Taxation legislation**
There are complex rules in place regarding the taxation of charities.
The audit team will need to familiarize itself with the taxation rules for charities to ensure that this area is correctly dealt with.

ii) **Control environment**
The control environment at EuKaRe may be weak for a number of reasons.
The staff working at the charity may be volunteers who may not have accounts experience and who may also not work there full-time. There may also be a high staff turnover because of the nature of the work.

There may be a lack, of segregation of duties in place due to the number of staff working at the charity. This means that trustees may play a role in the day to day running of the charity and there is therefore a risk of override of any controls that are in place.

The charity may not have an internal audit department in place due to its size or the equivalent of an audit committee to monitor its effectiveness.

There may also be a lack of budgetary information being produced on a timely basis which increases the control risk from the auditor's point of view.

**QUESTION 12**
a)
(i) **Risk assessment** procedures are performed at the planning stage of an audit to obtain an understanding of the entity being audited and to identify any areas of concern which could result in material misstatements in the financial statements. They allow the auditor to assess the nature, timing and extent of audit procedures to be performed.
(ii) **Sources of audit evidence that can be used as part of risk assessment procedures.**
- Inquiries of management
- Prior year financial statement
- Current year management accounts and budgets



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- Analytical procedures
- Observation and inspection

b)

**Poor internal controls and rapid growth**

The accounting systems of Serenity Go are changing rapidly and the control systems are difficult to maintain as the company continues to grow. This indicates that the internal controls are likely to be poor so control risk and the risk of material misstatements in the accounts will be high. Therefore a fully substantive audit is likely and Mal & Co must ensure it has enough time and resources to obtain sufficient audit evidence to support the figures in the financial statements.

**Reliance on internal audit department**

Serenity Co has only recently established its internal audit department so Mal & Co needs to be very careful in deciding whether It can place reliance on the work performed by Internal audit and ultimately in a reduced external audit fee, as desired by the financial controller. Additional time and work would be required to Assess Internal audit so an immediate reduction in the fee is very unlikely.

**Additional services required**

Serenity Co requires additional services of review and implementation of control systems but Mal & Co must consider whether it has sufficiently skilled resources to carry out this additional work as it Is a small firm with a number of clients in different sectors.

**Fce income**

Thc additional work required by Serenity Co will result In increased fee income to Mal & Co. The audit firm must ensure that its fee Income from this one client does not breach the guidelines set by the ACCA's Code of Ethics. These state that the fee income from an unlisted client should not exceed 15% of the firm's total fees.

**Self review threat**

The additional work required on the review and implementation of control systems at Serenity Co could result In the risk of self-review. Mal & Co must ensure it implements appropriate safeguards to mitigate this risk, such as separate teams to carry out tire review work and the external audit.
This may be difficult in a small audit firm. It would also be essential to ensure that the client makes all the management decisions in relation to the systems.

**Legal status of new mobile**

The legal status of the new mobile product is not known - it may be illegal. Any adverse publicity generated as a result will impact on Mal & Co as the auditors of the company. The audit firm needs to consider carefully whether it wants to be associated with Serenity Co. The fact that the company is planning to make a product of dubious legality raises questions about the integrity of the directors, arid the audit team should be cautious in relying on any written representations provided by the directors.

**Reliance on cash flow statement for license**

The granting of the license to market the mobile is dependent on the financial stability of the company, Mal & Co may be asked to provide a report on the company's cash flow statement for the following financial year. This need to be considered carefully - Mal & Co must ensure it has sufficient experienced resources for this work and determine what kind of assurance is required





**Going concern assumption**

The company is growing rapidly and is relying on the granting of a license for the new mobile, whose legal status is not known. These factors may indicate a possible going concern risk which should be monitored carefully.

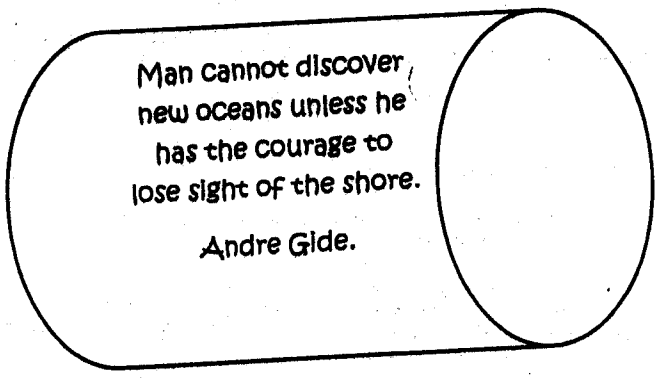
c)

**'Negative assurance'** refers to when an auditor gives an assurance that nothing has come to his or her attention which indicates that the financial statements have not been prepared according to the identified financial reporting framework, i.e. the auditor gives his or her assurance in the absence of any evidence to the contrary.

Negative assurance is given on review assignments such as the review of a company's cash flow forecast.

A cash flow forecast relates to the future so is based upon assumptions that cannot be confirmed as accurate. The auditor cannot confirm positively that the statement is materially true and fair (or presented fairly in all material respects).

This is because the conditions assumed when preparing the cash flow statement may not turn out as expected and it is not possible to gain the level of evidence expected to express absolute or reasonable assurance.



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# TOPIC 5

## CONDUCT OF AN AUDIT

**QUESTION 1**

**(a) Auditor's and management's responsibility for detecting the fraud committed by Abdul Yego**

ISA 240 (revised) requires that in planning and performing the audit to reduce audit risk to an acceptably low level, the auditor should consider the risk of material misstatement in the financial statements.

The primary responsibility for prevention and detection of fraud rests with both those charged with governance of the entity and management.

It is important that management, with the oversight of those charged with governance, place a strong emphasis on fraud prevention, which may reduce opportunities for fraud to take place, and fraud deterrence, which could persuade individuals not to commit fraud because of the likelihood of detection and punishment.

An auditor conducting an audit in accordance with international standards on auditing is responsible for obtaining reasonable assurance that the financial statements taken as a whole are free from material misstatement, whether caused by fraud or error

The risk of not detecting a material misstatement resulting from fraud is higher than the risk of not detecting one resulting from error. This is because fraud may involve sophisticated and carefully organised schemes designed to conceal it. As is the case with Abdul Yego's concealment.

**Therefore the auditor's responsibility in this case are:**

To identify and assess the risks of material misstatement of the financial statements due to fraud

To obtain sufficient appropriate audit evidence regarding the assessed risks of material misstatement due to fraud, through designing and implementing appropriate responses.

To respond appropriately to fraud or suspected fraud identified during the audit.

In this case the auditor is only concerned about the fraud in so far as the reliability of the financial statements are concerned.

Abdul's fraud was through mis-recording the transactions and thus he may be showing cash asset that does not exist and a debtor's balance that is overstated. This fraud could have been prevented by a strong internal control system and a strong oversight by those charged with governance but not only by an audit conducted at the end of the year.

**b) Audit tests that may be performed include:**

- Bank reconciliation. A careful bank reconciliation should detect the above misstatement.





This involves:
- Comparing cancelled cheques with the cash disbursement records.
- Examining cancelled cheques for signature, endorsement and cancellation.
- Comparing deposits in the bank with recorded cash receipts for date, customer and amount
- Accounting for the numerical sequence of cheques and investigating missing ones
- Reconciling all items causing a difference between the book balance and bank balance and verifying their appropriateness for the client's business
- Reconciling total debits on the bank statement with the total in the cash receipts record.
- Reviewing month end interbank transfers for appropriateness and proper recording
- Following up on outstanding cheques
- Conducting a debtor's circularization and comparing the closing balances with those in the client's books.

*JUNE 2012 QUESTION FOUR*

**QUESTION 2**

**(c) Procedures the auditor should adopt in respect of auditing accounting estimates include:**

- Enquire of management how the accounting estimate is made and the data on which it is based.
- Determine whether events occurring up to the date of the auditor's report (after reporting period) provide audit evidence regarding the accounting estimate
- Review the method of measurement used and assess the reasonableness of assumptions made.
- Test the operating effectiveness of the controls over how management made the accounting estimate.
- Develop an expectation of the possible estimate (point estimate) or a range of amount revaluate managements estimate
- Review the judgment and decisions made by management in the making of accounting estimates to identify whether there are indications of possible management bias.
- Evaluate overall whether the accounting estimates in the financial statements are either reasonable or misstated.
- Obtain sufficient appropriate audit evidence about whether the disclosures in the financial statements related to accounting estimates and estimation uncertainty are reasonable.
- Obtain written representations from management and where appropriate those charged with governance whether they believe significant assumptions used in making accounting estimates are reasonable

*JUNE 2012 QUESTION THREE C*

**QUESTION 3**

**(a) (i) Checking transactions and balances**

- They can trace a representative sample of room bookings and the booking of conference facilities from source documentation through the system, to ensure -that the correct amounts are billed, that the facilities are paid for within the time limits agreed and that the correct amounts have been recorded in the correct accounting period
- They can trace a representation sample of orders for food and other consumables through the system to ensure that authorised suppliers are used where necessary, that the correct prices have been billed by supplier.



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That payment has been made on the agreed terms and that the correct amounts have been recorded in the correct accounting period.

- They can trace a representative sample of additions to and disposals of assets through the system from the physical-assets themselves, through the day books and ledgers to the original authorization for purchase, to ensure that all assets acquired are properly authorized
- They can trace a representative sample of additions to and disposals of assets in the opposite direction that is from authorisations to assets to ensure they are in good conditions and still in the hotel's record.
- They can select representative samples of debtors and creditors for direct confirmation.
- They might check on the existence of certain employees and on the accuracy of the payroll calculations with reference to records of hours worked kept at the hotels.

**(ii) Review of systems**

- They might review the documentation of the centralised booking system and evaluate it. They might then review the actual operation of the system in practice and make recommendations for improvement or change.
- They might review the integrity of the systems by use of computer assisted audit techniques and other techniques to ensure that access to the system is restricted to those who should have access and to ensure that the system has produced exceptions reports as it should. The use of dummy data and false passwords might be used in such an assessment.
- Analytical procedures could be performed to evaluate the relative financial and operational performance of individual hotels, hotels in certain regions and the performance of the various classes of business (tourist and business accommodation) conference and leisure facilities, restaurants and bars. Performance could also be evaluated against budgets on a reasonable basis comparisons with prior years and period.
- Analytical procedures could be performed as relationships such as those between drinks and meals consumed and those between occupancy rates and other facilities used.

*JUNE 2012 QUESTION TWO A*

**QUESTION 4**

**i) Sifa Ltd's sales**

- Review the sales and the supporting documentation to ensure they relate to Sifa.
- Obtain a sample of all receipts for all sales that were made and confirm that they tally with all the supporting documentation, that is, orders, LPOs, quotations etc.
- Review the sales receipt to ensure all the relevant information is present.
- Check the sales journal and control account and ensure they reconcile and the necessary information is present, i.e. all the sales were recorded correctly in the relevant accounts.

**ii) Subira Ltd's purchases**

- Since Sifa sells all its goods to Subira, then ensure that the figure for sales for Sifa coincides with the figure for purchases in Subiras cost of sales.
- Obtain a sample of all purchases made and ensure they are supported by the supporting documentation, LPOs, GRNs, orders etc.
- Ensure all the purchases made relate to Subira and that they were not done on behalf of its sister company.
- Ensure all the purchases have been recorded in the accounts and in the period in which they relate.





**iii) Subira Ltd's receivables**

- Compare the credit sales and the accounts receivable to ensure they all have been recorded appropriately and relate to sales made by Subira.
- Obtain a sample of the receivables and circularize them to confirm that they actually owe Subira and that the sale was made in the year under consideration.
- Obtain a listing of all credit sales that were made at year end and test whether the receivables have been recorded in the correct period.

**iv) Subira Ltd's inventories**

- Ensure that the purchases are supported with actual inventory by checking the GRNs that accompanied the goods and ensure that the inventory that was paid for was the actual inventory received.
- Review previous years' working papers for the closing balance to avoid double counting.
- Compare the current years' inventory records with the purchases done in the year and the sales done in the year.
- Review the inventory records to ensure all the inventory that was brought in; sold or otherwise has been recorded appropriately in the books.

**v) Sifa Ltd's transport costs**

- Obtain a sample of all the extracts from the computer system and review the computations that were done to obtain the total transport costs including the drivers' allowance.
- Obtain the receipts from Sifa on the payments that were made on hiring the other trucks and ensure that they relate to the Sifa and were used for the correct purpose.
- Ensure all the costs have been recorded appropriately in the books and that they relate to the year under consideration.

**b) Challenges faced in carrying out the audit**

- Limited resources: The auditor may be unable to carry out the work effectively due to limited resources and time to efficiently carry out the audit.
- Overstretched: The auditor is bound to be overstretched in his work as he has to provide an opinion on the accounts of two companies at the same time.
- The auditor's will be faced with a conflict of interest since he owes a duty of care to each and in some instances may be forced to use the information obtained on one side for or against the other company which is against professional ethics.
- The auditor may be unable to uphold confidentiality since he reports to one office despite the fact that he is auditing two firms.

*DECEMBER 2011 QUESTION FOUR*

**QUESTION 5**

**b) i) Reliance on an experts work (ISA 620)**

- **Scope of the Experts work**
  The auditor should obtain sufficient appropriate audit evidence that the scope of the experts work is adequate for the purpose of the audit.
- **The skills and competence of the expert**
  The auditor should consider the expert's skills and competence in the particular profession, by considering the expert's professional qualifications, license or membership of an appropriate



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professional body and, the experience and reputation in the field in which the auditor is seeking evidence.

- **The assumptions and methods used:**
  The auditor should consider whether the assumptions and methods used by the expert in arriving at his opinion are appropriate to the circumstances. He should also determine that they are reasonable based on the auditor's knowledge of the client's business.
- **The sources of data used by the expert in arriving at his opinion**
  If the source of the data can be regarded as reliable, then the auditor can reasonably use the work of the expert as audit evidence.
- **Objectivity and independence of the expert**
  The auditor should consider whether the expert is independent from the client. For instance he should not be employed by the client.
- **Consistency**
  The auditor should ascertain whether the assumptions made and the methods used by the expert are consistent with those used in the prior period

ii) **Audit procedures**

- Ensure that only investment properties as identified by IAS 40 investment property are the properties to be revalued.
- Ensure that only a single model is used for all the investment properties in the firm, that is, either the fair value model or the cost model and that all assets to be revalued belong to the same model.
- Obtain a detailed listing of all the firm's investment properties to be revalued.
- Recomputed the impairments, depreciation if any, and check whether the policy used has been applied consistently.
- Obtain the certificate issued upon revaluation and assess whether the assumptions made during the revaluation are economically feasible and reasonable.

*DECEMBER 2011 QUESTION THREE*

**QUESTION 6**

**a) Opinion shopping**
This refers to the situation where a company looks for an auditor to give a positive opinion regarding company's affairs when it deserves a negative audit opinion. Some companies may go to the extent of charging external auditors and replacing them with an auditor who will provide positive audit opinion.

How to deal with opinion shopping

The audit firm should not risk giving any opinion to non-clients. There is need for the audit firm to correspond with the auditor of non-client so as to gain understanding of the matter. The auditor should decline to give an opinion if the discovers that the non-clients are opinion shopping.

b) **Planning the audit**

- The auditor will need to obtain an understanding of the industry in which the firm operates so as to be able to know the particular risk that may face the firm. The auditor also needs to understand the business purpose of all the transactions carried out.





- The auditor will need to carry out tests to establish the effectiveness of the internal controls and whether they can be relied upon by the auditors.
- The auditors will also look at the application of LAS 2, inventory to establish whether the firm is valuing inventory correctly and consistently. According to IAS 2, inventory should be valued at the lower of cost and net realizable value. The firm seems to be having a problem with the valuation of inventory especially damaged goods and those returned by customers.
- There have been concerns that actual inventory in the branches is less than the inventory in the computer system. During planning the auditor needs to establish the number of times inventory counts are done and if the actual inventory is reconciled with the items in the computer system. The auditor will also establish whether there is a need to request management to reconcile an inventory count at all branches so as to solve the problem.
- The auditor will also need to plan the audit procedures to carry out so as to obtain audit evidence.
- Perform analytical procedures on some of the high risk areas like inventory and other areas so to be able to allocate resources efficiently and economically.

c) **Matters to consider during overall review of an audit.**

**Assessment of risk**

The auditor needs to assess and identify the different risks facing the firm. There are two types of risks that are critical to an auditor.

**Audit risk.** This is the risk the auditor will express an inappropriate audit opinion on the financial statements based on the evidence.

**Business risk.** These are the risks that the operation of the company including its financial position. It could be due to internal or external factors. They provide evidence of possible frauds that may be perpetrated within the organization.

**Knowledge of the business.**
The purpose of this is to enable the auditor to have or obtain knowledge about the business sufficient enough to enable the auditor identify and understand events, transactions and practices that ill the auditor's judgment may have a significant effect on the financial statements or on auditor's report.

**Professional ethics**
The auditor needs to ensure that he acts in accordance with the code of ethics when performing his duties. Other than being independent the auditor needs to adhere to the other professional standards of integrity, confidentiality; due care and skill.
The adherence to professional ethics is important as it ensures that the auditor carries out his work in accordance with the applicable standards. It also reduces his liability in case of any litigation.

**Materiality**
Determination of materiality is a matter of professional judgment, and is affected by the auditor's perception of the financial information needs of users of financial statements.
Materiality enables the auditor to establish whether there are any items in the financial statements that require adjustments since their inclusion or omission is likely going to mislead the users of the financial statements.

*DECEMBER 2011 QUESTION TWO*

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QUESTION 7

a) **Substance procedures**

- Obtain an analysis of the sales account and test its mathematical accuracy, review the listing for any omissions and ensure that all sales recorded relate to the current year.
- Obtain a breakdown of the cost of sales and test the items independently. Review whether the purchases figure is mathematically correct and that no omission are present in the account.
- Compare the opening inventory with the closing inventory of the previous years 'using last years' working papers. Ensure management has carried out a stock take to ascertain the closing balance and that the valuations of inventory re in accordance with IAS 2 inventories.
- Obtain a detailed analysis of the expenses and confirm that is mathematically correct, no omissions and hat all expenses have been accounted for properly.
- Obtain a detailed analysis of the income tax expense including balances at the beginning, amounts provided for during the year, payments made and the balance at the end of the year. Ensure that current and deferred tax has been accounted for in accordance with IAS 12 income taxes, and that the correct amount has been transferred to the income statements.

**(b) Appropriateness of revaluation plan**

- IAS 16 property plant and equipment stipulates that if a revaluation results in a n increase in value, the gain should be credited to other comprehensive income and accumulated in equity under the heading "revaluation surplus" unless it represents the reversal of a revaluation decrease of the same asses previously recognized as an expense, in which casc it should be recognized as income.
- IAS 1 presentation of financial statements argues that there may be need to exclude some components of profit or loss and instead be included in other comprehensive income.

The comprehensive income shall include among others changes in revaluation surplus.

In this case, the management combined the revaluation gain as part of the income statement which is contrary to IAS I and IAS 16 as shown above and should therefore have shown the amount differently after the income statement under the heading other comprehensive income".

**(c) Implications of the decision to pay dividends**

- Under the going concern assumption (ISA 570 going concern) an entity is viewed as continuing in business in the foreseeable future and the management does not plan to liquidate the company in the foreseeable future or cease operations. The auditor is required to conclude on whether there is a material uncertainty of the entity's ability to continue as a going concern. In this case the auditor has identified that the firm may not be a going concern.
- Management has decided to pay dividends despite the firms plunge into losses. According to regulations, a company is required to pay dividends out of its retained profits only. In this case the firm has made profits which are not able to cover the dividends proposed by management, and this casts further doubt on the firms' ability to continue as a going concern as the firm may be required to source funding from outside to finance the payment of dividends.
- In light of these circumstances, the auditor should change his audit opinion and consider issuing a qualified opinion or an adverse opinion, as appropriate.





**(d) Audit procedures to verify tile revaluation gain.**

- Obtain a detailed listing of all assets that were revalued and classes of assets for which they belong.
- Establish whether the carrying amount of these assets was calculated accurately.
- Ensure that the depreciation expense on these assets was computed accurately and the depreciation policy was applied consistently.
- Under IAS 16 if an asset of a particular class is revalued, then all the assets in that class should be revalued. Confirm whether this was the case.
- Obtain the valuation certificates that were issued upon revaluation of the assets from a professional valuer or any item that was used as a basis for the revaluation and confirm that the amount on the certificate was the one used to compute the gain/loss on revaluation.
- Ensure that all assets that were revalued were restated based on the fair valuer after revaluation.
- Recomputed the revaluation gain, using the carrying amount and the fair value of the asset and compare to the figure with management's figure and incase of disparities obtain explanations for such disparities.

*DECEMBER 2010 QUESTION ONE*

QUESTION 8

**(b) Audit procedures on accounts payables, accruals and other provisions**

1. Obtain comparative summary of accounts payable and
   - Test the mathematical accuracy of the summary.
   - Trace account balances to the general ledger.
   - Review the summary for any possible omissions.
2. Perform substantive analytical procedures
3. Obtain detailed accounts payables listing (aged by vendor if possible) and
   - Trace the totals from the listing to the summary.
   - Test any reconciling items and trace them to supporting documentation.
   - Test the mathematical accuracy of the listing
   - Scan the listing and investigate significant or unusual items, for examples, debit balance, old unpaid invoices etc.
   - Consider whether there are unrecorded liabilities by using our knowledge of the company and its industry.
4. If appropriate apply targeted testing or non-statistical sampling to select vendors from the accounts payable detailed listing. Obtain the supplier statements and
   - Reconcile the account detail between the supplier statement and the accounts payable detailed listing.
   - Investigate all reconciling items by inquiring with management and agreeing to supporting documentation where necessary. Determine whether any adjustments are necessary.

If supplier statements are not available consider performing either a combination of the following

- Perform accounts payable confirmation procedures
- Verify accounts payable balance as follows;



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For vendor invoices subsequently paid trace recorded liabilities to the disbursement records and verify that the payments relate to
the account balance by agreeing invoices amounts and numbers

For vendor invoices not subsequently paid trace selected recorded liabilities on the detailed listing to supporting
documentations, for examples, invoices, purchase orders, GRNs etc.

5. Search for unrecorded liabilities - select a sample from all accounts payable source (that is, disbursement records, invoices received, goods received not) et invoiced and credits for returns records) for the period after the balance sheet date up to the date of completion of audit field work. By reference to supporting documentation determine whether the item has been properly included or excluded as a liability.
6. Test the translation of accounts payable balances denominated in foreign currency by determining that such amounts have been translated using correct rate.
7. Obtain a comparative summary of accruals, provisions and other liability balances and
   - Test the mathematical accuracy of the summary
   - Trace account balances to the general ledger
   - Review the summary for any possible omission.
8. Perform substantive analytical procedures for accrual, provisions and other liabilities.
9. Test year end accruals, provisions and other liabilities by
   - Examining documentation that supports year end balances, for example, contracts, invoices, BOD minutes etc.
   - For estimated balances
     - Discuss with management the methods of determining the balance.
     - Evaluate whether the assumptions used are consistent with each other, with prior period and with supporting data.
     - Determine whether the account estimates are in compliance with generally accepted accounting principle (GAAP)
     - Perform recalculation of amounts.
     - Apply analytical procedures
     - Assess the reasonableness of the year end balance.

10. Test for completeness by considering knowledge of the clients business, by analyzing relationships of account balances to other related accounts and by considering liabilities arising out of non compliance with appropriate regulation.
11. Review classification of accruals, provisions and other liabilities for appropriate presentation in the financial statements.

*JUNE 2010 QUESTION THREE B*

**QUESTION 9**

Internal audit can also be defined as an independent appraisal function within a firm for the review of systems of control and the quality of performance, as a service to the organization. It objectively examines, evaluates and reports on the adequacy of internal controls as a contribution to the proper, economic, efficient and effective use of resources. Internal audit should be carried out by independent personnel of the firm or outsourced from other firms. (ISSA 610 Using the work of an internal auditor).





Potential advantages and disadvantages of outsourcing internal audit functions are briefly described as follows:

**a) i) Advantages of outsourcing the internal audit function**

- Skills required for only a short time each year can be provided without incurring excessive cost of maintaining an in-house expertise.
- Internal audit staff can be used from a broader source of expertise, for example, professional firms that may specialize in particular types of organizations.
- With a professional outsourced department, less management time is required on internal audit, for example, in appraisals, training and development.
- There is greater focus on cost and efficiency of the internal audit functions.
- It reduces the risk of high turnover or loss of staff from the internal audit department.
- External sources are useful for providing specialist, experienced skills such as IT, than an in-house department may find difficult to recruit or retain.

**(ii) Disadvantages of outsourcing**

- There is the risk of lack of knowledge or awareness of the organization objectives, culture or business.
- An outsourced department may not be able to provide the same flexibility or ready staff available particularly where problems arise since they do not have a permanent presence.
- Standards or service may fall once the contract has been secured and the previous team disbanded.
- There is risk of blurring roles between internal and external audits, resulting in les creditability for both.
- In as much as external staff may be well experienced, there is still no way to confirm that they will guarantee quality. This can be left to speculation.
- Conflict of interest may arise if the outsourced internal audit service is provided hy the external auditors.

**b) Principles matters to be included in the final submission to provide internal audit services**

i) Responsibilities of the internal audit staff and the management

- This section will seek to make clear the responsibilities of both parties in relation to the internal audit function. The roles and responsibilities of both parties should be expl icitly stated and understood by both parties. This section will seek to stress the fact that the internal audit function will run independently and should be allowed unrestricted access to any documents and records that the auditors might require in carrying out their duties.
- Management should also provide channels that allow the external auditors to go directly to the audit committee where need arises.

ii) Scope of work

- This will indicate the various areas that the external auditors will seek to examine during the exercise, the nature of work to be done, the extent of audit procedures the impact of Stich



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procedures and any other work to be done beside what is explicitly required.

iii) Reporting responsibilities

- The internal audit function would be useless if the reports issued and the recommendations made are not implemented. This section will provide management with information about the nature of reports to expect and the implementation programs to be issued alongside the reports.

iv) Professional fees

- This section will seek to elaborate on how the professional fees will be calculated on work done and the terms of payment including the mode of payment to be issued alongside the reports.

v Other services

- This section will highlight any other services that may be offered by the firm alongside the internal audit function and their impact on the internal audit function in case they are offered together.

**c) Impact on the audit of financial statements**

Express on audit of opinion is the sole responsibility of the external auditor. Reliance on the work of internal auditors does not reduce this responsibility the auditor may rely on the work of Muslin only after confirming.

i. The work was done by auditors having adequate technical training and proficiency.
ii. The work was properly documented, reviewed and supervised.
iii. Adequate audit evidence has been obtained to enable the internal auditors draw reasonable conclusions.
iv. Conclusions reached are appropriate in those circumstances and any reports prepared by the auditors are consistent with the results of the work performed.
v. Any exceptions, or unusual matters disclosed by the auditors.
vi. Any potential risks to the audit are minimized.

- Weru & co. may expect the internal auditors to uncover most of the frauds and errors that may be perpetuated within the organization and may therefore reduce their procedures when it comes to frauds and other materials misstatements in the financial statements.
- The overall audit of the financial statements by Weru & Co. may be done even a notch higher because of the existence of two audit firms working on similar projects together leading to even a more conclusive opinion on the audit of financial statements.

*AUGUST 2009 QUESTION ONE*

**QUESTION 10**

**(a) Verification that school fees are paid to authorized schools and the existence of students.**

i) Obtain a list of authorized schools and ensure that all payments of school fees were only made to schools authorized by the trustees.





ii) Test the numerical sequence of payment vouches and check to approved school fees applications, cheques register/official school receipts and ensure that there is a complete audit trail.

iii) Select a sample of loan applications and compare the information supplied by applicants to reliable third party documents such as school admission letters birth certificates, parents identity card numbers and letter from provincial administrators and ensure that they reasonably agree.

iv) Visit some schools which are authorised and physically request to see the sponsored students and also their school registration details. Also check for how long the student has been receiving the fees.

v) Interview the students as to information in the application forms and whether they provided it.

vi) Obtain the schedules of fees paid and check arithmetic accuracy.

**(b) Verification of income from investments.**

- Income has been received by the entity and included in the financial statements.

According to ISA 500, management is responsible for the fair prevention of financial statements that reflect the nature and operations of the entity.

Management make assertions, explicit or implicit regarding recognition, measurement, presentation and disclosure of the various elements of financial statements and related disclosures. For income from investments, the following assertions are relevant; occurrence, completeness, accuracy, cut off and classification.

**Audit work will include;**

i) Obtain a listing of all investments held and confirm that the titles are in the name of the charity
ii) Obtain financial reports of the organisation and firms the charity has invested in and check when dividends were declared and/or paid, when interest was received and any other investment income.
iii) Compare the listing of all investments held and the listing of all income received or receivable by the entity and ensure that all income has been accounted for.
iv) For investment income received, trace the recording of income to the cash book and bank accounts to ensure that all income received was banked and any discrepancies fully investigated.
v) Obtain a detailed listing of all investments and check for changes or movements in balances. Confirm that there were no changes in fixed investment securities and for the shares confirm when the shares were sold and that if any dividends were receivable before the sale that they have been recorded.
For the investments that were purchased, confirm whether it was ex-dividend or cum-dividend and whether it has been recorded appropriately.
vi) Ensure that the documents of title for investments sold and purchased have been transferred.
vii) Ensure that minutes of the meetings that authorised the purchase and sale are available.
viii) Obtain the relevant schedule of income received and ensure that they are arithmetically accurate.
ix) Obtain receipts, interest and dividend warrants at the beginning and at the end of the financial period and confirm that they have been received and recorded in the correct accounting period.



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**To determine that all investment income had been properly recorded, the auditors would carry out the following work;**

i) Check in stock exchange lists or company accounts in respect of unquoted companies to determine the dividends that should have been received in the period.
ii) Obtain information on all bonus and rights issues during the year and investigate action taken and shares received.
iii) Check that the interest due is received on the due date and that it relates correctly to the nominal value of the security
iv) Verify the correctness of calculation and recording of capital gains and losses and their treatment in the financial statements.
v) Review the reasonableness of investment income accounts, taking into consideration the amounts budgeted for and the amounts received in previous year. Material variations would need to be explained, taking into account purchases, bonus issues and sales in the period.

**(c) Verify the ownership of fixed interest investments and the shares in listed companies.**

i) Inspect share certificates and contract notes. All documents should be inspected together at the same time and should be in the name of the charity.
ii) Examine documentary evidence to verity all purchases and sales during the year, including authorization minutes. Purchase cost and sales income would be vouched and traced to the bank.
iii) Ask third parties holding share certificates pending delivery, whether for sale custody or as collateral, to confirm directly to them their holding on behalf of the client. Verification is unsatisfactory in the following cases and the matter should be referred for action to the audit manager.

- Where stocks are being held by brokers for safe custody and not merely pending delivery (Since brokers are not considered to be appropriate as custodians except in the event of purchase or sale of an investment.)
- Where stock is held in the name of a third party other than a bank nominee, for example a debtor.

iv) Examine board meetings, agreements and supporting correspondence in respect of unquoted shares if any. (Companies which had been quoted may cease being quoted or suspended.)
v) Review investment income received, as it is prima facie evidence of the existence and beneficial ownership of the investments/securities.

*DECEMBER 2005 QUESTION THREE*

**QUESTION 11**

**(a) BCD Stores Ltd is a high risk audit client in view of the problems associated with**
i) Inventory misappropriation by employees and customers
ii) Slow moving and damaged goods, work less than cost.
iii) Incomplete recording of sales when customers pay by cash

The above are areas of high audit risk and as the manager responsible for the audit, I would consider the following matters and carry out the necessary audit work before the commencement of detailed audit work;

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**Matters to be considered;**
i) The significance and materiality of the audit risk areas
ii) The relevance of the knowledge gained in previous audits and whether any changes have occurred that may affect the relevance of the information to the current audit
iii) Since BCD has high audit risk areas, I will consider the following logistical issues
- Staffing of the audit – level of qualification, relationship with audit staff, availability, special correct level of experience
- Client management
- Locations of the client considering distance to be travelled by audit staff, mobility, determine which location to visit, staff allocations.
- Deadlines, considering the key dates which the audit team will need to know such as date of inventory count, main audit visit, reviews by managers, draft accounts, date when audit report is signed and date of AGM.

iv) Consider the use of information technology
v) Consider time budgets
vi) Consider other objectives of the audit in addition to the expression of an opinion.

**The audit work to be carried out includes;**
i) Review client acceptance and continuance relationships and for this specific audit engagements and ethical clearance.
ii) Determine adequate staffing of this audit assignment
iii) Hold meetings to discuss the risk of material misstatement in the areas of risk and its implications for the financial statements.
iv) Determine an appropriate audit strategy. In this audit, a combination of tests of control and extensive substantive testing will be required
v) Review stock taking instructions by the client for adequacy, staffing of the stock take and recommend changes as appropriate.
vi) Review stock taking procedures for identifying obsolete and damaged stock
vii) Discuss with the client and the audit staff to agree on timings for interim vist, final visit and stock take data.
viii) Allocate adequate resources for this audit
ix) Prepare the overall audit strategy and audit plan, document it and communicate with the relevant audit staff
x) Review the internal audit, and decide whether to rely on its work.

**(b) Procedures to be carried out to control the audit**
ii) Communication to the audit staff of the engagement details and ensuring that all logistical arrangements are complete
iii) Ensure that staff follow the detailed audit plans especially in the high audit risk areas.
iv) Review the audit plans and the ICE and ICQs for completion
v) Consult as necessary with the engagement partner and the clients management in case of any difficulties.
vi) Ensure that stock taking instructions are followed, be present at some locations during the stock take and ensure that I test the stock sheets for accuracy.
vii) Review the work done by the internal audit department if we decided to rely on it.
viii) Ensure that deadlines are being met and if not, consult with the client and engagement partner.

*DECEMBER 2005 QUESTION FOUR*

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QUESTION 12

(a) (i) ISAE 3400, the examination of prospective financial information defines prospective financial information as financial information based on assumptions about future events that may occur in the future and possible actions by the entity.

It is highly subjective in nature and its preparation requires the exercise of considerable judgement. PFI can be in the form of - forecast a projection or a combination of both, for example a one year forecast plus a five year projection.

(ii) In carrying out the review so as to be able to report on the company's forecast, the auditors should pay attention to the following matters.
- The nature and the background of the company's business
- The accounting policies normally followed by the company
- The assumptions on which the forecast is based
- The procedure followed by the company in preparing the forecast.

(b) Procedure to be followed by an auditor in doing a fraud investigation.

**Investigations**

An investigation can be defined as an enquiry commissioned by a client for some purpose of his. The scope of enquiry, the range of possible clients and the number of purposes can be very large. We shall therefore confine ourselves to the most common types of investigations that the professional accountant may be called upon to do.

**Common types of investigations:**

a) Acquisition of companies;
b) Purchase of business;
c) Prospective investments;
d) Admission of new partners
e) Prospective lending;
f) Fraud;
g) Systems breakdown;
h) Company acts investigation;

Investigations may be needed whenever facts are in doubt or in dispute or where knowledge is required. Anybody can commission an investigation and you will find that companies, individuals, financial institutions and banks, local authorities, the tax authorities can all commission various investigations.

**Investigations: the stages**

All investigations are carried out in the same way.

**Stage 1: instructions from the client**

You must always obtain precise written instructions from the client. This must incorporate a very clear view of the aims of the investigation, the scope of the investigation, the degree of the detail required, the degree of secrecy to be observed, and the person to whom the accountant must address his report.





At this level, consideration must be given to the resources the client is ready to utilize and the cost of the job, both in terms of money and time.

**Stage 2. Professional courtesies**

Professional etiquette requires that if investigations are carried out in the affairs of organizations to whom the accountant is not the auditor then the auditors must be communicated with. This is to observe the usual courtesies and to obtain their cooperation.

**Stage 3: organization of the investigation**

This involves the accountant assessing the aims of the investigation, estimating the time to be taken and the likely costs and ensuring that the appropriate staff will be available.

**Stage 4: obtaining the background information**

This is particularly important in investigations in acquisition of business. It involves gathering as much background information as possible about the object of the investigation, the size of the industry and its structure, history since commencement, the future prospects, the relevant

legislation affecting that industry, investment information and relevant accounting ratios. This information is usually available from published sources such as government statistics, trade associations and the financial statements.

**Stage 5: gathering preliminary information**

This information has to be gathered on the subject to be investigated. This information includes the location of the subject, its products, its range of services and its share of the market, key personnel, major accounting control systems and past reports.

**Stage 6: preparing the report outline**

A report that meets the needs of many accounting investigations is as follows:
Part A: introduction whereby we have references to the instructions given. The object of the investigation must be apparent from the introduction.
Part B: a summary of the instructions must be given.
Part C: a statement of the precise objectives of the investigation and the report
Part D: a statement of the scope of investigation stating the time, period and the area covered
Part E: a statement of the documents use. If it is necessary to reproduce any of these documents this is usually done in an appendix.
Part F: an outline of the work actually done, again it may be necessary to put some of this material in an appendix.
Part G: a summary of the information obtained.
Part H: further information which could be of use to the client but does not flow from the investigation proper.
Part I: Recommendations of the accountant. In giving recommendations, the accountant must always ensure that:

a) He gives information from which the client can draw his own conclusions
b) Avoid presenting information in such a way that the client's judgment is influenced.
c) If information is based upon assumptions, then the accountant must state the assumptions in full and substantiate them if possible.



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d) Make no forecasts
e) If you are giving opinions, estimates or forecasts, then the accountant must state who made them and what qualifications they had to making them.
f) The recommendations are practical
g) The investigation has been comprehensively completed.
h) The report is drafted and discussed with the client.
i) The final report is submitted.

**Stage 7:** The investigation proper

**Stage 8:** Drafting and discussing the report with the client

**Stage 9:** Finalizing and delivering the report

**Stage 10:** Being available for further inquiries and investigations.

*JUNE 2005 QUESTION THREE*

**QUESTION 13**

**(a) Work expected to be carried out by the internal auditors of UPS hotel Ltd.**
ISA 610 defines internal auditing as a means of appraisal activity established within an entity as a service to the entity. Its function includes among other things, monitoring internal control.

The scope and objectives of internal auditing vary widely and depend on size and structure of the entity and the requirements of its management. Ordinarily, internal auditing activities include one or more of the following:-
- Monitoring of internal control
- Examination of financial and operating information
- Review of the economy, efficiency and effectiveness of operations including non-financial controls of an entity.
- Review of compliance with laws, regulations and other external requirements and with management policies and directives and other internal requirements.

The tribunal report requires;
- Have a defined process for the review of effectiveness of internal control
- Review regular reports on internal control
- Consider key risks and how they have been managed
- Check the adequacy of action taken to remedy weaknesses and incidents.
- Consider the adequacy of monitoring
- Conduct an annual assessment of risks and effectiveness of internal control.

**(b) Factors to consider and work to be performed to assess extent of reliance on work of internal auditors.**
- The external auditor should perform an assessment of the internal audit function when internal auditing is relevant to the external auditors risk assessment. The external auditors assessment of the internal audit function will influence the external auditors judgement about the use to be made of internal auditing in making risk assessments and thereby modifying the nature, extent and timing of further audit procedures.





- When obtaining an understanding and performing an assessment of the internal audit function; the important criteria are the following;
  - Organisational status of the audit function
  - Scope of the internal audit function
  - Technical competence of persons performing internal audit activities

- Evaluation of the work of IA considers whether
  - The work is performed by persons having adequate technical training and proficiency as internal auditors and the work of assistants is properly supervised, renewed and documented.
  - Sufficient appropriate audit evidence is obtained to be able to draw reasonable conclusions
  - Conclusion reached are appropriate in the circumstance and any reports prepared are consistent with results of the work performed, and
  - Any exception or unusual matters disclosed by internal auditing are properly solved.

**(c) Effect of reliance on work of internal audit on audit work**
This will affect the nature, extent and timing of audit procedures. It will reduce the amount of work required, the time taken and ultimately the cost of the audit. However, sufficient appropriate audit evidence must still be obtained.

*JUNE 2005 QUESTION FIVE*

**QUESTION 14**

**a) Changes to be made at the interim audit:**

(i) The timetable for the audit will be considered for it applicability in view of the fact that more substantive procedures will be undertaken.Significant dates in the timetable include, the date of the AGM, the date when the directors sign the financial stsatements,the period of the final audit, stock take dates

(ii) A visit will be made to the company prior to any detailed work to meet the directors to make them aware of the fact that the controls are not operating effectively . I will show them the revised timetable to ensure that they understand the need for the changes nad schedule the role of the clients staff in areas such as bank reconciliations, suppliers statements, doubtful debt schedules and fixed asset movements.
(iii) Ascertain early in the process key changes in accounting personnel
(iv) Resolve previous years problems
(v) The introduction of any new standards will be considered.
(vi) I will assess the level of experience required in this audit which can be described as being risky.
(vii) Specify the materiality levels at slightly lower levels compared with the preliminary materiality levels in view of the ineffective controls.
(viii) Prepare a detailed audit planning memorandum including moist of the issues mentioned above.
(ix) Discuss the above issues with the partner responsible for the audit.



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b) **Changes to the audit plan at the final audit**

a. During the final audit the impact of the ineffective controls will be mainly to emphasize on substantive procedures, increase samples and lower materiality levels.
b. I will attend the stock take since this is likely to a material figure in the accounts and is likely to be affected by the weak controls. Issues to be taken care of include existence, ownership and valuation.
c. The audit procedures and the results will be recorded in sufficient details to ensure that all work done, matters considered, and the conclusions reached have been recorded.
d. Similarly to what happens during the interim audit level of quality control will, be very strict.
e. Work will be allocated to staff according to their abilities and all work will be reviewed by senior staff.
f. For the partners review, I will prepare a detailed memorandum which will include:
g. A summary of the financial statements and rations
h. Summary of work done including material items in the financial statements and in areas of high audit risk.
i. A list of all significance errors and suspected fraud
j. List of matters to be discussed with company directors and suggested adjustments.

*DECEMBER 2004 QUESTION TWO*

**QUESTION 15**

(a) **The general access controls will include both physical controls and programmed access controls.**

- The computers should be kept in rooms with restricted access. Only authorised personnel should have access.
- When the computers are unattended relevant programs should not be left running.
- That the terminals will be . linked to the mainframe computer through a dial up link means that the machines communicate through a telephone line. This means that there is a danger that communication between the computers could be interpreted and transmission intercepted without proper authority. Therefore I would expect that built into the system would be the provision of a dedicated line at Mwebeni Ltd. such that when the mainframe computer receives a signal from a terminal it will not accept instructions directly rather it would call back at the dedicated number at. to facilitate the dial up link.
- All authorized users should have been issued with passwords or some other form as identification such that once the dial up link has been facilitated the system should demand for a password which must be keyed in. In this way different levels of access can be given to the staff e.g. the purchases ledger clerk can access the system for reading purposes only without the authority to effect any transfers.
- The password has to be keyed in for the computer to determine the degree of access the password holder is permitted.
- The system should have been programmed that transfers can only be effected at certain times like between 11 a.m. and 3 p.m. on a working day. When any attempt is made to effect transfer the system checks against its in built clock and confirm that time access is being attempted is reasonable.





- A comprehensive creditors master file should have been built up with all details of the creditors bank and the account number at that bank. These details would have to be keyed in when a transfer is to be made. The creditor's master file must be on line when transfers are being effected so that the sytem automatically performs a master file check to ensure that the company does have such a supplier. At the same time the programme would also perform a reasonableness check that the proposed amounts to be transferred do not exceed the amount due to that supplier.
- Both ends of the system should have been programmed to automatically prepare a record of the transfers that have been effected.
- A limit should have been built into the ystem such that only transfers below this amount should be effected by line system, any amounts in excess should be rejected requiring a cheque signed by the authorized signatories.
- A requirement should have been in place that passwords should be changed regularly. There should have been built into the sytem to deny access or refuse to act on the instructions of password users who has not changed their password within the stipulated time.
- Should have built into the system a ,mechanism for the system to close down automatically if a wrong password is entered more than 3 times.
- Similarly it should close down it require the password to be keyed in again if no activity takes place when the 2 machines are linked for a period of time, say 5 minutes.
- Should have built into the system a mechanism that informs the mainframe computer the number of transfers to be effected so that once many transfers have been effected the dial up link is immediately disconnected.

(b) **The additional measures that Mwebeni. should take in order to prevent unauthorized transfers:**

(1) Ideally the terminals should be located in a secure office to which access is restricted to only authorized personnel at approved times. This is the normal lock and key.
(2) The microcomputer that facilitates the dial up link could be required for other work therefore it may not be practicable to only use it to effect transfers.
(3) There should be restrictions on opening new accounts for suppliers or removing names of suppliers from the creditors master files or even changing the supplier details. There should be pre printed, prenumbered change forms when a new suppliers has been approved by the purchasing committee and their details entered in these forms whould be approved by both the chief accountant and purchase committee.
(4) There should be arrangements for the creditors master file to be regularly dumbed and normally checked.
(5) Before any transfers are affected the invoices to be paid should be subjected to a payment selection criteria. They should have been supporting documents attached to them. A list should be prepared and it should have the written authority for the transfers to be effected in the form of a signature by the cheque signatories and this list should be retained.
(6) Once the transfers have been effected the supporting documents should be stapled and cross referenced to the transfer number.



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(7) At almost all the times of the month only the minimum balance should be retained on this bank account. When the list if transfers to be effected has been approved the money can then be transferred from the main account to this account for the transfers to be made.
(8) Regular bank reconciliations should be prepared, reviewed by responsible officials and approved. Any long outstanding items should be investigated.
(9) Reconciliations of creditors statements should be regularly prepared, the long outstanding reconciling items being investigated.

c) **Controls to be implemented at eh accounts payable and payroll systems over:**
i) Retrieval of information:
- Access controls should be implemented by use of pass passwords
- The relevant software should not be installed in all terminal to ensure that there is no possibility of unauthorized access
- A list of all retrievals and by who should be maintained.

ii) Input of transaction data.
These controls aim at ensuring the completeness of input and it validity. Most errors in computerized accounting systems can be traced to faulty input. controls over the completeness and validity of all input are therefore essential. The controls over input will include:
- Data conversion
- Controls over rejections which should be investigated
- Correction and processing of rejections
- Batch controls and computer edit controls.

The most common input controls include:
- Missing field checks
- Validity character check
- Reasonableness checks
- Missing file checks
- Check digits
- Document counts

*DECEMBER 2004 QUESTION ONE*

**QUESTION 16**
(a)
(i) Audit procedures to verify the accuracy of the inventory count.
(ii) Before the inventory count.
(iii) On the day of the inventory count.

(b)
(i) Request for the schedule and check its arithmetical accuracy
(ii) Take a sample of the stock sheets and evaluate the accuracy
(iii) Select a random sample of the goods received on the same day
(iv) Evaluate the reasonable of the overhead allocation and the basis
(v) Request a schedule for production labour and their work areas to ensure that non production labour is not include
(vi) Request a letter of representation


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(c) **Purchases cut off procedures**
The procedures applied by the auditor will be designated to ascertain whether:
(i) Goods received for which no invoice has been received or accrued;
(ii) Goods received which have been invoiced but not yet posted are accrued; and
(iii) Goods returned to suppliers prior to the year end are excluded from stock and trade creditors.

At the year end stock take the auditor will have made a note of the last serial numbers of goods received notes. Suggested substantive procedures are as follows:
(a) Check from goods received notes with serial numbers before the year end to ensure that invoices are either
(i) Posted to purchase ledger prior to the year end; or
(ii) Included on the schedule of accruals

(b) Review the schedule of accruals to ensure that goods received after the year end are not accrued
(c) Check from goods returned notes prior to year end to ensure that credit notes have been posted to the purchase ledger prior to the year end or accrued
(d) Review large invoices and credit notes included after the yearend to ensure that they refer to the following year
(e) Reconcile daily batch invoice totals, around year end to purchase ledger control ensuring batches are posted in the correct year.
(f) Review the control account around the year end for any unusual items.

Evidence of completeness, existence and ownership – credit circularization
We have established that the verification of trade debtors by direct communication is virtually a standard procedure. Is it therefore also standard procedure to carry out a creditor circularization? The answer is qualified 'No'. The principal reason for this lies in the nature of the purchase cycle – third party evidence in the form of suppliers' invoices and even more significantly suppliers' statements are part of the standard documentation of the cycle. He auditor will hence concentrate on these documents when designing and conducting his test to gain assurance in respect of objective – Do trade creditors represent bonafide amounts due to the company.

In the following circumstances the auditor may, however, determine that a circularization is necessary
(i) Where suppliers statements are, for whatever reason, unavailable or incomplete.
(ii) Where weaknesses in internal control or the nature of the client's business make possible a material misstatement of liabilities that would not otherwise be picked up
(iii) Where it is thought that the client is deliberately trying to understate creditors
(iv) Where the accountants appear to be irregular or if the nature or size of balance transactions is abnormal.

In these cases confirmation requests should be sent out and processed in a similar way to the debtors' confirmation requests described above. 'Positive' requests will be the order of the day in these circumstances.

In normal circumstances the following substantive procedures based on accounting records and documentation maintained and retained by the company will be performed:
(i) Select from the trade creditors listing and check to supporting documentation (invoices, goods received notes, purchase orders, etc.)that the purchase was for the purpose of the business.
(ii) Reconcile a sample of purchase ledger balances with suppliers' statements
(iii) Review balances for unusually low balances with major suppliers

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(iv) Compare ratio of trade creditors to purchases with previous year's figures.
(v) Compare ratio of trade creditors to stock with previous year's figures.
(vi) Verify reasonableness of deductions from liability figures (e.g. discounts) by reference to subsequent events.
(vii) Ascertain reasons for significant debit balances.

*JUNE 2004 QUESTION THREE*

**QUESTION 17**

(a) According to ISA 240 the auditor has no responsibility for the prevention and detection of fraud and error although the annual audit may act as a deterrent.

Auditors are required to assess the risk of fraud and error causing financial statements to contain material misstatements and should enquire of management as to any fraud or error that has been discovered. Based on this assessment which will involve consideration of the integrity on the entity, unusual pressures on the entity, unusual transactions and problems in obtaining sufficient appropriate audit evidence.

Management is responsible for the prevention and detection of fraud and error though the implementation and operation of adequate accounting and internal control; systems will reduce the possibility of fraud and error.
This responsibility has been reinforced in recent years especially for listed companies by the promotion of codes of corporate governance.

(ii) The audit firm is not negligent of the fraud amounted to Shs.400,000.
This represents x% of sales and x% of profit before tax.

(iii) If the fraud amounts to Shs.1,600,000,then the firm is negligent because tis represents x% of sales and x% of profit before tax.

(b) (i) The amount of Shs.8,000,000 is a material item in the financial statements.

$$\frac{8{,}000{,}000}{640{,}000{,}000} \times 100 \qquad \frac{8}{640} = \frac{1}{8}$$

(ii) Matters to consider and action to be taken.
- Materiality of the amounts
- The overall opinion on the financial statements

If I am replaced as the auditor I will seek legal advice and advise the client to streamline the operations and do everything correctly.
Since the Managing Director is the majority shareholder this will prevail

(iii) This scenario is much better than the previous one.
Matters to be considered
- Materiality of the work
- Write or go through the cards





(iv) I would report and explain the fraud to the audit committee since the Managing Director is a minority shareholder, the other directors will impress upon him that the fraud should be reported.

The Managing Director is likely to agree to amendments of the accounts because adverse publicity is very serious for a listed company.

I would seek legal advice.

*JUNE 2004 QUESTION FOUR*

**QUESTION 18**

(a) For the assignment to be completed in the specified time restriction the client will take the following steps:
- Ensure that all employees affected by the audit are aware
- The books of account should be up-to-date so that the auditor will not be delayed
- An interim audit should be undertaken to ensure that work that can be done early is done.
- The following key audit tasks will be undertaken during the interim audit.

(b) Steps to be taken by the auditor
- Adherence to deadlines in the audit process
- Use more experience staff
- Perform most of the work during the internal audit
- Group accounting issues should be dealt with early in the process
- Quality assurance procedures should be adhered to.

*DECEMBER 2003 QUESTION ONE*

**QUESTION 19**

For many businesses, sales are made on credit and thus the sales cycle includes control objectives for receivables. These controls objectives include:

(a) Customers' orders should be authorized, controlled and recorded in order to execute them promptly and determine any allowance required for losses arising from unfulfilled commitments.

(b) Goods shipped and work completed should be controlled to ensure that invoices are issued and revenue recorded for all sales.

(c) Goods returned and claims by customers should be controlled in order to determine the liability for goods returned and claims received but not entered in the accounting records.

(d) Invoices and credits should be appropriately checked as being accurate and authorized before being entered in the accounting records.

(e) Validated receivables transactions, and only those transactions, hold be accurately entered in the accounting records.



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(f) There should be procedures to ensure that sales invoices are subsequently paid and that doubtful amounts are identified in order to determine any allowance required.

In order to achieve these objectives there should be good segregation of duties. There are three distinct processes in the sales system which should be segregated and performed by different staff in order to establish effective internal controls. They are:

i) Accepting customers' orders: Sequence controlled documents should be used to acknowledge all order received. Any uncompleted orders should be regularly reviewed.
ii) Credit limits should be checked by the credit control department. Selling prices, special discounts and delivery dates should be fixed by senior members of the sales department – never by the account staff.
iii) Dispatch department: Sequence controlled documents should be used (goods outwards or dispatch notes) for all goods leaving he premises. These should be completed by the gatekeeper or the dispatch department – never by the account staff.
iv) Invoicing the goods: Sequence-controlled invoices should be raised by the sales department and then passes to the accounts department for recording. Independent checks should be made to ensure that invoices have been raised for all goods outwards notes.

In addition strict control of credit notes is essential to ensure that they are raised by proper authority in the sales department against goods received notes. It is not uncommon for credit notes to be raised to 'hide' what are in fact bad debts or to conceal theft of cash receipts. Credit notes can also be used to cancel out fictitious sales invoices which have been raised in order to boost sales figures artificially.

There are a large number of controls that may be required in the sales cycle due to the importance of this area in any business and the possible opportunities that exist for diverting sales away from the business and other persons benefiting.

**(a) Orders**

(i) The orders should be checked against the customer's account; this should be evidenced y initialing. Any new customers should be referred to the credit control department before the order is accepted.

(ii) Existing customers should be allocated a credit limit and it should be ascertained whether this limit is to be exceeded if the new order is accepted. If so the matter should be referred to credit control.

(iii) All orders received should be recorded on pre-numbered sales order documents.

(iv) All orders should be authorized before any goods are dispatched.

(v) The sales order should be used to produce a despatch note for the goods outward department. No goods may be despatched without a dispatch note.

**(b) Despatch**

(i) Dispatch notes should be pre-numbered and a register kept of them to relate to sales invoices and orders.

(ii) Goods dispatch notes should be authorized as goods leave and checked periodically to ensure they are complete and that all have been invoiced.





**(c) Invoicing and credit notes**

(i) Sales invoices should be authorized by a responsible official and referenced to the original authorized order and dispatch note.

(ii) All invoices and credit notes should be entered in sales day book records, the accounts receivables ledger, and accounts receivable ledger control account. Batch totals should be maintained for this purpose.

(iii) Sales invoices and credit notes should be checked for prices, casts and calculations by a person other than the one preparing the invoice.

(iv) All invoices and credit notes should be serially pre-numbered and regular sequence checks should be carried out.

(v) Credit notes should be authorised by someone unconnected with dispatch or accounts receivable ledger functions.

(vi) Copies of cancelled invoices should be retained.

(vii) Any invoice cancellations should lead to a cancellation of the appropriate dispatch note.

(viii) Cancelled and free of charge invoices should be signed by a responsible official.

(ix) Each invoice should distinguish between different types of sales and any sales taxes. Any coding of invoices should be periodically checked independently.

**(d) Returns**

(i) Any goods retuned by the customers should be checked for obvious damage and, when accepted, a document should be raised.

(ii) All goods returned should be used to prepare appropriate credit notes.

**(e) Receivables**

(i) A receivables ledger control account should be prepared regularly and checked to individual sales ledger balances by an independent official.

(ii) Receivables ledger personnel should be independent of dispatch and cash receipt functions.

(iii) Statements should be sent regularly to customers.
(iv) Formal procedures should exist for following up overdue debts which should be highlighted either by the preparation of an aged list of balances or in the preparation of statements to a customers.

(v) Letters should be sent to customers for collection of overdue debts.

**(f) Bad debts**

(i) The authority to write off a bad debt should be given in writing and adjustments made to the account receivable ledger.



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(ii) The use of court action or the writing-off of a bad debt should be authorized by an official independent of the cash receipt function.

**Tests of Control**

Tests of control should be designed to check that the control procedures are being applied and that objectives are being achieved. Tests may be appropriate under the following broad headings:

(a) Carry out *sequence test checks* on invoices, credit notes, dispatch notes and orders. Ensure that all items are included and that there are no omissions or duplication.

(b) Check the *authorization* for the
- Acceptance of the order (the credit worthiness check)
- Dispatch of goods
- Raising of the invoice or credit note
- Pricing and discounts
- Write-off debts

Check both that the relevant signature exists and that the control has been applied, e.g. check pricing for accuracy and credit limits to ensure that they have not been exceeded. This last test will also serve as a substantive procedure.

(c) Seek evidence *of checking of the arithmetic accuracy* of
- Invoices
- Credit notes
- Sales tax

This is often done by means of a 'grid stamp' requiring several signatures on the face of the invoice. Ensure that the control has in fact been applied by checking the accuracy of such invoices and credit notes. This last test will also serve as a substantive procedure.

(d) Check *dispatch notes* and gods returned notes to ensure that they are referenced to invoices and credit notes and vice versa.

(e) Check that *control account reconciliation* have been performed and reviewed. Refer form the control by checking the reconciliation to source documentation.

(f) Ensure that *batch total controls have been applied* by seeking signature and tracing batches from input to output.

In all cases, test should be performed on a sample basis. The auditor should investigate errors and consider the need for further testing to obtain comfort on the proper application of the control procedures.

*DECEMBER 2003 QUESTION TWO*

**QUESTION 20**

(a) **My attitude and action to take will be influenced by several considerations as follows;**
- Objectives of the audit engagement and implications of the fraud and illegal activity on the auditors report.
- The materiality and extend of the misappropriation.





- The questionable integrity of the managing director.
- The managing directors understanding of the implications of the illegal acts on company as well as personal implications.
- The implications for the audit firm with regard to professional negligence with respect to the company.
- The reputational risk the audit firm faces for associating with clients like Craig Ltd.
- Professional authoritative guidelines governing fraud and illegal activities mainly ISA 240, Auditors responsibility to consider fraud in an audit of financial statements and ISA 250, consideration of laws and regulations in the audit of financial statements.
- The specific provisions of the Value Added Tax (VAT) Act with reference to penalties, fines and the implications for the auditor for Craig Ltd and the managing director.
- Professional obligations, criminal and civil law with regard to illegal acts by clients.

**The actions I would take will be dictated by professional guidance, legislation and legal advice from my lawyer.**
- On discovery of the above, I would conduct further audit procedures altering the nature, extend and timing of the procedures to ensure that other material misstatements due to fraud or error exist.
- Evaluation the impact of the misstatement due to fraud at the assertion level and financial statements as a whole for materiality and its implications for the audit report.
- For the non compliance with the value added tax law, I will consider the potential financial consequences, such as fines, penalties, damages, disclosure requirements, the seriousness of the non compliance so as to call into question the time and fair view given by the financial statements.
- I would seek permission from Mr. Craig to discuss with his lawyer the implications.
- I would also consult with my own lawyer to discuss the possible legal consequences and the action I should take.
- Consider withdrawing from the engagement.

(b) If my firm was doing the audit for the first time, I would consider the reputational risk posed by associating with Mr. Craig to our firm and seek legal advice.
I would discuss with the risk partner in our firm and withdraw from the audit if Mr. Craig has not undertaken corrective action.
If Mr. Craig does not adjust the financial statements and underlying records, I will withdraw from the engagement, seek legal advise.

(c) If Mr. Craig demands for my immediate resignation, I would discuss the issues with him, explain to him the implications of the fraud and illegality of his actions to the company and himself.
If no amicable understanding is achieved, I would seek legal advice and consider my professional and legal obligations having been the audit of Craig Ltd.

*DECEMBER 2003 QUESTION FIVE*

**QUESTION 21**

(a) **The controls that ensure that only authorized purchase invoice and credit notes are posted to the purchases ledger will include;**

(i) The establishment of a purchasing committee that considers the material and service needs of the company and through some tendering system identifying the optimum suppliers and after entering into trade agreements with them producing an approved suppliers list.



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(ii) Accounts for suppliers would only be opened in the creditors ledger on the basis of the approval list of suppliers

(iii) There should be a stipulation that only the purchasing committee can add or delete names from the list of approved suppliers. This list should be distributed to all the departments that have some dealing with the suppliers such as stores, accountants, administration and particularly the cheque signatories.

(iv) A purchase order should be raised for all purchases. A goods received note should be raised to acknowledge receipt of the materials ordered and checking it for quality and quantity.

(v) The suppliers invoice should be matched against the purchase order and the goods received note. It should be checked for accuracy. The same should apply to credit notes. A goods returned note should be raised and a debit note to the supplier. These should be matched before the credit note is posted. A thoroughly checked invoice and credit note should then be posted to the creditor's ledger card. The work of accounts clerks should be checked and supervised by the chief accountant.

(vi) A budgetary control system should be instituted to ensure that unexpected trends are quickly noted and corrected. Unusual trends will be detected by falling margins etc and investigated.

(vii) An internal audit function should regularly match the records with each to ensure consistency and completeness.

(viii) Creditors statements should e requested and reconciled to the creditors ledger cards.

(ix) Payments should be on the basis of genuine invoices and not statements. A selection criteria should be in place for determining the invoices to be paid

(x) The cheque signatories should ensure that the cheques are payable to suppliers on the approved suppliers list. A cheque requisition should have been raised to authorize the payment of the invoice.

(b) **Controls over the addition, amendment and deletion of suppliers from the suppliers list and ensuring that only authorized suppliers are on the standing data file.**

(i) There must be in place a competent purchases committee composed of knowledgeable officers from the concerned departments, accounts, stores, buying and production. This committee will identify the material needs of the company well in advance. Then invite quotations from possible suppliers. Identify the optimum suppliers and enter into written contracts or agreements with them. Then produce an approved suppliers list which is distributed to the other department who may have dealings with the suppliers.

(ii) The accounting department should be under clear stipulation that they will only open an account for a supplier in the creditors ledger or remove a suppliers name from the creditors ledger upon written formalized authority of the purchasing committee. A pre-printed, pre-numbered change form should be filled in and signed by both the purchasing committee and the chief accountant.

(iii) Periodically the accounting department should produce a hard copy of all the suppliers who still have open operational accounts and this list should be scrutinized by the purchasing committee and compared with their own list to detect changes not authorized.

(iv) There should be an internal audit function to review the records of the company for consistency

(v) Bank reconciliations should be produced regularly and checked and approved by a senior officer. All long outstanding reconciling items should be investigated.

(vi) Blank unused cheques should be under lock and key. Should be subject to control by a register and released in numerical sequence.

(vii) The blank unused cheques should be checked physically regularly to ensure that they have not been stolen and used out of sequence





(viii) All the supporting evidence should be regularly checked to ensure that it has not been used to support more than one payment. Infact it should be stamped paid once the payment has been made.

(ix) The distribution of the cheques should be closely monitored

(x) Reconciliations of supplies accounts with their statements should be routinely carried out to confirm that payments are being credited by suppliers on the statements

(c) **Controls over the cheque payments and custody of the cheques**

(i) A senior official should routinely match all automatic payments of up to Kshs.5000 to the underlying supporting documentation even if it is after the cheques are released. This would detect suspicious payments such as cheque splitting where many small cheques are raised for one supplier to defeat the authority levels.

(ii) The numerical sequence of the cheques upto Kshs.5000 should be checked automatically by the computer and any missing numbers reported and investigated immediately. This is to ensure completeness of accounting for all cheques.

(iii) The numerical sequence of all cheques should be checked regularly and exception reports produced by the computer should be reviewed and approved by senior officers.

(iv) The cheque signatories whose signatories are pre-printed on the cheque upto Kshs.5000 should periodically monitor the distribution of those cheques.

(v) Regularly a sample of cheques that have been paid should be obtained from the bank and the details agreed to the documents and regularly checked for any changes to standing data and to confirm that they have been authorized.

(vi) Any changes to the standing data should be automatically logged by the computer system which should 'flag' any such changes and these should be confirmed as authorized changes by the purchasing committee.

(vii) Authority to alter the standing data should be vested in the chairman of the purchasing committee and the chief accountant. The computer should be programmed to only effect changes authorized by these two officials upon keying in their passwords.

*JUNE 2003 QUESTION FIVE*

**QUESTION 22**

To carry out starters and leavers test, I will select two payrolls, the first at the start of the company's financial year and the second a recent payroll. I will note:

1. Employees not on the first payroll who are on the second payroll. These are starters.
2. Employees on the first payroll who are not on the second. These are leavers.

For both starters and leavers, I will go to the personnel department and find the date each employee started or left.

For starters I will check to the relevant payrolls that they were not paid before they started employment. For most employees, the first payment should be at the end of the week or month they started work and not for the previous week or month. For manufacturing employees, the first payment should be made the week after they started work and they should not be paid at the end of the week they started work.



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For leavers I will check to the relevant payrolls that they were not paid after they ceased employment. For most employees, they should be paid at the end of the week or month they finished work but not for the subsequent week or month. For manufacturing employees, the last payment should be the week after they left employment and they should not be paid in the following weeks payroll.

An alternative way of performing this test is to start from the personnel records of staff who have started or left during the period. I will check that starters have not been paid before the period. I will check that starters have not been paid before they started employment and leavers have not been paid after they left employment in the same way as that described in the two paragraphs above.

If I find any problems, I will discuss them with the company's management. If I detect a fraud, this will require further investigation and I should report it to the company's management and include it in my management letter. This will suggest there should be greater controls over preventing frauds over starters and leavers, such as the personnel department periodically checking the wages department are treating these types of employee correctly.

**(b) I will carry out the following audit procedures when I attend the pay out of wages to employees:**

1. Before the wages are paid, I will take a copy of the payroll and check there is a pay packet for each employee. If the pay packet is transparent, it may be possible to test check the money in the pay packet agrees with the net pay on the payroll.
2. When the employee is given his/her wage, he/she should sign for it. The signature should be test checked to the employee's signature kept by the personnel department. I will mark on my list when each employee collects his/her wage.
3. I will check that no employee receives more than one pay packet or one for another employee. I will note if this is happening.
4. At the end of the wages payout, I will check that there is a wage packet for each employee who has not collected his/her wage. These will be the unmarked items on my payroll list. These are unclaimed wages.
5. I will check that these unclaimed wages are recorded in the unclaimed wages book. The information recorded in the unclaimed wages book should include the payroll date (and payment date, if different), the employees name and umber, and the net wage. I will note cases where unclaimed wages are not recorded in the unclaimed wages book.

   This is not unusual, as frequently wages collected in the day of payment are not recorded in the unclaimed wages book, and the unclaimed wages book records only those wages, which are unclaimed at the end of the day. This creates a weakness in the wages payment system (although it is minimized by the employees signing for their wages).

As indicated above, one of the purposes of attending the wages payout is to check the existence of employees.

**c) In checking the procedures over unclaimed wages:**

1. I will have checked procedures for recording unclaimed wages in the unclaimed wages book in part (b) (v) above. To qualitatively check that the same procedures are carried out in the weeks when I did not attend the pay-out. I will check the number of unclaimed wage packets is about the same each week. If they are significantly less in other weeks, this indicates that some unclaimed wages are not recorded in the unclaimed wages book. If I am concerned that proper procedures have not been followed in other weeks, I will ask the company's staff if the procedures are different in other weeks and I may attend another pay-out of wages. I will report the matter to the company's management and include it in my management letter.
2. I will check there is a wage packet for each recorded in the unclaimed wages book.
3. Where employees have collected their wages, I will check that they have either signed for the wage or there is a letter from the employee authorizing another person to collect the wage packet (e.g. when the employee is ill). I will check the employee's signature to the personnel records.
4. The company should pay into the bank wage packets which have been unclaimed for more than a month. The date the wages are banked should be recorded against details of each wage packet in the unclaimed wages book. For a sample of bankings of unclaimed wages, I will check that the amount banked (per the cash book) agrees with the total net wages of the employees as recorded in the unclaimed wages book.
5. If there is a long delay before the wage packets are banked (e.g. over three months), I will report it to the company's management and I may include it in my management letter.

I will report any weaknesses I find to the company's management. The unclaimed wage packets should be kept in a secure place, such as a sage. Ideally, unclaimed wages should not be dealt with by employees in the wages department, and there should be an independent check (probably by the accounts or personnel department) to ensure that proper procedures are carried out and there is no fraud.

**(d) To verify the existence of employees, I will first select a sample of employees from the most recent payroll. The procedures I will use for checking the existence of the employees will include:**

1. For employees at head office and at sales branches, my audit firm visits, I could go and see them and ask for a signature which would be checked to the personnel records.
2. Employees could be checked to the personnel records, as being currently employed by the company. The question says the personnel department is independent from the wages department.
3. Department managers could be asked to sign a list of employees who work for them and return it directly to me.
4. If the employees are paid by cheque, the cheques could be inspected before they are given to the employee or sent to their bank.
5. Other evidence of employees will include expense claims signed by the employee and records of tax and national insurance. For instance, there could be notifications from the Inland Revenue of changes in tax code, and there will have been an annual return to the Inland Revenue (at the end of the tax year) which lists each employee.

Based on the results of these test, I will decide whether all the employees on the payroll actually work for the company. It should be noted that the checks above are the variety of methods which can be used to verity employees on the payroll and in practice not all of them would be used.

*DECEMBER 2002 QUESTION ONE*

## QUESTION 23

**1. Stock valuation**

The finance director's claim that the issue of the report after balance sheet date is a non-adjusting event is irrelevant. As at balance sheet date the material could not be used in road construction. In accordance with its value, at the lower cost and net realizable value was 2 million. The issue of the report failed to change the situation. The value of stocks and operating profit should therefore be





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reduced by the amount of the write down to net realizable value being 5 million. This amount is material being in excess of 10% of operating profit.

If the company fails to adjust its financial statements, the effect on the auditors report would be an "expect for – disagreement" qualification as the matter affects only stock valuation and is therefore not pervasive. The opinion would be headed "Qualified opinion arising from disagreement about accounting treatment". The first paragraph in this section should describe the nature of the disagreement and quantify the effect on the financial statements. The second paragraph would then express the qualified opinion.

**(b) Depreciation**

Accounting for depreciation requires that useful lives of assets be reviewed regularly and the depreciation adjusted where there is found to be a change in useful life. The finance directors claim that technological obsolescence need not be taken into consideration is not consistent with depreciation for the current financial year should be adjusted so as to write off the written down value of computer controlled earth movers over their revised useful life.

| Year of purchase | Cost | Depreciation to 1/1/98 | Written down value 1/1/98 | Remaining useful life in years including 1998 | Required depreciation charge for 1998 on an overall basis of 5 years <000 | Depreciation provided 1998 | Adjustment required |
|---|---|---|---|---|---|---|---|
| 1995 | 5,000 | 1,500 | 3,500 | 2 | 1,750 | 500 | 1,250 |
| 1998 | 8,000 | | 8,000 | 5 | 1,600 | 800 | 800 |
| | | | | | | | 2,050 |

The depreciation charge should be increased by 2,050,000, which would have the effect of reducing the written down value of plant and machinery and of operating profit by that amount.

If there were no other uncorrected errors I would probably accept the amount as not being sufficiently material to justify issuing a qualified audit opinion. If the financial statements were not adjusted it is just over 5% of operating profit but depreciation is based on an estimate of the useful economic lives of the assets. As such it is not a precise amount and on a qualitative basis does not indicate the financial statements are necessary materially misstated.

If there were other detected but uncorrected errors in the financial statements then no matter how small these other errors might be it would probably be appropriate to qualify my opinion on the financial statements along the same lines as in the case of stock valuation.

**(c) Contingent liability**

A threat to claim for damages might be regarded as remote but the actual issue of a must be taken seriously if successful the claim would be certainly be material being in excess of the years profit. There certainly appears to be some substance to be the claim and the existence of the lawsuit should be disclosed in the note on contingent liabilities. This note needs to be reasonably comprehensive as to the basis for the claims the amounts involved and the company's grounds for not making a provision.





If the company does not disclose the existence of the claim then an except for - disagreement audit qualification is required. The opinion would be headed qualified opinion arising from disagreement about disclosure. The first paragraph in this section should describe the nature of the disagreement. The second paragraph would then express the qualified opinion.

A further concern is that the existence of the lawsuit might constitute an inherent uncertainty the potential effect on the company as a going concern leading to it being regarded as pervasive. The auditor might need to take legal advice on the potential consequences of the Ministry's investigation. Depending on this advice it may be necessary to add a paragraph to the basis of opinion section of the auditors report with a subheading 'fundamental uncertainty'. This would refer to the note on contingent liabilities in the financial statements of the company continues to refuse to disclose the contingency to the opinion section of the auditors report.

*DECEMBER 2002 QUESTION FOUR*

**QUESTION 24**

**The Stock System**

The stock system can very important in an audit because of the high value of stock or the complexity of its audit. It is closely connected with the sales and purchases system.

**Control considerations**

- Stocks may be as susceptible to irregularities as cash and, indeed, in some circumstances the risks of loss may be materially higher. Arrangements for the control of stocks should be framed with this in mind.
- The stock control procedures should ensure that stocks held are adequately protected against loss or misuse, and are properly applied in the operations of the business.
- Stock should be duly accounted for by appropriate recording and authorization of all movements.
- It is also important that the business has proper control over stock levels to prevent on the one hand the possibility of running out of stock and on the other of holding too much stock, and hence incurring increased holding costs and the risk of stock obsolescence.

A further aim should be to ensure stock is appropriately valued, and that write-downs of stock are kept to a minimum.

According to the nature of the business separate arrangements may be necessary for different categories of stocks, such as raw materials, components, work in progress, finished goods and consumable stores.

**Other controls:**

1. Segregation of duties;
2. Custody and recording of stocks received
3. Checking and recording of goods inwards
4. Precautions against theft
5. Misuse and deterioration
6. Restriction of access to stores
7. Controls on stores environment (temperature, precautions against damp)
8. Control of stock levels



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9. Maximum stock limits
10. Minimum stock limits
11. Maintenance of stock records
12. Stock ledgers
13. Bin cards
14. Transfer records
15. Arrangements for dealing with returnable containers
16. Security over stock held by third parties, and third party stock held by entity.
17. Stocktaking
18. Regular stocktaking
19. Fair coverage
20. Counts by independent persons
21. Recording
22. Cut-off for goods in transit and time differences
23. Reconciliation of stock counts to book records and control accounts
24. Computation of stock valuation

Accord with IAS 2
Checking of calculations

25. Review of condition of stock
26. Treatment of slow-moving, damaged and obsolete stock
27. Authorization of write-offs
28. Accounting for scrap and waste
29. Control considerations: cash at bank and in hand-receipt
30. Segregation of duties between the various functions listed below is particularly important.

(b) **Receipts by post**

1. Safeguard to prevent interception of mail between receipt and opening
2. Appointment of responsible person to supervise mail
3. Protection of cash and cheques (restrictive crossing)
4. Amounts received listed when post opened
5. Post stamped with date of receipt

**Control over sales of and collections**

1. Restrictions on receipt of cash (by cashiers only, or by salesmen etc)
2. Evidencing of receipt of cash

- Serially numbered receipt forms
- Cash registers incorporating sealed till rolls

3. Clearance of cash offices and registers
4. Agreement of cash collections with till rolls
5. Agreement of cash collections with banking and cash and sales records
6. Investigation of cash shortage and surpluses



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**Recording**

1. Maintenance of records
2. Limitation of duties or receiving cashiers
3. Holiday arrangements
4. Giving and recording of receipts

- Retained copies
- Serially numbered receipt books
- Custody of receipt books
- Comparisons with cash records and bank paying in slips

**Paying into bank**

1. Daily banking
2. Make-up and comparison of paying-in-slips against initial receipt records and cashbook
3. Banking of receipts intact/control of disbursements

**Cash and bank balances**

1. Restrictions on opening new bank accounts
2. Limitations on cash floats held
3. Restrictions on payments out of cash received
4. Restrictions on access to cash registers and offices'
5. Independent checks on cash floats
6. Surprise cash counts
7. Custody of cash outside office hours
8. Safeguarding of IOUs, cash in transit
9. Insurance arrangements
10. Control of funds held in trust for employees
11. Bank reconciliation's.

- Issue of bank reconciliation's
- Frequency of reconciliation's by independent person
- Reconciliation procedures
- Treatment of longstanding unpresented cheques
- Stop payment notice
- Sequence of cheque numbers
- Comparison with cashbooks.

*JUNE 2002 QUESTION ONE*

**QUESTION 25**

a) According to ISA 200, objectives and general principles governing an audit of financial statements audit risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. The ISA requires the auditor to plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit.

The ISA states that the objective of an audit of financial statements is to enable the auditor to express an opinion whether the financial statements are prepared in all material respects in accordance with an applicable financial framework.



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(i) Audit risk is a function of the risk of material misstatement of the financial statements (risk of material misstatement) (i.e. the risk that the financial statements are materially misstated prior to audit) and the risk that the auditor will not defect such misstatement (detection risk)

Therefore audit risk has the following components:-
- Risk of material misstatement
  - ✓ Inherent risk
  - ✓ Control risk

(ii) Inherent risk is the susceptibility of an assertion to a misstatement that could be material, either individually or when aggregated with other misstatements, assuming that there are no related controls.

(iii) Control risk is the risk that a misstatement that could occur in an assertion and that could be material either individually or when aggregated with other misstatements, will not be prevented or detected and corrected on a timely basis by the entity's internal control. Control risk is a function of the effectiveness of the design and operation of internal control in achieving the entity's objectives relevant to the preparation of the entity's financial statements.

(iv) Detection risk is the risk that the auditor will not detect a material misstatement that exists in an assertion that could be material either individually or when aggregated with other misstatements. Detection risk is a function of the effectiveness of an audit procedure and its application by the auditor.

b) The factors which influence inherent risk in an audit. Factors influencing inherent risk could be internal or external, specific to account balances, transactions, disclosures and presentation or the environment in which a firm operates.

Complex calculations
Amounts derived from accounting estimates

External circumstances include technological developments which might make a particular product obsolete.

- Lack of sufficient capital
- Declining industry characterized by a large number of business failures.

c) **Audit work to be done to assess the control risk in a purchases system.**

Control risk is a component of the risk of material misstatement. ISA 315, understanding the entity and its environment and assessing the risk of material misstatement

Paragraph 7 of the ISA 315 states that the auditor should perform the following risk assessment procedures to obtain an understanding of the entity and its environment including its internal control.
- Inquiries of management and others within the entity
- Analytical procedures
- Observations and inspection



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The auditor can also perform other audit procedures where the information obtained may be helpful in identifying risks of material misstatement.

**With respect to the purchases system, the audit work will include:-**
(i) Inquire from the persons charged with the purchases system and internal audit personnel concerning the design and effectiveness of controls of the purchases system.
(ii) Inquire about the procedures for requisitioning of goods and services by specific personnel on standard specified forms.
(iii) Check sequence of order forms used and whether missing items are investigated
(iv) Observation of operations of the system such as when goods are being delivered and the documentation process.

*DECEMBER 2001 QUESTION ONE*

QUESTION 26

(a)

**Further procedures to be adopted in order to reach a conclusion on whether the company's system of control can be relied upon include:**

1. Obtain copies of the invoices that cannot be traced from the supplier. Compare this invoice obtained from the supplier and the uninitiated one with the related purchase order which was initially sent to the suppliers. Compare this with purchase order with the related goods received note. Confirm the receipt of these goods as evidenced by the goods received note to the stock cards of concerned stocks. If all the above documents are in agreement, this would indicate the validity of the liability or payment, if not, this would indicate a lapse in the internal control system which would affect the extent to which it can be relied upon.
2. Approval of invoices for payment that are not initialised (as evidence of being checked) would indicate a departure from the prescribed internal control. Thus, I would increase my sample size to determine if it is common for invoices to be approved that are not checked.
3. Carry out a walk through test on the altered stock cards by tracing the entries on these stock card to the documents of origin such as:

   - The purchase order
   - The goods received notes
   - The suppliers invoice

This would help me to determine whether the adjustments were correcting errors or they were fraudently done. I would also make enquiries regarding this adjustment from the responsible officers or employees.
For the supplier who is paid on the basis of the pro forma invoice.
I would select a sample of these pro forma invoices and carry out a walk through test by: -

- Trace the pro forma invoices to their related purchase orders and determine whether the goods were actually ordered.
- Inspect the related goods received note to determine whether the goods were actually received in the quality and quantity ordered.

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- Trace the pro forma invoice to the proper invoice subsequently received and whether these match the pro forma invoices in every detail.

Review the agreed trade and payment terms with this supplier.

Obtain representations from management as to why the unusual method of operating was adopted.

If the above documents are in agreement with each other, then it means that the prescribed controls work and may be relied upon.

Part (b) according to ISA 400 and 49 the auditor should make management aware as soon as practical and at an appropriate level of responsibility, of material weakness in the design or operation of accounting and internal control systems which have come to the auditors attention in the course of his audit.

As such the main purposes of reports to directors or management are for auditors to communicate points that have to their attention during the audit: -

a. On the design and operation of the accounting and internal control systems and to make suggestions for their improvement.
b. Of other constructive advice, e.g. comments on potential economies or improvements in efficiency.
c. On other matter e.g.

- Comments on adjusted and unadjusted errors in the financial statement or on particular accounting policies and practices.
- Details of inefficiencies or delays in the agreed timetable for preparation of the accounts or of working schedules, which delayed the completion of the audit and may have resulted in additional costs.
- Any significant differences between the accounts and any management accounts or budgets, which not only caused audit problems but also detract from the value of management information.
- Any results of the auditor's analytical procedures of which management may not be aware and may be of benefit to them.

The principal limitation of the report included: -

(i) Only those matters that come to the auditor's attention are reported on.
(ii) If the shortcomings point to management weaknesses they are unlikely t be corrected or implemented on a timely basis.
(iii) The shareholders or the regulatory authorities may not receive a copy of this report and thus only one executive director may see it.

*JUNE 2001 QUESTION ONE*





**QUESTION 27**

1. Nakuru Motor Spares is a material debtor to Nairobi Motor Spares ltd. However the client is of the view that they have obtained a floating charge on the stock of Nakuru Motor Spares hence no need to make a provision

To determine whether a provision is necessary, I will need to take the following factors into consideration:

a) A floating charge is an equitable charge securing a loan on the assets of a going concern. It remains dormant until crystallization. Therefore, the issue is what are the chances that the charge will crystallize? It seems to me that there are high chances of crystallization as the customer, Nakuru Motor is a slow payer and his debt has increased over the year. This should cast doubts on the going concern of Nakuru Spares, as it seems to have difficulty in meeting its current obligations.
b) A floating charge created six months before winding up is void since Nakuru Spares seems to be in financial difficulty, it is worth considering the date the charge was created.
c) A floating charge is subordinate to any specific charge, therefore I would consider whether there exists other charges which are superior to this charge.
d) The charge may crystallize at a moment when Nakuru Spares does not have any items at hand or the stock may be worth less the amount owed occasioning a loss to Nairobi Spares. Again, these stock may need to be resold at a value which cannot be predetermined. Therefore in conclusion a provision is still required due to the above limitations.

2. The occurrence of so many errors indicate that their stock value in the records could be misstated. Many items could be carried at wrong quantities and values. Therefore the auditor should attempt to reconcile the physical count with computerized book stock records to determine the extent of misstatement of the stock value. The auditor may: -

a) If the physical count was reliable, the auditor may use these quantities as the basis of valuing the items. These values would be compared with the latest purchase invoices and if the resultant valuation shows a reasonable comparison with the computer generated values, no provision is necessary. If the differences are material, the auditor should consider whether proper books of accounts are kept or not. If not, this would constitute a limitation on scope. The auditor should then consider whether the limitation of scope is so material and persuasive that a disclaimer of opinion or qualified opinion is call for.

b) Selected number of stock items and check their movements and produce quantity reconciliations.
c) Carry out analytical procedures to determine whether fair values have been attributed to the stocks.
d) Consider whether internal audit carries out regular physical stock counts and the resultant investigations that take place.

3. An increase in the value of stock could be attributed to various factors such as: -

a. Inclusion of stock at wrong values. According to IAS 2, inventories should be valued at the lower of cost and net realizable value. Sometimes management may include stock at their selling prices which may lead to such an increase. To establish items of stock carried at the



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wrong prices, a line-by-line review may be carried out. The client is unwilling to this, the auditor may carry out analytical review procedures on

- Gross profit margin
- Stock turnover
- Percentage increase in stock value

b. A decline in sales made by the organization hence resulting in a build up of stock. This is definitely a contributing factor for the client as is indicated by the 25% increase on the old stock listing. To determine this, the auditor may attempt to identify movements of stock to see whether there is a slow down in the pace

*JUNE 2001 QUESTION TWO*

**QUESTION 28**

**The procedures that could have been adopted to detect the fraudulent activities of Mr. A. Chiengo would have included the following:**

(i) Comparing the source documents to the records and the physical items. For example, capitalized items should have been vouched and physically inspected to confirm existence at the year end. Obviously the auditors did not sight the additions to fixed assets.

(ii) Reviewing for window dressing, the process of selling all stock items just before the year end and repurchasing them shortly after the year end would have disclosed serious cut off problems and window dressing.

(iii) Relating the re-purchases to sales under ratio and trend analysis.

(iv) Comparison with performance in the rest of the industry, as the growth in the company's sales astronomical and not possible to achieve through straight business.

(v) Circularisation of debtors as it would have been unlikely that fictitious sales agents would reply.

(vi) Searching for circumstances that should arouse the auditors suspicion, such as the confidentiality agreement, high bonuses paid to other directors and employment on commission basis.

(vii) Inherent risk assessment that should have targeted the directors competence and integrity.

(viii) Attending a stock take and comparing the records with actual quantities counted.

(ix) Analytical review involving audit risk areas and figures that do not make sense.

The companies Act, Section 162 gives the auditors unrestricted access to the documents, vouchers and accounts of the company. The 'confidentiality' agreement constitutes a very serious breach and places a material scope limitation on the auditors. The auditors would be unable to conclude on the completeness, accuracy and validity of a significant number of transactions and balances.

They will not have received all the information and explanations deemed necessary for the purposes of their audit. This is a ground for qualifying their report. If therefore the





auditors had not qualified their report they would have made a big mistake. It is unethical for auditors to accept an engagement under such terms that restricts their scope

(c) An audit is carried out principally to form an opinion on the true and fair view. To form such an opinion the auditor has to obtain sufficient and appropriate audit evidence. The auditor takes full responsibility for his opinion.

Under the provisions of ISA 910, the objective of a review of financial statements is to enable an auditor to state whether on the basis of procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditors attention that causes the auditor to believe that the financial statements are not prepared in all material respects, in accordance with an identified, financial reporting framework (negative assurance).

Thus an audit has not been carried out and the negative assurance is less assuring than an auditor's report.

(d) **Upon legal advice and accepted position within the accountancy profession and legal precedent an auditor would be guilty of profession negligence if:**

(i) He does not exercise due care and skill during the performance of his professional assignments or

(ii) He fails to detect material misstatements caused by errors or irregularities including frauds which a reasonably competent auditor would have detected or

(iii) He has performed his audit and failed to comply with approved auditing standards or generally accepted auditing practices or procedures.

Attendance at stock takes, cut off tests reviews for window dressing and debtors circularization as well as physical inspection of addiction to fixed assets are all well accepted and expected auditing procedures.

And whereas the auditor should not go out seeking to discover every fraud or error or other irregularity, once his suspicion has been aroused he should probe the matter in detail to the bottom. Clearly there were glaring indications that fraudulent activity was taking place. That the auditor was not put upon enquiry and that he did not carry out normal audit tests as in (a) above that could have detected the fraud would make it very difficult for the auditor to prove that he has not been negligent.

*DECEMBER 2000 QUESTION THREE*

Knowledge speaks, but wisdom listens.

Jimi Hendrix.



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# TOPIC 6

# REVIEW OF AN AUDIT

## QUESTION 1

(b) **Possible financial indications of going concern problems:**

- Net liability or net current liability position
- Fixed term borrowings approaching maturity without realistic prospects of renewal or repayment, or excessive reliance on short-term borrowings to finance long term assets
- Indications of withdrawal of financial support by creditors
- Negative operating cashflows indicated by historical or prospective financial statements
- Adverse key financial ratios
- Substantial operating losses or significant deterioration in the value of assets used to generate cash
- Inability to pay creditors on due dates

*JUNE 2012 QUESTION FIVE*

## QUESTION 2

a) Measure to improve the financial position

- Unnecessary expenditure should be cut down
- The Sh.48 million can be invested into profit making ventures that will improve the cash position of the firm and profitability
- Meet expenses using (he available funds in the organization and not overdrafts
- Negotiate with the creditors and especially the trade payables to review their credit policy towards the firm to avoid a situation either the firm does not have inventory or they all claim their cash at once.
- Reduce the pressure on the cash position of the firm by requesting the bank to convert the loan into a five year loan.
- Assets of the firm that are not economically viable should be disposed off
- Make payments that are urgent and critical to the firm's operations but payments that are not urgent should be deferred.
- Demand payments from receivables and even consider seeking the services of debt collectors at a small fee where there is total default of payments.

b) Information to support the MDs comment

- Assessment of the firms operating environment should be assessed to determine whether it is likely that the firm will return to profitability given the prevailing market conditions.
- Obtain the assumptions upon which management is making such conclusion and assess their reasonableness and economic sense.
- Review the firms' books for any major financial obligation that is to be settled within the foreseeable future and assess its impact on the firm.
- The basis upon which management is placing its hopes of returning to profitability should be





reviewed to determine whether they are being real in light of the current circumstances facing the firm.

c) Audit opinion under the following circumstance

i) Financial statements give sufficient disclosure of the going concern problems

It is the auditor's responsibility to obtain sufficient appropriate audit evidence about the appropriateness of management's use of the going concern assumptions. If there is adequate disclosure in the financial statements about an event or condition that casts doubts on the entity's ability to continue as a going concern and management intend to deal with it, then the auditor shall express an unmodified opinion and
include an emphasis of matter paragraph' in the auditor's report.

ii) There is no disclosure of going concern problem in the financial statements

This amounts to a disagreement with management; since the item in contention is material the auditor should issue a qualified opinion. However, if the auditor feels that the disagreement is so material and pervasive to the financial statements as is the case in this scenario, a qualification of the report may not be sufficient to disclose the misleading nature of the financial statements, therefore the auditor should issue an adverse opinion.

*DEC 2011 QUESTION FIVE*

## QUESTION 3

a) Audit procedures that should be performed during final audit in respect of the estimated warranty provision

1. Review and test the process used by management to develop the estimate

- Correspondence with customers during the year should be reviewed to gain an understanding of claims already in progress at the year end.
- Re compute the warranty provision.
- Contracts or orders for the terms of the warranty should be reviewed to gain an understanding of the obligation of the client
- Agree the percentage applied in the calculation to the stated accounting policy of the company.
- Review board minutes for discussion of on-going warranty claims, and for approval of the amount provided.
- Use Management accounts should be used to ascertain normal level of warranty rectification costs during the year.
- Discussions on assumptions used to determine the percentage used in his calculations should be held with the managing director
- Analytical procedures should be performed to compare the level of warranty provision year by year and compare actual to budgeted provisions.
- Consider whether the assumptions used are consistent with the auditor's understanding of the business.
- Compare prior year's provision with actual expenditure on warranty claims in the accounting period.



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- Review any Work carried out after the year end on specific faults that have been provided for should be reviewed.
- Agree cash expended on rectification work in the post reporting period to the cash books.
- Cash expended on rectification during the post reporting period should be agreed to supplier's invoices.

*JUNE 2011 QUESTION FOUR A*

**QUESTION 4**

(b) Audit procedures to assess the going concern

IAS 1 presentation of financial statements provides that when preparing financial statements, management should make an assessment of an entity's ability to continue as a going concern. Furthermore according to ISA 570 going concern the auditor, when performing audit procedures should consider the appropriateness of the going concern assumption underlying the preparation of financial statements. Financial statements should be prepared on a going concern basis unless management intends to liquidate rite entity or to cease trading or has no realistic alternative but to do so.

Audit Procedures include:

i. Check out minutes of the meetings of shareholders, the board of directors and important committees for reference to financial difficulties.
ii. Confirmation of the existence, legality and enforceability of arrangements to provide or maintain financial support with relate and third parties and assess the financial ability to repay.
iii. Discussing cash flow, profit and other relevant forecasts with management.
iv. Consider the firm's new product line and its profitability and the effect of a lack of a dedicated accounting system.
v. Analyzing and discussing any available interim financial statements

*DECEMBER 2009 QUESTION THREE B*

**QUESTION 5**

a) International Accounting Standard (IAS) 1, "Presentation of Financial Statements" paragraphs 23 and 24 state: "When preparing financial statements, management should make an assessment of an enterprise's ability to continue as a going concern. Financial statements should be prepared on a going concern basis unless management intends to liquidate the enterprise or to cease trading, or has no realistic alternative but to do so. When management is aware, in making its assessment, of material uncertainties related to events or conditions which may cast significant doubt upon the enterprise's ability to continue as a going concern, those uncertainties should be disclosed. When the financial statements are not prepared on a going concern basis, that fact should be disclosed, together with the basis on which the financial statements are prepared and the reasons why the enterprise is not considered to be a going concern.

In assessing whether the going concern assumption is appropriate, management takes into account all available information for the foreseeable future, which should be at least, but is not limited to, twelve months from the balance sheet date. The degree of consideration depends on the facts in each case. When an enterprise has a history of profitable operations and ready access to financial



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resources, a conclusion that the going concern basis of accounting is appropriate can be reached without detailed analysis. In other cases, management may need to consider a wide range of factors surrounding current and expected profitability, debt repayment schedules and potential sources of replacement financing before it can satisfy itself that the going concern basis is appropriate."

The phrase "material uncertainty" is used in IAS 1 in discussing the uncertainties related to events or conditions which may cast significant doubt on the enterprise's ability to continue as a going concern that should be disclosed in the financial statements. In other financial reporting frameworks, and elsewhere in the ISA's, the phrase "significant uncertainties" is used in similar circumstances. The detailed requirements regarding management's responsibility to assess the entity's ability to continue as a going concern and related financial statement disclosures may be set out in accounting standards, legislation or regulation.

b) In planning the audit, the auditor should consider whether there are events or conditions which may cast significant doubt on the entity's ability to continue as a going concern. The auditor should remain alert for evidence of events or conditions which may cast significant doubt on the entity's ability to continue as a going concern throughout the audit. If such events or conditions are identified, the auditor should, in addition to performing the procedures in paragraph 26, consider whether they affect the auditor's assessments of the components of audit risk.

The auditor should evaluate management's assessment of the entity's ability to continue as a going concern.

The auditor should consider the same period as that used by management in making its assessment under the financial reporting framework. If management's assessment of the entity's ability to continue as a going concern covers less than twelve months from the balance sheet date, the auditor should ask management to extend its assessment period to twelve months from the balance sheet date.

The auditor should inquire of management as to its knowledge of events or conditions beyond the period of assessment used by management that may cast significant doubt on the entity's ability to continue as a going concern.
When events or conditions have been identified which may cast significant doubt on the entity's ability to continue as a going concern, the auditor should:
(a) Review management's plans for future actions based on its going concern assessment;
(b) Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists through carrying out procedures considered necessary, including considering the effect of any plans of management and other mitigating factors; and
(c) Seek written representations from management regarding its plans for future action.

Procedures that are relevant in this regard may include the following:
- Analyzing and discussing cash flow, profit and other relevant forecasts with management.
- Analyzing and discussing the entity's latest available interim financial statements.
- Reviewing the terms of debentures and loan agreements and determining whether any have been breached.
- Reading minutes of the meetings of shareholders, the board of directors and important committees for reference to financing difficulties.



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- Inquiring of the entity's lawyer regarding the existence of litigation and claims and the reasonableness of management's assessments of their outcome and the estimate of their financial implications.
- Confirming the existence, legality and enforceability of arrangements to provide or maintain financial support with related and third parties and assessing the financial ability of such parties to provide additional funds.
- Considering the entity's plans to deal with unfilled customer orders.
- Reviewing events after period end to identify those that either mitigate or otherwise affect the entity's ability to continue as a going concern.

When analysis of cash flow is a significant factor in considering the future outcome of events or conditions the auditor considers:

(a) The reliability of the entity's system for generating such information; and
(b) Whether there is adequate support for the assumptions underlying the forecast.

In addition the auditor compares:
(a) The prospective financial information for recent prior periods with historical results; and
(b) The prospective financial information for the current period with results achieved to date.

c) Examples of events or conditions, which individually or collectively, may cast significant doubt about the going concern assumption, are set out below. This listing is not all-inclusive nor does the existence of one or more of the items always signify that a material uncertainty3 exists.

*Financial*

- Net liability or net current liability position.
- Fixed-term borrowings approaching maturity without realistic prospects of renewal or repayment; or excessive reliance on short-term borrowings to finance long-term assets.
- Indications of withdrawal of financial support by debtors and other creditors.
- Negative operating cash flows indicated by historical or prospective financial statements.
- Adverse key financial ratios.
- Substantial operating losses or significant deterioration in the value of assets used to generate cash flows.
- Arrears or discontinuance of dividends.
- Inability to pay creditors on due dates.
- Inability to comply with the terms of loan agreements.
- Change from credit to cash-on-delivery transactions with suppliers.
- Inability to obtain financing for essential new product development or other essential investments.

*Operating*

- Loss of key management without replacement.
- Loss of a major market, franchise, license, or principal supplier.
- Labor difficulties or shortages of important supplies.





*Other*

- Non-compliance with capital or other statutory requirements.
- Pending legal or regulatory proceedings against the entity that may, if successful, result in claims that are unlikely to be satisfied.
- Changes in legislation or government policy expected to adversely affect the entity.

The significance of such events or conditions often can be mitigated by other factors. For example, the effect of an entity being unable to make its normal debt repayments may be counter-balanced by management's plans to maintain adequate cash flows by alternative means, such as by disposal of assets, rescheduling of loan repayments, or obtaining additional capital. Similarly, the loss of a principal supplier may be mitigated by the availability of a suitable alternative source of supply.

d) The current requirements are mainly passive and the interests of all stakeholders would be better served by making the auditor proactive in dealing with going concern issues.
The auditor should be required to participate actively.
The procedures should be dictated by statute so that the auditor will have no alternative but to deal with the issue.

*DECEMBER 2004 QUESTION THREE*

**QUESTION 6**

(a) The auditor's responsibilities in the periods listed in the question are given IAS 560 (subsequent events)

1. In the period 31 October to 6 December 2002, the auditor should carry out sufficient appropriate audit work so that he/she has a reasonable expectation of detecting and quantifying material subsequent events. Examples of the types of audit procedures carried out are included in part (b) of this answer.
2. In the period 6 December 2002 to 19 December 2002 the auditor's responsibilities are the same as in the period (a)(i) above.
3. The period from 19 December 2002 to 5 January 2003, the standard says that the auditor should reasonably expect the directors to inform him/her of any material subsequent events detected in this period, which may affect the financial statements. During this period auditors do not have any obligation to perform procedures or make enquiries regarding financial statements.

When the auditor becomes aware of material subsequent events in this period, he/she should carry out appropriate audit procedures to determine whether the subsequent event has a material effect on the financial statements.

If the directors amend the financial statements, the auditor should produce a new report on the amended financial statements.

If the directors do not amend the financial statements, and the subsequent event is material, the auditor should consider how the shareholders can be informed of the subsequent event. This may include the auditors making a statement at the annual general meeting at which the financial statements are approved by the shareholders. The auditor may consider taking legal advice, and it points out that auditors do not have a statutory right to communicate directly in writing to shareholders.



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4. In the period from 6 January to 28 January 2003, the auditors have no duty to seek out whether material subsequent events have occurred in this period. However, if the auditor becomes awar a material subsequent event in this period, he should consider whether he should withdraw his a report. He will probably have to take legal advice on the matter. Also, he should discuss problem with the company. It may be necessary for either the directors or the auditors to ma statement at the annual general meeting (AGM)

   If the directors revise the financial statements, the auditor will have to audit these revisions come to a conclusion on whether the revised financial statements show a true and fair view. audit report on the revised financial statements should refer to the note in the financial statem which describes the changes and it should refer to the earlier audit report. The audit report on revised financial statements should not be dated before the date the directors approve th financial statements (normally, the dates are the same).

   If the directors do not revise the financial statements, and do not make a statement at the AGM, auditor should take legal advice on the course of action he should take. Normally, he should ma a statement to shareholders at the AGM.

5. IAS 560 does not provide guidance on the auditor's responsibilities after the financial statemen have been approved by members at the annual general meeting. However, it does appear that t auditor has no responsibility for detecting subsequent events in this perio. If, during this perio the directors find material mis-statements in the audited financial statements, and inform the audi of the fact, the procedures will be the similar to those described in part (a)(Iv) above.

(b) The audit techniques which involve checking subsequent events include:

1. Checking cash received from debtors after the year-end to check recoverability of year-end a sales ledger balances. Any year-end balances which are unpaid at the time of the audit will potential bad debts and further investigations should be carried out.
2. A debtor's circularization carried out after the year-end could be a post balance sheet check debtors at the year-end.
3. Checking sales after the year end to check recoverability of stock at the year end, if for stock held the year end, the selling price after the year end is more than cost, then the stock can be valued cost. However, if the selling price is less than cost, this stock should be valued at net realizab value.
4. Checking sales cut-off. Starting from the dispatch note, for sales before the year-end, the sal invoice should be posted to the sales ledger before the year-end. For sales after the year-end, t auditor should check the sales invoice is not posted to the sales ledger before the year en (technically, only this latter check is a check of subsequent event).
5. Checking purchases cut-off. Starting from the goods received before the year-end, the purchas invoice should either be posted to the purchase ledger before the year-end or included in purcha accruals at the year-end. For goods after the year-end, the purchase invoice should be neith posted to the purchase ledger before the year-end nor included in purchase accruals at the year-end
6. Checking supplier's statements to the balances on the purchase ledger. If the balances agree, this good evidence that the purchase ledger balance is correct. If there is a difference, it should b reconciled and the auditor should consider whether the differences are reasonable. Supplier statements are an effective way of checking purchases cut-off, and of detecting late issue o cheques after the year-end.





heck any sales or disposals of fixed assets after the year-end. This will check whether these assets ve been sold for more or less than their balance sheet value. If they are sold for less than their alance sheet value, normally they should be written down to their realizable value at the year-end.
hecking returns of goods from customers and other sales credit given after the year-end. This elps determine whether the provision for these items in the financial statements is reasonable. Similar checks can be made for purchase items, such as goods returned before the year-end when he credit is received after the year-end, and other credits received from suppliers after the year-end.
Checking about legal claims against the company, which exist, at the year-end. This will involve asking the company secretary and the directors if there are any claims, and (with the clients permission) asking the company's auditor, inspecting board minutes (see item (x) below) could highlight any claims against the company. The bank letter may include details of a claim against he company of Companies House may have some information (but this is uncommon).
Checking board minutes and management reports after the year-end, which relate to events at or before the year-end.
Checking management accounts after the year-end for any items, which should have been included at the year-end (e.g. bad debts, stock write-downs etc.)
Checking cashbook and petty cash transactions after the year-end to see if there are any unrecorded accruals and prepayments at the year-end, and to confirm those items in the financial statements. For instance, receipts after the year end may indicate sundry debtors at the year end and payments after the year end may highlight sundry creditors and accruals which existed at the year end (e.g. the payment of tax and national insurance in November would be good evidence of the liability at the year end.
Checking purchase invoices received after the year-end. Some of these may relate to pre-year end transactions (i.e. those which are dated before the year end). Purchase invoice for electricity received after the year-end are an effective way of determining the accrual at the year-end.
Checking the bank reconciliation to check if payments were actually made before the year end and there is no teeming and lading fraud (see answer to question 3(a). If there is a delay in clearing a significant value of cheques issued before the year-end, this indicates the actual payment (i.e. when the cheques were sent to the creditors) was made after the year-end. A delay in lodging cash received into the bank indicates a teeming and lading fraud. The fact that the cashbook balance can be reconciled to the balance on the bank statement is good evidence that the cash book balance in the financial statements is correct.

) As no detailed audit work would have been carried out during the period, there is a risk that material subsequent events may have occurred in this period. Thus, the auditor will have to ask the director's and senior management, if any material subsequent events have occurred in this period or whether further evidence is available for uncertainties existing at 6 December 2002. Also the auditor should examine such documents as Board and Management minutes, management accounts and seek further evidence relating to uncertainties at 6 December 2002 (e.g. whether a doubtful debit at 6 December has been settled).

*DECEMBER 2002 QUESTION THREE*

**QUESTION 7**

According to the framework for preparation and presentation of financial statements, going concern is a fundamental assumption whereby it is assumed that; -

(i) The entity will continue in operation in the foreseeable future
(ii) The entity has is neither the intention nor the need to liquidate or curtail materially its scale of operations



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Thus, the going concern assumption assumes that the company will be able to discharge its operation
normally and meet its financial obligations as they fall due.
In the case of a given company, the factors that could indicate that the going concern assumption ma
be put into question can be described as follows; -

1. Inability to pay the creditors on the due dates.
Major suppliers could withdraw credit or demand cash on delivery. This could mean that as th
company maybe unable to collect its debtors as quickly as it is required to settle its liabili
then it will be unable to meet financial obligations as they fall due.
2. Excessive holding of stocks and debtors
Cash is what pays liabilities and not other assets therefore, inability to collect cash or to conve
stock and liabilities to cash could lead to inability to pay creditors.
3. Use of short term finance for example overdraft to finance long term assets e.g. fixed assets o
research and development on new products, a company can still be in a net asset position bu
due to the unrealisability of fixed assets still find that its not a going concern as it has no readil
realizable assets to pay off its current liabilities.
4. Use of expensive finance or being highly geared.
Few entities are able to achieve gross profit margin of over 50%, expensive finance e.g. Hir
purchase, lease hire or company being highly geared means that the interest expense can reduc
the margin such that little is left to finance other costs. Use of expensive finance also indicate
inability to obtain normal credit and overdraft facilities.
5. Over trading
A company growing too fast may find itself unable to finance the necessary investment i
finance and stock holding.
6. Dependence on one supplier, customer product or market.
This means that insolvency or loss of such suppliers or collapse of market for the product coul
precipitate crises that could lead to the death of the company.
7. Long term loan reaching maturity without realistic chances of obtaining alternative financing.
Such loans are usually secured on significant and indispensable assets of the company thus i
new facilities cannot be negotiated quickly, the entity may lose its productive facility as they
are sold to settle the liability.
8. Receiving losses
Eventually a loss making company will run out of money thus have going concern problems.
9. Dividend arrears
Shareholders not getting a return on the investment will eventually withhold their support for
the company and may not subscribe for more equity.

(B) ISA 570: - Going concern. The auditors should assess the adequacy of the means by which the directors have satisfied themselves that:

(a) It is appropriate for them to adopt the going concern basis in preparing the financial statements and

(b) The financial statements include such disclosures, if any, relating to going concern as are necessary for them to give a true and fair view.

For this purpose:

(i) The auditors should make enquiries of the directors and examine appropriate available financial information and





Having regard to the future period to which the directors have paid particular attention assessing going concern, the auditors should plans and perform procedures specifically designed to identify any material matters which could indicate concern about the entity's ability to continue as a going concern.

reliminary assessment

he auditors approach includes a preliminary assessment, when the overall audit plan is being eveloped, of the risk that the entity may be unable to continue as a going concern. The auditor should nsider:

Whether the period to which the directors have paid particular attention in assessing going concern is reasonable in the entity's circumstances and In the light of the need for the directors to consider the ability of the entity to continue in operational existence for the foreseeable future.
The systems or other means (formal or informal), for timely identification of warnings of future risks and uncertainties the entity might face.
Budget and/or forecast information (cash flow information in particular) produced by the entity. and the quality of the systems (or other means, formal or informal in place for producing this information and keeping it up to date.
Whether the key assumptions underlying the budgets and/or forecasts appear appropriate in the circumstances. This should include consideration of:

- Projected profit;
- Forecast levels of working capital;
- The completeness of forecast expenditure;
- Whether the client will have sufficient cash at periods of maximum need;
- The financing of capital expenditure and long-term plans.

The sensitivity of budgets and/or forecasts to variable factors both within the control of the directors and outside their control.
Any obligations, undertakings or guarantees arranged with other entities (in particular, lenders, suppliers and group companies) for the giving or receiving of support.
The existence, adequacy and terms of borrowing facilities, and supplier credit.
The director's plans for resolving any matters giving rise to the concern (if any) about the appropriateness of the going concern basis. In particular, the auditors may need to consider:

- Whether the plans are realistic;
- Whether there is a reasonable expectation that the plans are likely to resolve any problems foreseen; and
- Whether the directors are likely to put the plans into practice effectively.

The nature and scope of the auditor's procedures will depend on the circumstances; the extent will depend mainly on the excess of the financial resources available over the financial statements required: The auditors and directors procedures can be very simple in some cases, particularly in the case of smaller companies, where budgets and forecasts are not normally prepared and no specific systems are in place to monitor going concern matters.

The auditor's examination of borrowing facilities



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The auditors will usually:

(a) Obtain confirmations of the existence and terms of bank facilities; and
(b) Make their own assessment of the intentions of the bankers relating thereto.

These procedures will become more vital in any of the following circumstances (for example).

1. There is a low margin of financial resources available to the entity
2. The entity is dependent on borrowing facilities shortly due for renewal.
3. Correspondence between the bankers and the entity reveals that the last renewal of facilities was agreed with difficulty, or that, since the last review of facilities, the bankers have imposed additional conditions as a prerequisite for continued lending.
4. A significant deterioration in cash flow is projected
5. The value of assets granted as security for borrowings is declining
6. The entity has breached the terms of borrowing covenants, or there are indications of potential breaches

If the auditors cannot satisfy themselves then, in accordance with the audit reporting standard (ISA 700) they should consider whether the relevant matters need to be:

1. Disclosed in the financial statements in order that they give a true and fair view and/or
2. Referred to in the auditors report (by explanatory paragraph or a qualified opinion).

*JUNE 2002 QUESTION TWO*

**QUESTION 8**

The purposes of the auditor sending a management letter:

i. To enable the auditor to give his comments on the accounting records, systems and controls
ii. To enable the auditor to bring to the attention of the management areas of weakness that might lead to material errors
iii. To enable the auditor to communicate matters that may have an impact on future audits
iv. To enable management to put right matters that may otherwise have led to audit report qualification
v. To enable the auditor point out areas where management could be more efficient or more effective or where economies could be made or resources used more effectively.

The contents of the report include:

i. A list of weakness in the structure of systems of accounting and internal controls. This means where the client has records or controls which are ill designed or inadequate.
ii. A list of deficiencies in operation of the records or controls. This is principle good records and controls have been designed but they may be by-passed or not always carried out.
iii. Unsuitable accounting policies and practices
iv. Non compliance with accounting standards or legislation
v. Explanations of the risks arising from each weakness
vi. Comments on inefficiencies as well as weaknesses.
vii. Recommendations of improvement.



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Items (iii) and (iv) may require the auditor to qualify his report to the members as required by statute.

The proposal that the report to management by the auditors should be distributed to the shareholders as well as the financial statements has some merits such as:

i. Giving the shareholders more information on how their funds are being controlled and thus giving them increased opportunities for monitoring their investment and checking the performance of the directors. It will alert the shareholders to breaches by the directors of legal and other requirements, items that due to materiality considerations do not appear in the auditors report to shareholders.
ii. Bad investment decisions by the directors and inefficient, uneconomical and ineffective policies of the directors will be highlighted.

On the other hand, the main role of the auditors is not to judge on the ability of the management. Distributing the report to the shareholders would therefore have the following demerits:

i. Allows more conflict between the providers of funds and the controllers stifling possible initiative by the directors, yet the director's performance can easily be monitored through the price movement on the stock exchange.
ii. In most cases a good number of the directors, are themselves shareholders. Thus they are able to act to correct shortcomings on behalf to the rest of the directors.
iii. Too much information to shareholders may counter productive, as the shareholders attention will be detracted from the more important issues.

The current practice is not to send such a management letter to the shareholders, although in certain industries such as banking, building society or insurance, such information is provided freely not only to management but also to the regulatory authorities such as the central bank of Kenya and the commissioner of insurance.

Shareholders in the main tend to be interested in such a report to give their directors some leeway in operations.

*JUNE 2001 QUESTION FIVE*

**QUESTION 9**

1) Under the accruals assumption a prepayment is a payment made in one period but the benefit to be derived is properly for a future period. There must be a rational basis for determining the period over
which the future benefit will be derived.

For the cost incurred of 15,840,000 to qualify as a prepayment consideration will have to be given to:

(i) The normal accounting policy adopted by the company. Whether the treatment being adopted is consistent with previous years

(ii) Whether the brochures and advertising is to be utilized after 30 April even though paid for in advance, such as whether there are still TV shows to be aired.

(iii) The ability to measure with sufficient reliability when the expenditure will be fully utilized.

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(iv) How close to the year end it was incurred and whether the benefits can be spread into the future.

The figures prepaid represents 31% of the Profit before Tax. To defer it would appear to be distort the profit figure. It is unlikely that it is justified to treat it as a prepayment. The most likely effect n the auditors' report would be a qualification on disagreement although an emphasis of matter could suffice.

2) The analytical procedures indicate that the closing stock at 30 April 2000 was overstated However, the impact on the profit before tax of the possible misstatement is likely to be less than 1%.

If however the quantities can be determined based on sales and receipts of new supplies during the month of April 2000 then physical quantities can be determined and properly valued.

The materiality of the misstatement indicates a very small figure that would have no impact on the profit before tax.

Thus the impact on the auditors report is likely to be minimal and will not be mentioned. However, the auditors will refer to the matter in the management letter to the management.

The failure to take stocks is a major weakness in controls and should be rectified. A reference in the management letter will be sufficient.

3) Significant amounts of expenditure must be adequately supported to prove that they are complete, valid and accurately recognized.

The evidence to support the casual labour absolutely inadequate. The list required by the managers are not adequate evidence of the expenditure. This represents a major limitation of scope and appropriate audit procedures with regard to the report should be undertaken.

4) The correct procedure for the treatment of provisions is authoritatively prescribed in IAS 37. The provision of future maintenance of shs.24,000,000 is not in accordance with IAS . the amount involved is material and should therefore be adjusted , failure to which the report should be qualified.

*JUNE 2000 QUESTION THREE*

**QUESTION 10**

a) Audit actions to ascertain whether an entity is a going concern
When planning the audit the auditor must:
- Consider in particular whether there are any events, conditions and business risks which might cast doubt on the entity's ability to continue as a going concern
- Evaluate management's assessment of the entity's ability to continue as a going concern

When events or conditions have been identified which cast significant doubt on the viability of the business the following additional actions should be taken:
- Review management's plans for future actions based on its going concern assessment and ensure that these are feasible and that the outcome of these plans will improve the situation. (Specific procedures might include analyzing and discussing cash flow, reviewing the terms of debentures and loan agreements)





- Gather sufficient appropriate audit evidence to confirm or dispel whether or not a material uncertainty exists regarding going concern. This will involve considering any additional facts or information which has become available since management's going concern assessment.
- Seek written representations from management regarding its plans for future actions and the feasibility of these plans
- Obtain information regarding the continuance of loan facilities from the company's bankers.
- Identify indications of cash flow problems e.g. determine whether there has been an increase in receivables days by reviewing the receivables ageing analysis

**QUESTION 11**

a) **Audit procedures**
Reviewing procedures management has established to ensure that subsequent events are identified. Reading minutes of board minutes and any minutes of meetings with shareholders
Reading the latest available interim financial statements, budgets, cash flow forecasts and other related management reports
Reviewing correspondence with solicitors regarding any litigation or legal claims
Making inquiries of management as to whether events have occurred which might affect the financial statements. These inquiries would include:
- Updates on any ongoing issues already Identified
- Whether new commitments, borrowings or guarantees have been entered into
- Whether sales or acquisitions of assets have occurred or are planned
- Whether the issue of new shares or debentures has been made or is planned
- Whether any assets have been destroyed eg by fire
- Whether there have been any developments regarding risk areas and contingencies
- Whether there are any events which call into question going concern

b) **Three events: IAS 10**

15 August 20X5
The bankruptcy of the major customer is an adjusting event after the reporting period. It provides additional information concerning the recoverability of the debt at the reporting date and as it represents 11% of receivables is likely to be material to the financial statements. An adjustment should be made in the financial statements reducing the receivables balance and profits.

1 November 20X5
The accidental release of the chemicals is a non-adjusting event. It occurred after the reporting date and does not provide further information about conditions at the year end. On this basis the adjustment made is not necessary. However the impact of the leak is likely to be significant as the company may incur penalties or fines due to the environmental damage. Disclosure of the event and .estimate of the financial effect should be made.

30 November 20X5
The fire at the well is a non-adjusting event. It occurred after the reporting date and does not relate to conditions which existed at the year end. Although there will be a loss of production and education in profits there i ; no indication that this is significant enough to call into question going concern. Disclosure should be made of the events surrounding the fire and an estimate of the financial effect.

Auditor's responsibility and audit procedures



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15 August 20X5
The bankruptcy of the major customer takes place after the year end but before the audit report is signed. In accordance with ISA 560 the auditor is required to perform audit procedures designed to obtain appropriate evidence that all events up to the date of the auditor's report that may require adjustment of, or disclosure in, the financial statements have been identified.
These procedures would include the following:

- Confirming the details of the bankruptcy to documents received by oilRakers from the liquidator
- Agreeing the balance outstanding to the confirmation received from the customer as part of the audit of receivables. If this is not available agree the outstanding balance to pre year-end invoices.
- Verifying that the adjustment has been made correctly in the financial statements receivables are i educed in the statement of financial position and profit in the income statement.
- Requesting written representation that there are no further amounts due from this customer

I November 20X5
This event takes place after the audit report has been signed but before the financial statements have been issued. After the date of the audit report the auditor does not have any responsibility to perform audit procedure or make inquiries. However in This cast; as the auditor has been made aware of the chemical spill the situation should be discussed with management and an appropriate course of action decided.
Audit procedures would be as follows:

- Confirm the details included in the disclosure notes in the accounts by discussing the situation with management, looking at press reports and any other records which are available. Assess the adequacy of the disclosure in compliance with IAS 10.
- Confirm that no adjustment has been made in the accounts in respect of the spill.
- Review correspondence with legal experts regarding any liability for environmental damage.
- Obtain further written representations confirming that there are no other events which should be brought to the auditors' attention.
- As the financial statements have been amended after the auditors report has been signerl a new audit report would need to be issued. This should be dated no earlier than the data of the revised financial statements. The revised report should include an emphasis of matter paragraph highlighting the events which are disclosed in the notes to the accounts.

30 November 20X5

- The fire at the oil well takes place after the financial statements have been issued. The auditor has no obligation at all to make any inquiries regarding such financial statements by this date. When, as in this case, the auditor becomes aware of a fact which would have had an impact on the audit report, the auditor should consider whether the financial statements need revision, should discuss the matter with management and decide on the appropriate course of action.

Procedures would be as follows:

- Clarify the facts by discussion with management, reading minute of board meetings and any reports submitted by expels on site.
- Inspect insurance documents to confirm that the damage caused to the well and any consequential damage e.g. environmental, is covered. Assess the basis on which the ten month time period has been calculated for drilling the new well to determine whether it is reasonable. Both of these factors may affect the viability of the business which should be assessed.



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- Determine how management intends to deal with the issue. If the accounts are to be revised review the steps taken by management to ensure that anyone who had received the previously issued financial statements is informed of the situation.
- If management does not revise the financial statements and the auditor considers that, revision is necessary, consider the means by which recipients of the initial financial statements can be contacted. Before any further action is taken legal advice should be sought.

**QUESTION 12**
Definition: The going concern assumption
Under the going concern assumption, an entity is viewed as continuing in business for the foreseeable future. When the use of the going concern assumption is appropriate, assets and liabilities are recorded on the basis that the entity will he able to realize its assets and discharge its liabilities in the normal course of business. Under IAS 1 Presentation of financial statements, the minimum period for the foreseeable future is 12 months after the year end.

a) Going concern indicators

| Indicator | Why indicator impacts on going concern |
|---|---|
| 30% of Medimade's (M's) revenue comes from just two products in a competitive market | The dependence on just two products in a competitive market means, if competitors develop a similar or superior product at the same or lower prices, then M will probably struggle to make enough sales to cover expenses (already evidenced by declining demand) |
| There has been insufficient investment in product development which would appear essential in this competitive product driven market. | Existing products are in decline and there are not likely to be sufficient new products to fill the cash flow void these declining products will leave. |
| Recruitment of suitably trained staff is proving difficult. | In the pharmaceutical industry, specialized staffs are needed to develop the products which will create cash Inflows. Without them, It will be difficult to see how new products and related revenue will be forthcoming. |
| $2m of investment in plant and machinery is needed but the company has been unable to secure funding for this. | Again this will hold up new product development and also suggests the bank consider M a risky M I investment and have reservations about its financial' health. |
| Trade payables are being paid late and withdrawn credit terms. | The company has to now pay cash on delivery and this adds further cash flow strain to M which is already utilizing its overdraft facility. Also some suppliers may not supply M and prevent them from getting their products into a saleable condition. |
| The cash flow forecast shows a significantly worsening position over the next 12 months | The company already seems to have significant cash flow problems. A worsening position suggests further net cash outflows and the company may not be able to meet liabilities as they fall due, particularly given the bank's cautious stance over providing finance. |



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b) **Audit procedures to assess whether the company Is a going concern**
- Review correspondence with the bank for indications of the likelihood of renewal of the overdraft facility
- Obtain the cash flow forecasts and assess whether the cash inflows and outflows appear realistic and consistent with knowledge built up during the audit. Consider the reasonableness of the assumptions on which the forecasts are based and discuss any findings with management.
- Review any post year end management accouhts and compare the cash position they show with that forecast to help assess the reliability of the forecasts.
- Review any available post year end correspondence with suppliers to see if the trend of withdrawal of credit terms has continued, or eased, since the year end date.
- Review board minutes for meetings held after the year end for issues which indicate further financial difficulties or issues/funding which will alleviate cash flow problems to some degree.
- Obtain written representations from directors/management that they consider the company to be a going concern.

c) **Impact on audit report: going concern appropriate by material uncertainty exist**
The auditor agrees with the directors that the company is a going concern and this is the basis on which the accounts are drawn up. However, the directors have agreed to include going concern disclosures and these disclosures will need to-be assessed to see if they adequately describe the material uncertainty over going concern.
If the disclosure is inadequate the audit opinion will be modified on the grounds that the financial statements are material misstated.
If the inadequate disclosure is deemed a pervasive material misstatement, then an adverse opinion will be expressed stating the accounts are not presented fairly, in all material respects. The reason for the adverse opinion will be stated in a 'basis for adverse opinion' paragraph immediately before the opinion paragraph.
If the misstatement is not deemed pervasive, a qualified opinion will be expressed stating that except for the disclosure over going concern, the financial statements are presented fairly. The reason for the qualified opinion will be stated in a 'basis for qualified opinion' paragraph immediately before the opinion paragraph.
If the disclosure is adequate, then the accounts will be fairly presented in all material respects and an unmodified opinion will be issued, but as a material uncertainty exists, an emphasis on matter paragraph will be included after the opinion paragraph and will highlight this and refer to the disclosure provided by management.

**QUESTION 13**

a) **Going concern**
The going concern assumption is a fundamental principle in the preparation of financial statements. It assumes that an entity will continue in business for the foreseeable future with neither the intention not the necessity of liquidation, ceasing trading or seeking protection from creditors. Assets and liabilities are recorded on the basis that the entity will be able to realize its assets and discharge its liabilities in the normal course of business.

Auditor's responsibility





The auditor must consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements, through the review of future projections and discussion with management.
The auditor must also consider whether there are material uncertainties about the entity's ability to continue la's a going concern, which need to be disclosed in the accounts.
The auditor must consider whether there are adequate disclosures regarding the going concern basis in the 3 accounts for them to give a true and fair view.
The auditor must also report to the audit committee and members if he or she believes that the going concern assumption has not been used appropriately.

b) **Audit procedures to determine whether Smithson Co is a going concern**
- Discuss with Smithson's managements to ascertain whether they consider that the company is able to continue as a going concern
- Review the cash flow forecast prepared, and consider the assumptions used in preparing it
- Review and discuss with management Smithson's latest available interim financial statements or management accounts
- Review board minutes for references to financial difficulties
- Review events after the year-end for issues that could affect Smithson's ability to continue as a going concern
- Discuss with Smithson's legal advisers what the outcome of the two court cases is likely to be and whether there are any other cases pending or likely to result
- Discuss with relevant management whether any new contracts have been awarded to the company, given that several contracts have been withdrawn as a result of the adverse publicity caused by the legal cases
- Obtain a written representation from management to confirm that Smithson can continue as a going concern
- Discuss with management the situation regarding the equipment and what their intentions are - will they be replacing machines in the near future?.
- Discuss the requirement for additional finance by the company and how this will be acquired.
- Review future cash flow projections and forecasts
- Review current borrowings of the company and repayment terms and consider whether the company will be able to repay these

c) **Audit procedures where Smithson Co considered not to be a going concern**
The auditor should discuss with Smithson's management their opinion that the company cannot continue as a going concern, and the reasons for coming to this conclusion.
The auditor should consider the Impact of his findings on the audit report to be Issued at the end of the I audit, and explain to the directors the effect on the opinion if any disclosures required are not made, or if the accounts are prepared on an incorrect basis.
Where appropriates disclosure has been made, the opinion on the financial statements will not be modified, but the report will Include an emphasis of matter paragraph bringing readers attention to the material uncertainty that may affect the entity being able to continue as a going concern.
If the directors disagree and do not make additional disclosures that are required, the audit opinion will be' qualified (except for) or adverse.

d) 'Negative assurance' is when an auditor gives an assurance that nothing has come to his attention which indicates that the cash flow forecast (in this case) is free from material misstatement. He therefore gives his assurance in the absence of any evidence to the contrary. The cash flow statement would have been, prepared using forecast information which cannot



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easily be verified as correct as it is based on assumptions about the future. Therefore, the auditor can only provide limited, negative assurance on it.

The audit report, however, provides reasonable assurance that the financial statements present fairly, in all material respects the financial position of the company (or give a true and fair view). It does not guarantee the accounts are correct, but that they are true and fair within a reasonable margin of error. The financial statements are prepared using historical information and therefore the figures can be verified by the auditor, hence his ability to provide reasonable, positive assurance as to their truth, and fairness.

Be more concerned your character than your reputation, because your character is what you really are ,while your reputation is merely what others think you are.

John Wooden.



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# TOPIC 7

# AUDITORS REPORT

**QUESTION 1**

**a) Responsibilities of the auditors with respect to;**

**i) Financial statements of plasma**

The Companies Act covers the auditor's responsibilities

- Whether in his opinion proper books of account have been kept and proper returns received from branches of the entity.
- To state whether he has received all information and explanations from the clients necessary for the audit of the financial statements.
- Whether the financial statements are in agreement with the books of account.
- Whether in his opinion the information contained in the financial statements comply with the provisions of the Companies Act in all material respects.
- Whether the financial statements portray a true and fair view.
- All the above matters are contained in the 7th schedule and should be stated in the auditor's report.

**ii) Information contained in the director's report**

These matters are a requirement of the companies Act under section 157 and include;

- Results from the company's operations, that is earnings or profit before tax,
- Any proposed dividends
- Any proposed allocation to reserves
- Principal activities of the entity.
- Directors who held office and their nationality

It is the responsibility of ensuring that such information is properly reflected as required by the law and is consistent with the financial statements.

**Matters contained in chairman's statement**

- This include issues that directors were unable to provide in the director's report, such as interpretation of general prevailing economic conditions and the company's progress.

  Generally the auditor has no obligation over matters contained in the chairman's statement; however, he should ensure such matters are consistent with his understanding of the environment and with the financial statements.

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**b) Actions to take due to inconsistency between financial statements and director's and chairman's report**

- Where the financial statements are correctly presented but are inconsistent with the director's report the auditor should advise the directors to amend their report.
- If they fail to amend it, he may not qualify his report but may modify it to include an emphasis of matter" paragraph to explain the position.
- Where the report is correct but the financial statements are incorrect the auditor should recommend amendments to the financial statements and if the client refuses he should qualify his report appropriately.

c)
**Form of report to issue to issue to members of Plasma Industrial Products Limited**
The management refusal to adjust the accounts amounts to a disagreement with the auditor meaning that the auditor should decide whether it is only material or both material and pervasive. An "except for" form of qualification may be appropriate in the circumstances

**Justification**
Relevant accounting principle
The bankruptcy of the customer indicates that company has overstated the profits and assets at the year-end by Sh. 3.6 million. The information on the bankruptcy provides evidence relevant to events after the reporting period (ISA 10) and should therefore be treated as an adjusting event. Prudence concept would also dictate that the loss be provided in full in the financial statements as at 31 March 20 11

**Materiality**
The amount of the loss of Sh.3, 600,000 represents 20 % of the pre-tax profit and more than 40 % of the accounts receivable. It would therefore seem material in both income statement and statement of financial position terms.

*JUNE 2011 QUESTION FIVE*

**QUESTION 2**

(c) (i) Two circumstances under which an auditor may not be able to express an unqualified opinion on a matter whose effect is or may be material to the financial statements.

There is a limitation on the scope of the auditors work or,

There is a disagreement with management regarding the acceptability of the accounting policies selected, the method of their application or adequacy of financial statement disclosures.

ii) Types of audit reports that may be expressed
Limitation of scope

- Qualified opinion- limitation of scope
The auditor qualifies the report on the basis of him being unable to obtain sufficient appropriate audit evidence on matters he considers material but not pervasive and whose impact on the financial statements is likely to lead to material misstatements. Such inability is mostly imposed by the management when they refuse to provide information or records that the auditor considers important or places such conditions on the auditors that he is unable to carry out his work.





- Disclaimer of opinion
This opinion is expressed the effect of a limitation on scope is so material and pervasive that the auditor was unable to obtain sufficient appropriate audit evidence on which to base his audit opinion on the financial statements

**Disagreements with the management.**

**Qualified opinion-except for**

It arises when the matter in question is material but not pervasive to the true and fair view of the financial statements.

It arises due to;

- ✓ Material limitation in the scope of the audit
- ✓ Material circumstances of disagreement with the directors.

**Adverse opinion**

This report is issued when the possible effect of a limitation of scope is so material and pervasive to the financial statements that the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete nature of the financial statements.

*DECEMBER 2009 QUESTION THREE C*

**QUESTION 3**

(a) (i) Circumstances under which an auditor may issue a qualified opinion are explained as follows:

1. Inherent uncertainties
   - The unavoidable risk that in the client's financial statements material errors and frauds would occur during the audit.
   - The unavoidable risk that the client systems of controls and accounting systems are too complex for the auditor to understand or operate.
2. Limitation in the scope of the audit
   - The audit procedures can be limited by;
     - ✓ Management of the client
     - ✓ Circumstances prevailing within the entity
3. Circumstances of disagreement with directors
   - During the audit the auditor may disagree with directors on;
     - ✓ Accounting policies
     - ✓ Material misstatements discovered.



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**(ii) Types of qualified audit opinions**

**I. Adverse opinion**

- This report is issued when the possible effect of a limitation of scope is so material and pervasive to the financial statements that the auditor concludes that a qualification of his report is not adequate to disclose the misleading or incomplete nature of the financial statements.

**2. Disclaimer of opinion**

- This report is issued when the possible effect of a limitation of scope is so material and pervasive that the auditor has not been able to obtain sufficient appropriate audit evidence and therefore is unable to express an opinion on the financial statements.

**3. 'Except for' form of qualification**

- It arises when the matter in question is material but not pervasive to the true and fair view of the financial statements.
- It arises due to;

✓ Material limitation in the scope of the audit
✓ Material circumstances of disagreement with the directors.

**(iii) Alpha Ltd**

- A discontinued operation according to IFRS 5: Non-current assets held for sale and discontinued operations is defined as a component of an entity that either has been disposed of or is classified as held for sale and represents among others a major line of business. In this case they contributed 10% of the total revenue compared to 23% in the previous year. This represents a material contribution to the total revenue of the firm. IFRS 5 further indicates that the gain or loss of the discontinued operation should be presented as a single value on the face of the statement of comprehensive income. A detailed analysis of the loss or gain of the discontinued operation is presented in the notes or in the SCI in a section distinct from continuing operations. It further provides that the net cash flows attributable to the operating, investing and financing activities of a discontinued operation shall be separately disclosed on the face of the cash flows statement or disclosed in the notes, this is also a requirement of IAS 7 statement of cash flows. Since Alpha is a listed company, IFRS 8 operating segments requires separate segmental disclosure of discontinued operations. Failure to disclose the above is a material breach of IFRS.
- The audit opinion should therefore be qualified on the grounds of disagreement on disclosure. The matter is material but not pervasive and therefore an "except for opinion" should be issued.
- The opinion paragraph must clearly state the reason for the disagreement and an indication of the financial significance of the matter.

**Deema Ltd**

- IAS 37 provisions, contingent assets and contingent liability provides that if taking into account all the evidence, it is more likely that a present obligation exists at the balance sheet date, a provision should be made for that present obligation. If it is more likely present obligation exists, the entity should disclose a contingent liability, unless the possibility of an



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outflow of resources is remote. In the case of Deerna, the event is after the balance sheet. If the accident had occurred prior to year end, the claim would provide additional evidence of a condition existing at year end. The evidence points to the fact that the claim will not be successful and hence no need of a provision. The matter has since been fully disclosed as a material contingent liability in the notes to the financial statements in accordance with IAS 37 and IAS 10 events after the reporting period. There is therefore no disagreement or a limitation of scope and the audit senior is correct to propose an unqualified opinion.

*AUGUST 2009 QUESTION FOUR A*

**QUESTION 4**

(a) Categories of information.

(i) **Cover page**
This would include a title, a date, the name of the author of the report and a distribution list.

(ii) **Executive summary**
This would include:
- Background to the assignment
- Objectives of the assignment
- Major outcomes of me work
- Key risks Identified
- Key action points
- Summary of the work left to do

(iii) **The main report contents**
This would include
- Details of audit tests carried out and their findings
- A full list of action points and who has responsibility for carrying them out
- Future time-scales
- Costs

(iv) **Appendices**
These would include detailed schedules and summaries which form the basis of the conclusions in the report.

(b) **Contents of the external audit report**
In accordance with ISA 700 Forming an opinion and reporting on financial statements the following are the basic elements of the external audit report:

(i) Title
(ii) Addressee
(iii) Introductory paragraph identifying the financial statements audited
(iv) A statement of management's responsibility for the financial statements
(v) A statement of the auditor's responsibility
(vi) Opinion paragraph containing an expression of opinion on the financial statements
(vii) Any other reporting responsibilities and conclusion
(viii) Auditor's signature
(ix) Date of the report
(x) Auditor's address



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(c) **Differences**

i. The format and content of the external audit report is governed by legislation and auditing standards. There is no standard format for an internal audit report. It depends on the requirements of management and the approach chosen by the individual internal auditor.

ii. The requirement to issue an external audit report comes from company law. The internal audit reports produced as a result of the management's decision to commission certain projects and reviews.

iii. The main aim the external audit report is to express an opinion as to whether the financial statements are presented fairly in all material respects (or give a true and fair view). It does not aim to give a detailed account of the work performed or to offer solutions for problems identified. The internal audit report is normally expected to be an assessment of the work completed. It will therefore summarize results, conclusions and action points.

iv. The external audit report is normally addressed to the shareholders and is a published document available to a wide range of users. As a result of this it is a highly regulated document. The internal audit report is for internal purposes only. The content can therefore be tailored more specifically to the needs of the individual business and management team.

## QUESTION 5

a) **The following items would be included in the engagement letter**

- Objective of the financial statements
- Management's responsibility for the financial statements
- Scope' of the audit
- Form of any reports or other communication of results from the engagement
- A statement that due to the test nature and inherent limitations of the audit and internal control, there is a risk that some material misstatements may remain undetected
- Unrestricted access to records and documentation requested for-the audit
- Arrangements regarding planning and performance of the audit
- Expectation of receiying written representations on specific matters
- Request for client to confirm the terms of the engagement by acknowledging receipt of the letter
- Basis on which fees are calculated and any billing arrangements
- Description of any letters or reports the auditor expects to issue to the client
- (Note. Only six were required.)

b) **Audit evidence that can be obtained by the auditor is described below:**

**Inspection**
Inspection can encompass examining records, documents or assets. Looking at records and documents: provides different levels of reliability depending on their nature and source. Inspection of assets can provide good evidence of existence but not of rights and obligations or valuation.

**Observation**
This consists of looking at a process or procedure being performed. An example would be observation of inventory counting.

**Inquiry**
Inquiry consists of seeking information from knowledgeable individuals, both from within and outside the organization, being audited. It can encompass either formal written inquiries or informal oral inquiries,





**Confirmation**
This is the process of obtaining a representation of information or of an existing condition from a third party, for example, a bank confirmation.

**Recalculation**
Recalculation is checking the mathematical accuracy of documents or records

**Re-performance**
This is the auditor's independent execution of procedures or controls that were originally performed as part of the organization's internal control, either manually or using CAATs.

**Analytical procedures**
Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

**Modified audit opinions**
There are three types of modified opinion:

**Qualified opinion**
A qualified opinion will be issued due to either the auditor being unable to obtain sufficient appropriate audit evidence in respect of a material matter or because the auditor concludes the financial statements contain material misstatements. The opinion will be expressed as being 'except for the effects' (or possible effects; of the matter that the qualification relates to. The misstatements (or possible misstatements) will be material but not pervasive.

**Disclaimer of opinion**
Where the auditor is unable to obtain sufficient appropriate audit evidence and the possible effects are both material and pervasive, the auditor is unable to express an opinion on the financial statements and a disclaimer of opinion will be expressed

**Adverse opinion**
Where the auditor concludes the accounts are materially misstated and the misstatements are both material and pervasive, the financial statements are misleading, and an adverse opinion will be expressed

## QUESTION 6

a) **Preparation of financial statements**
The directors have a legal responsibility to prepare financial statements giving a true and fair view. This implies that they have been prepared in accordance with the relevant IASs and IFRSs.
The auditor's duty is to carry out an audit (according to the International Standards on Auditing) and to give an opinion on whether a true and fair view is given (or whether the financial statements present fairly, in all material respects, the financial position of the entity). In doing this they will have to consider whether the relevant accounting standards have been properly followed.

**Estimates and Judgments and accounting policies**
The directors have the responsibility for making the estimates and judgments underlying the financial statements and for selecting the appropriate accounting policies.



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The auditor's responsibility is to assess the appropriateness of the director's judgments and to modify the audit opinion in the case of any disagreement causing the auditors to conclude the financial statements are not free from material misstatement.

**Fraud and error**
The directors have a duty to prevent and detect fraud and error. This is a duty they owe to the shareholders and there is no 'materiality' threshold attached to their duty.
The auditor is responsible (under ISA 240) for obtaining reasonable assurance that the financial statements are free from material misstatement including material misstatement caused by fraud.
The auditor is responsible for maintaining professional scepticism throughout the audit, considering the possibility of management override of controls. The audit team must discuss how and where the entity's financial statement may be susceptible to material misstatement due to fraud, including how fraud might occur.

**Disclosure**
The directors are responsible for disclosing all information required by law and accounting standards.
The auditor's responsibility is to review whether all the disclosure rules have been followed and whether the overall disclosure is adequate. There are certain pieces of information, which, if not disclosed by the directors, must be disclosed by the auditor in his report. Examples of this are related party transactions and j transactions with directors.

**Going concern**
The directors are responsible for assessing whether it is appropriate to treat the business as a going concern. In doing this they should look at forecasts and predictions for at least twelve months from the reporting date. They should also disclose any significant uncertainties over the going concern status of the company.
The auditors' responsibility is to consider whether there are any indicators of going concern problems in the company, and assess the forecasts made by directors and decide whether the correct accounting basis has been used and whether there is adequate disclosure of significant uncertainties.
The auditor must consider modifying the audit opinion in the auditor's report if:

i. The directors have considered a period of less than twelve months from the reporting date (this could result in a qualified opinion due to an inability to obtain sufficient appropriate evidence)
ii. The directors have used the going concern basis when the auditor believes that its use is not appropriate (this will be a result in an adverse opinion)
iii. The auditor agrees with the basis chosen by the directors but feels that the disclosures are inadequate (this will probably result in a qualified except for opinion)
iv. The auditor agrees with the chosen basis, and that the disclosures are adequate but there are uncertainties over the going concern status of the company, in this case the opinion will be unmodified but an emphasis of matter paragraph will be added.

b) **Errors in the report extract**
Presentation of information in the company's annual report'
The auditor's legal responsibilities relate to the financial statements, which comprise the primary statements plus the supporting notes. They do not extend to any other information, for example's chairman's statement or 5-year summary. To make this clear, this section should refer only to the financial statements.





Under ISA 720 The auditor's responsibilities relating to other information in documents containing audited financial statements the auditor has a responsibility to read the other information to identify whether there are any inconsistencies with the financial statements or anything that is misleading, but the primary opinion is given on the financial statements only.

'In accordance with Auditing Standards'
The report should specify exactly which auditing standards have been used so that there is no risk that readers misunderstand how the audit has been done. It should specify that the audit has been performed in accordance with international Standards on Auditing.

'Evaluating .... the reasonableness of all accounting estimates'
It is inappropriate to imply that the auditor has considered every estimate made by management. This is unlikely to be true because auditors do not look at every single transaction and item in the financial statements; it is the duty of the auditor to give assurance only on whether the financial statements are free from material misstatement.

'As much audit evidence as possible in the time available'
This phrase is inappropriate because it implies that the auditor has not had time to obtain all the evidence that is needed. The auditor is expected to obtain sufficient evidence on which to base conclusions. The-auditor should have planned the audit so as to obtain sufficient evidence in the time available.

Confirm
This word should not be used because it implies a greater degree of certainty than is possible based or' normal audit procedures. The certainty implied by the word 'confirm' may expose the auditor to negligence; claims if it turns out that there are any material errors in the financial statements. A more accurate description of the level of assurance given by an audit is 'reasonable assurance'

'No liability for errors can be accepted by the auditor
This disclaimer at first might appear to be useful in protecting the auditor against liability. However, the view of the ACCA is that general disclaimers should not be included in audit reports, as their use would tend to devalue the audit opinion.

'The directors are wholly responsible for the accuracy of the financial statements'
This statement should not appear in the auditor's responsibility section of the report. Details of management's responsibilities are differently worded and should appear in an earlier separate section of the report outlining the responsibility of management for the preparation of the financial statements.

c) Positive assurance is the form of words used in a report where the auditor has obtained sufficient evidence to feel confident to give reasonable assurance that the information is free from material error. A normal audit opinion takes this form, i.e. 'in our opinion the financial statements present fairly, in all material respects, (or give a true and fair view of) the financial position of.
Negative assurance is the form of words used where the auditor has obtained a lower level of evidence and can therefore give only a lower level of assurance. A review of a forecast would be an appropriate example of when this would be used. The auditor cannot be as confident about forward-looking information, based on the directors1 assumptions.



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A negative assurance opinion would be worded perhaps as nothing has come to our attention to suggest that the information is not based on reasonable assumptions...

The advantages of the negative assurance would be:

- The bank will be able to place more reliance on the forecast as it has been subject to review by an independent professional. The level of comfort given will be less than that of an audit but forecast information cannot be verified to the same degree as historical information so the negative assurance is the best that could be expected in the circumstances.
- Negative assurance requires a lower level of work than a full scope audit so will be cheaper for the company.

## QUESTION 7

**a) Audit report**

**Title**
The audit report should have a title which includes the wording 'Independent auditor' to distinguish this report from others that may be prepared internally by the company.

**Addressee**
The report should be appropriately addressed as required by the engagement and local regulations. This is normally to the shareholders of the company or to those charged with governance.

**Introductory paragraph**
This section identifies the financial statements being audited, including the date and period covered. It also identifies the title of each statement that comprises the financial statements being audited.

**Management's responsibility for the financial statements**
This part of the report is included to describe the responsibilities of those who are responsible for the preparation of the financial statements including those in respect of internal control

**Auditor's responsibility**
This section describes the auditor's responsibility for expressing an opinion, notifies users that the audit was carried out in accordance with ISAs and explains what an audit involves.

**Opinion**
This indicates the financial reporting framework used to prepare the accounts and states the auditor's opinion as to whether the financial statements present fairly, in all material respects (or show a true and fair view of) the financial position of the audited entity in accordance with that framework.

**Date**
The audit report should be dated as at the completion of the audit, to show that the auditor has considered any events after the reporting period date up to the date of completion and how these might affect the financial statements. The report should not be dated earlier than the date on which the accounts are signed or approved by management.

**Auditor's address**
The audit report should name a specific location, which is normally the city or town where the auditor maintains the office that has responsibility for the audit.





**Auditors' signature**
The audit report should be signed in the name of the audit firm, the personal name of the auditor, or both, as appropriate. It is usually signed in the name of the firm because the firm assumes responsibility for the audit.

**b) Issue 1 - understatement of sales income**

i. Audit procedures
- Discuss the issue with the other directors of the company so that they are aware of the matter
- Following these discussions, ascertain what action the other directors intend to take against the director in respect of the matter
- Perform further substantive audit work, such as detailed analytical review, to confirm the extent of the understatement
- Obtain written representation in relation to the estimate of the amount of the fraud

ii. Potential effect on audit report
As this issue is material, the understatement of sales income representing 5% of total revenue for the year, it is likely to be material and require a modification of the opinion in the auditor's report. The report should include a qualified opinion due to an inability to obtain sufficient appropriate audit evidence on sales for the year.
The audit report should provide details of this matter giving rise to the qualified opinion In a Basis for qualified opinion' paragraph.

**Issue 2 - personal use of boat**

i. Audit procedures
- Discuss the issue in more detail with the director concerned and ask why it is located at his house
- Through discussion, find out whether the director purchased the boat and if so, agree the amount to the cash book and bank statements and non-current asset register
- Review financial statements to ensure correct disclosure as a director's benefit within directors' emoluments
- Consider increasing procedures for inspection of other non-current assets to ensure other assets are not used in the same way

ii. Potential effect on audit report
Non-current assets on the statement of financial position will be overstated since they include a boat that is used for personal use by one of the directors and not for the purposes of the business
Given that non-current assets are likely to be material to the statement of financial position, this issue may result In a qualified audit opinion on the basis that the overstatement of non-current assets has ' resulted in the accounts being materially misstated.
The value of the boat should be taken off the statement of financial position and it should be reclassified as a benefit within the directors' emoluments notes.

## QUESTION 8

**(a) Additional procedures and actions**
These would be as follows:
- Confirm the facts of the situation and ensure that appropriate audit evidence has been collected and recorded to date.
- Consider whether there are any legitimate reasons why depreciation has not been provided e.g a departure from IFRSs is required to give a true and fair view.



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- Assess whether the potential adjustment is material to the financial statements, if it is not material no further action would be necessary.
- Discuss the situation with management and obtain an explanation as to why depreciation has not been provided.
- Explain to the management that In my opinion depreciation should be provided. Request that management adjust the financial statements and explain that failure to do so would result in a modified audit opinion.
- Assess the potential impact of the matter to determine whether the modified audit opinion i.e material or pervasive.
- Obtain a written representation stating that depreciation will not be charged on buildings.
- Draft the relevant sections of the modified audit report.

**b) Meaning and purpose of extracts**

| Extract 1<br>Meaning | Purpose |
|---|---|
| International Standards on Auditing prescribe the principles and practices to be followed by auditors in planning, designing and carrying out various aspects of their audit work. Members are expected to follow these standards. | This confirms to the leader that best practice has been adopted by the auditor, assuring the reader that the audit has been properly conducted. |
| Ethical requirements refer to the professional code of conduct followed by the auditor. | This confirms that the auditor has acted professionally throughout the course of the audit |
| Reasonable assurance means that, based on the judgment of the auditor, sufficient work has been performed in order to form an opinion within a reasonable margin of error. | This indicates however that not every balance and transaction has been considered in detail and result there could be additional errors apart the non-depreciation of buildings. |
| Audit work identifies material misstatements i.e. those that would affect the reader's assessment of the financial statements. | This confirms that audit work is designed to identify significant issues, not necessarily all issues and therefore the identification of the non-depreciation of bun-Dings work carried out. |
| Extract 2<br>Meaning | Purpose |
| This explains that the accounting treatment of non-depreciation adopted by the company is not conducted in accordance with recognized practice as contained within the IFRSs. | The basis of the auditor's and conclusion that the accounts contain a misstatement is highlighted i.e the non-depreciation of buildings: The reference to the IFRSs gives authority to the -auditor's opinion that the non-depreciation is incorrect |
| Extract 3<br>Meaning | Purpose |
| The depreciation provision in the financial statements is understated by $420,000. | This explains the adjustment which should have been made in the financial statements and quantifies the effect of the non-depreciation so that the reader can assess the impact; it also indicates the depreciation policy so that the reader can understand the basis of the adjustment |
| Extract 4<br>Meaning | Purpose |
| Non-current assets, profit for the year and accumulated reserves are all materially misstated. | This quantifies more specifically the effect of the adjustment on both the position statement |



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| | balances and income statement. |
|---|---|
| Extract 5<br>Meaning | Purpose |
| Based on the professional judgment of the auditors the financial statements are factual, are free from bias and reflect the commercial substance of the businesses transactions with the exception of the treatment of depreciation. This misstatement does materially affect the financial statements but does not render them meaningless overall. | This highlights that the audit report is modified due on the basis the financial statements are not free from material misstatement. The phrase 'except for' indicates that the misstatement relates to one specific issue but that in other respects the financial statements give a true and fair view. |

(i) Impact on audit report
- The auditor would issue a modified audit opinion on the grounds that the accounts contain a material misstatement due to the continued non-depreciation of non-current assets.
- Due to the significant impact of the adjustment (a profit to a significant loss) the auditor may conclude that the effect is both material and pervasive and issue an adverse opinion. Otherwise a qualified opinion will be issued.

(ii) The auditor would issue a modified audit opinion on the grounds the auditor was unable to obtain sufficient appropriate audit evidence. The auditor has been unable to confirm the existence of inventory by attending the inventory count leading to uncertainty regarding the inventory valuation.
- The opinion is likely to be an 'except for the possible effects of opinion (rather than a disclaimer of opinion) indicating that whilst material adjustments may be required to the inventory balance in all other respects the financial statements give a true and fair view of the company's financial position.

1. The client's accounting systems will be documented, or documentation prepared in prior year audits will be update
2. An assessment will be made of inherent risk and control risk.
3. Appropriate materiality levels will be estimated.
4. The information obtained dining the planning stage will be documented along with an outline of the audit strategy to be followed.
5. If control risk has been assessed as low in particular areas, then controls testing will need to be performed on the controls to confirm the initial assessment of the risk. These tests of controls will be started in the interim audit although they will generally need to be performed oh a sample of items extending right over the accounting period so may need to be completed at the final audit.
6. The detailed audit approach should be prepared. Programmes of audit procedures, both tests of controls and substantive procedures, will be designed to show the work that needs to; be done and to enable subsequent review of audit completion.
7. If substantive procedures are to be performed that involve auditing a sample of transactions j selected to cover the whole accounting period, it is likely that some of these procedures1 will also be started at the interim audit, but these will again be completed at the final audit.

Main audit procedures and practices during the final audit

i. The tests that were started at the interim visit, both tests of controls and substantive procedures should be completed.

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ii. Year-end balances may be verified through confirmations obtained from third parties such' as:
- Receivables
- Payables
- Banks

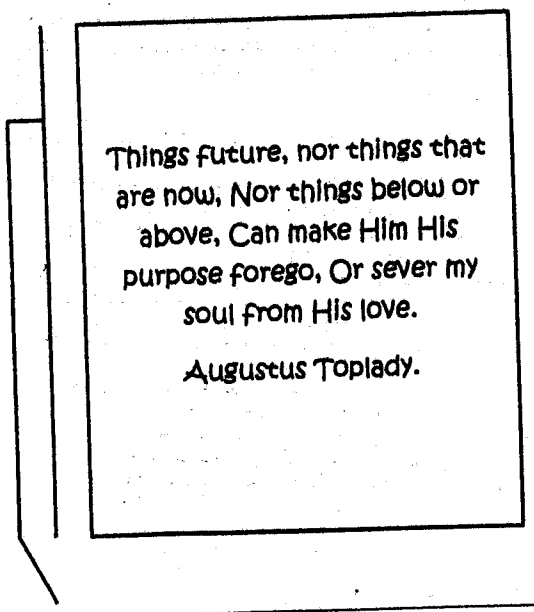
iii. If the client has carried out a year-end inventory count, detailed procedures will be carried out to verify the accuracy of the compilation of the year-end inventory lifting and also to follow up any evidence gathered by the auditor when attending the inventory count.

iv. Detailed calculations will need to be obtained of any estimates the client has made at the year-end such as allowances for receivables, depreciation and provisions. Procedures will need to be performed to:
- Assess the reasonableness of the methods used to make the estimates
- Re-perform the calculations; or
- Develop point estimates to evaluate management's point estimates.

v. Analytical procedures will be performed on the draft accounts to consider whether the view given by the financial statements is in line with the auditor's understanding of the business.

vi. The auditor must review the directors' assessment of whether the business is a going concern. The auditor must consider whether the assumptions made by the directors are reasonable and whether it is appropriate to prepare the accounts on the going concern basis.

vii. A review of events after the reporting period must be performed in order to assess whether any appropriate adjustments or disclosures as required by IAS 10 have been dealt with correctly.








# TOPIC 8

## GROUP AUDITS

**QUESTION 1**

**(a) The audit procedures on the consolidation schedule of the Bane Group are:**

- Agree correct extraction individual company figures by reference to individual company audited financial statements.
- Cost and cross-cast all consolidation schedules.
- Recalculate all consolidation adjustments, including goodwill, elimination of pre- acquisition reserves, cancellation of inter-company balances, fair value adjustments and accounting policy adjustments.
- By reference to prior year audited consolidated accounts, agree accounting policies have been consistently applied.
- Agree brought down figures to prior year audited consolidated accounts and audit working papers such as goodwill figures for the acquisitions and consolidated reserves.
- Agree that any post acquisition profits consolidated for any acquisition during the year arose since the date of acquisition by reference to date of acquisition as per the purchase agreement.
- Reconcile opening and closing group reserves and agree reconciling items to group financial statements.

*JUNE 2012 QUESTION THREE*

**QUESTION 2**

**(a) (i) Audit procedures for determining the existence of related parties**

- Evaluate the company's procedures for identifying and properly accounting for related party transactions.
- Request from appropriate management personnel the names of all related parties and inquire whether there were any transactions with those parties during the period.
- Where the company is listed on the stock exchange; review filings by the reporting entity with the stock exchange commission and other regulatory agencies for the names of related parties and for other business in which officers and directors occupy directorship or management positions.
- Determine the names of all pension and other trusts established for the benefit of employees and the names of their officials and trustees.
- Review stockholder listings of closely held companies to identify principal stockholders.
- Review prior year working papers for the names of known related parties.
- Inquire of predecessor, principal, or other auditors of related entities concerning their knowledge of existing relationships and the extent of management involvement in material transactions.
- Review material investment transactions during the period under audit to determine whether the nature and extent of investments during the period created related parties.



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**(ii) Procedures for identifying transactions with related parties**

- Provide audit personal performing segments of the audit or auditing and reporting entity with the names of known related parties so that they may become aware of transactions with such parties during their audits.
- Review the minutes of meetings of the board of directors and executive or operating committees for information about material transactions authorised or discussed at their meetings.
- Review proxy and other materials filed with the securities commission and comparable data filed with other regulatory agencies for information about material transactions with related parties.
- Review conflict-of-interest statements obtained by the company from its management.
- Review the extent and nature of business transacted with major customers, suppliers, borrowers and lenders for indications of previously undisclosed relationships.
- Consider whether transactions are occurring, but are not being given accounting recognition such as receiving or providing accounting management or other services at no charge or major stockholder absorbing corporate expenses.
- Review accounting records for large, unusual or non-recurring transactions or balances, paying particular attention to transactions recognised at or near end of the reporting period
- Review confirmation of compensating balance arrangements for indications that balances are or were maintained for or by related parties.
- Review invoices from law firms that have performed regular or special services for the company for indications of the existence of related services or related party transaction.
- Review confirmation of loans receivable and payable for indications of guarantees. When guarantees are indicated, determine their nature and the relationships, if any, of the guarantors to the reporting entity.

*JUNE 2012 QUESTION ONE*

**QUESTION 3**

Matters auditor will consider when auditing the financial statements of group companies with respect to the following

**(a) Accounting policies**

- Where there are differences in accounting policies, the auditor should obtain reconciliations of the accounting policies from the different firms that make up the group.
- The group should use similar accounting policies and standards for ease of consolidations.
- The auditor should establish that the accounting policies are applied consistently within the group and incase of changes, the same changes are effected throughout the group.
- The auditor should ensure there is correct classification of investments throughout the group.
- The auditors should ensure the accounting policies applied within the group are consistent with the IFRSs and ISAs and any other relevant financial reporting framework.

**(b) Consolidation adjustments**

- There should be a proper mechanism of identifying inter-company transactions and balances.
- The auditor should ensure that the inter-company transactions and balances are eliminated from the financial statements.
- The auditor should ensure the consolidation adjustments are done in accordance with the





firm's accounting policies.

- The auditor should ensure that all items to be included upon consolidations are included and those that require elimination have been eliminated.

**(c) Reporting periods**

- The firms within the group should have a similar reporting period and that all items to be consolidated are within the same reporting period.
- The auditor should also ensure that the year ends fall within 3 months of each, in case there are disparities.

**(d) Loss making subsidiaries**

- Confirm whether the loss making subsidiary is consolidated according to IAS 27 consolidated and separate financial statements.
- The auditor should confirm whether the losses attributable to NCI are charged to them accordingly.
- The auditor should confirm whether in cases where the losses attributable to NCI are in excess of the shareholders funds attributable to NCI, the losses are charged to the group unless the minority has a binding obligation to, and is able to make good the losses.
- Where the losses have been taken up by the group and the subsidiary reports profits, all such profits are attributable to the group until the NCI's share of losses previously absorbed has been recovered (IAS 27,35)

**(e) Contingent liabilities and events after the reporting period**

- The auditor needs to review the events after the date when the component's financials were signed and the date the group financials were signed to establish whether any adjustments are necessary.
- The auditor needs to review if there are any events before the year end that require disclosure in terms of a contingent liability where the possibility of cash outflow is very minimal.

*JUNE 2010 QUESTION FOUR*

**QUESTION 4**

**(a) Discussion on the responsibility of an auditor with regard to related parties.**

ISA 550 (Related parties) defines related party as follow;
Parties are related if one party has the ability to control the other party or exercise significant influence over the other party in making financial and operating decisions. Related party transactions are a transfer of resources between related parties regardless of whether a price is charged.

ISA 550 requires the auditor to perform audit procedures designed to obtain sufficient, appropriate audit evidence regarding the identification and disclosure by management of related parties and the effect of related transactions that are material to the financial statements. The auditors knowledge of the client must be sufficient to identify related parties for the following reasons;

- The financial reporting framework may require disclosure in the financial statements of certain related party relationships and transactions, such as required IAS 24.
- The existence of related parties or related party transactions may affect the financial statements i.e. tax liability



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- The source of the audit evidence affects the auditors assessment of its reliability. A greater degree of reliance may be placed on audit evidence that is obtained from or created by unrelated third parties.
- A related party transaction may be motivated by considerations other than ordering business considerations.

(b) (i) **Factors to consider in deciding on the extent t which you could rely on the work of the auditor of a subsidiary.**

- The materiality of the portion of the financial statements which the principal auditor audits
- The principals auditor degree of knowledge regarding the business of the components
- The risk of material misstatement in the financial statements of the components audited by the other auditor
- The performance of additional procedures resulting in the principal auditor having significant participation.
- The principal auditor should consider the competence of the other auditor in the context of the assignment
- Obtain sufficient appropriate evidence that the work of the other auditor is adequate for the principal auditor purpose

ii) When the principal auditor concludes that the work of the other auditor cannot be used and the principal auditor has not been able to perform, sufficient audit procedures, regarding the financial information of the component audited by the other auditor, the principal auditor should express a qualified opinion or disclaimer of opinion because there is a limitation in the scope of the audit.

If the other auditor issues or intend to issue, a modified auditors report, the principal auditor would consider whether the subject of modification is of such a nature and significance in relation to the financial statements of the entity on which the principal auditor is reporting, that a modification of the principal auditors report is required.

*JUNE 2005 QUESTION FOUR*

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**QUESTION 5**
**Hydrasports**
(a) (i) Business risks (ii) Financial statement risk

The standard design of facilities increases operational' risk as any difficulties encountered in one facility will be compounded by the number of other facilities (potentially all) which are similarly affected. This is illustrated by the closure of the saunas.

**Standard design may also reduce risk as it results in a higher quality 'product'.**

- The carrying amount of the associated non-current assets (i.e. equipment, fixtures and fittings) is likely to be overstated as they are likely to be impaired if they are not in use.
- Centralised control through company policy is resulting in inefficient and ineffective operations as managers cannot respond on a timely basis to local needs.
- Management circumvention or override of control procedures laid down by head office may result in system weaknesses. If errors arising are not detected and corrected the risk of misstatement in the financial statements is increased.



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- Business reporting risk is likely to be increased by centre managers preparing monthly accounting returns. Operational risk may be increased if centre managers cannot fulfil their day-to-day responsibilities (e.g. relating to customer satisfaction, human resources, health and safety).
- Information processing risk is increased as accounting information flowing into the financial statements may not be properly captured, input, processed or output by the centre managers.
- Inherent risk, of errors arising, in monthly 'branch' returns is high.
- Advanced payments contribute to business reporting and financial (cash flow) risk. Cash received must be available to meet the costs of providing future services.
- Revenue may be overstated if an accurate cutoff is not achieved. In particular, there is an estimate risk in determining the amount of deferred income at the balance sheet date. An error of principle may also arise if Hydrasports' revenue recognition policy does not comply with IAS 18 'Revenue'.
- Hydrasports cannot operate a centre if a licence is suspended, withdrawn or not renewed (e.g. through failing a local authority inspection or failing to apply for renewal).
- An error of principle arises if licences are not capitalized as intangible assets (but instead written off as expenses when incurred).
- Intangible assets (licences) should be reviewed for impairment at each balance sheet date (e.g. for centres which are closed).
- Closure may result in customers finding alternative facilities with permanent loss of fee revenue.
- 'Early bird' customers dissatisfaction similarly increases operational risk.
- Failure risk (i.e. that Hydrasports will not continue to operate as a going concern) is increased.
- This creates disclosure risk if the disclosures relating to going concern as the basis of accounting do not meet the requirements of IAS 1 'Presentation of Financial Statements'.
- Serious accidents may prompt investigation by local authority – resulting in penalties, fines and/or withdrawal of license to operate.
- If licences are withdrawn, the intangible asset (amounts prepaid) should be written off to the extent that monies are not refundable.
- The likelihood of contingent (if not actual) liabilities increases disclosure risk.
- Although fees are non-refundable, suspension of a facility (e.g. sauna) may result in customers asking for partial refund. In particular Hydrasports may have an obligation to refund fees paid in advance when centres are closed (e.g. the Verne centre from July–September 2003).
- Provisions may be understated at 31 December 2003 if Hydrasports has a legal obligation to refund fees where it has failed to provide services.
- Permanent loss of customers requiring childcare facilities increases operating risk. Compliance risk is increased if the new guidelines are not met.
- Similarly, inability to retain lifeguards increases operational risk that pools cannot open (due to health and safety regulations). Compliance risk is increased by the possibility that pools may be operated without a lifeguard being on duty.
- Disclosure risk is (again) increased if fines/penalties arising are material and not disclosed.
- High staff turnover indicates increased operational risk (poor human resource management, inefficiency in working practices, reduced capacity, etc).
- Staff costs may be overstated as the risk that payments may be made to leavers is increased.
- Limitations on centre managers' levels of authority may not be commensurate with their responsibilities. Empowerment risk arises if managers are not properly led (and if they, in turn, do not properly lead their centre staff).
- Any lack of integrity may increase the risk of management and/or employee fraud, illegal acts and unauthorised use of company assets. In particular the assertion of existence of assets may be at risk (resulting in overstatement).
- More centres may become loss-making if the reasons for falling membership are not addressed.

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- Loss-making centres should be tested for impairment as cash-generating units.
- The hydrotherapy pool cannot operate until construction is completed and completion may be threatened by cash flow difficulties.
- The value of the asset in construction should be written down if it is impaired (even though it has not yet been brought into use).
- Cash flow difficulties increase liquidity/financial risk. See above reference to going concern and disclosure risk.
- Obsolete gym equipment increases operational risk as customer satisfaction decreases and health and safety risks are increased.
- Depreciation may be overstated if Hydrasports continues to calculate depreciation on fully-depreciated assets.
- Disclosures for capital commitments (e.g. to replace equipment) in the financial statements may be inappropriate if Hydrasports does not have funds to finance such commitments.
- The reduction in insurance cover reduces the recoverable amount of assets in the event of loss through fire (for example). Inability to replace lost/damaged assets increases operational risk (see obsolete gym equipment above).
- See above reference to going concern and disclosure risk.
- Operational risk is increased if the substantial increase in liability insurance premiums is a reflection of an increase in the level of claims being made.
- Disclosure risk is increased in relation to contingent assets (for reimbursement under insurance policies).

**(b) Principal audit work**

**Deferred income**

- Agreeing Hydrasports' analysis of joining fee and peak/off-peak membership fees on a sample basis.

  Tutorial note: Initial joining fees should not be deferred but recognised when received.
- Reconciling membership income to fees paid. If customers can renew their membership without payment there should be no deferral of income (unless the debt for unpaid fees is also recognised).
- Assessing the collectibility of unpaid fees (if any) by reviewing after date receipts and correspondence with members.
- Recomputing the deferred income element of fees received in the three months before the balance sheet date.
- Comparison of year-end balance with prior year and investigation of variance.

**Hydrotherapy pool**

- Verifying the initial cost of this constructed asset will include an examination of:
  - the contract with the builder
  - contractors billings; and
  - stage payments.
- Hydrasports is likely to be advised by its own expert (a quantity surveyor) on how the contract is progressing. Audit work will include a review of the expert's assessment of stage of completion as at the balance sheet date, estimated costs to completion, etc.
- Physical inspection of the construction at the year end to confirm work to date and assess the reasonableness of stage of completion.
- Borrowing costs associated with this substantial ('heavy') investment should be agreed to finance terms and payments. The calculation of any amount capitalised should be recomputed to confirm accuracy.



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- The basis of capitalisation, if any, should be agreed to comply with IAS 23 'Borrowing Costs' (e.g. interest accruing during any suspension of building work should not be capitalised).
- As the construction has already cost twice as much as budgeted, its value in use (when brought into use) may be less than cost. Management's assessment of possible impairment (of the hydrotherapy pool and the centre) should be critically appraised.

**(c) Performance indicators – social/environmental responsibility**

**Member satisfaction**

- Number of people on membership waiting lists (if any).
- Number of referrals/recommendations to club membership by existing members.
- Proportion of renewed memberships.
- Actual members: 100% capacity membership (sub-analysed between 'peak' and 'off-peak').

**Membership dissatisfaction**

- Proportion of members requesting refunds per month/quarter.
- Proportion of memberships 'lapsing' (i.e. not renewed).

**Staff**

- Average number of staff employed per month.
- Number of starters/leavers per month.
- Staff turnover/average duration of employment.
- Number of training courses for lifeguards per annum.
- Average hourly (weekly) wage: average national hourly (weekly) wage (or national minimum).

**Predictability**

- Number of late openings (say more than 5, 15 and 30 minutes after advertised opening times).
- Number of days closure per month/year of each facility (i.e. pool, crèche, sauna, gym) and centre.

**Safety**

- Incidents reports documenting the date, time and nature of each incident, the extent of damage and/or personal injury, and action taken.
- Number of accident free days.

**Other society**

- Local community involvement (e.g. facilities offered to schools and clubs at discount rates during 'off-peak' times).
- Range of facilities offered specifically to pensioners, mothers and babies, disabled patrons, etc.
- Participation in the wider community (e.g. providing facilities to support sponsored charity events).

**Environment**

- Number of instances of non-compliance with legislation/regulations (e.g. on chemical spills).
- Energy efficiency (e.g. in maintaining pool at a given temperature throughout the year).
- Incentives for environmental friendliness such as discouraging use of cars/promoting use of bicycles (e.g. by providing secure lock-ups for cycles and restricted car parking facilities).

  Evidence

**As there is a wide range of measures of operational performance which candidates could suggest, there is always a wide range of possible sources of audit evidence. As the same evidence may contribute to providing assurance on more than one measure they are not tabulated here, to avoid duplication. However, candidates may justifiably adopt a tabular layout.**

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- Membership registers clearly distinguishing between new and renewed members, also showing lapsed memberships.
- Pool/gym timetables – showing sessions set aside for 'over 60s', 'ladies only', schools, clubs, special events, etc.
- Staff training courses and costs.
- Staff timesheets – showing arrival/departure times and adherence to staff rotas.
- Documents supporting additions to/deletions from payroll standing data (e.g. new joiner/leaver notifications).
- Engineer's inspection reports – confirming gym equipment, etc is in satisfactory working order. Also, engineer and safety check manuals and the maintenance program.
- Levels of expenditure on repairs and maintenance.
- Energy saving equipment/measures (e.g. insulated pool covering).
- Safety drill reports (e.g. alarm tests, pool evacuations).
- Accident report register – showing date, nature of incident, personal injury sustained (if any), action taken (e.g. emergency services called in).
- Any penalties/fines imposed by the local authorities and the reasons for them.
- Copies of reports of local authority investigations.
- The frequency and nature of insurance claims (e.g. to settle claims of injury to members and/or staff).

## QUESTION 6

**1 Amber Pan Europe**

**(a) Principal business risks**

Communications industry

- Rapid and new technological developments in the industry, providing faster data transmission and increasingly interactive capabilities, will render certain existing products and services obsolete.
- Amber cannot predict how emerging and future technologies (e.g. cordless technologies such as 'Bluetooth') will affect demand for its services.

Competition

- Although Amber may have reduced competition in the short-term (by having acquired a competitor), the communications market is still expanding. Increasing competition from other existing and new competitors offering new technologies could:
  - affect Amber's ability to attract and retain customers
  - reduce Amber's share of new customers
  - force Amber to reduce prices.
- The cost (and revenue-generating capabilities) of new technologies tends to fall significantly and relatively quickly (e.g. mobile phone technology is now available in disposable form).

Integration

- Combining two groups which have previously operated independently (and competitively against each other) is likely to result in disruption.
- Potential difficulties may be encountered in seeking to retain customers and key personnel.
- The anticipated 'significant synergies' (in revenue, cost and capital expenditure) may have been optimistic. If they do not materialise to the extent predicted, Amber's operational activities, financial condition and future prospects are likely to be adversely affected.



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- Amber may have difficulty in adapting its corporate image to the culture of the East African network.
- Operating losses
- Loss before taxation has doubled. If Talc was making significant losses before it was acquired by Amber those losses may have been expected to continue in the short-term. Although the group's operations are being combined and synergies are expected, clearly recurring losses will threaten the new group's operational existence as a going concern.

Falling ARPU

- ARPU, a key performance indicator, has fallen by 8·3% for contract customers and 14·8% for prepaid customers (% calculated on 2001 actual).

Sustaining growth

- Growth may not be sustainable as further expansion will incur significant costs and investment which must be financed.
- The significant costs expected to be incurred in upgrading networks may not be recouped if additional revenues are insufficient. Failure to maintain existing networks is likely to result in a loss of customers and market share.
- If Amber's financial resources are insufficient to meet the operating losses it may need to issue equity and/or increase its debt. Possible adverse consequences of increasing indebtedness include:
  - high debt-service costs
  - operating and financial restrictions being imposed by lenders
  - difficulty in obtaining further finance in the future
  - being unable to take advantage of business opportunities
  - reduction in credit ratings.

**Countries of operation**

- Operations have been expanded from European countries to East Africa. Amber's inexperience of economic and legal developments in East Africa may impair the investment in Socolla.

**Foreign exchange rates**

- Amber transacts business in several countries and foreign exchange rate fluctuations could have a material adverse effect on operating results.

**Highly regulated market**

- Network operations could be adversely affected by changes in the laws, regulations or government policies which regulate the industry.
- Difficulties in obtaining approvals for the erection and operation of transmitters could have an adverse effect on the extent, quality and capacity of Amber's network coverage.
- Allegations of health risks (e.g. associated with radio waves from transmitter masts and mobile handsets) could reduce customer demand and increase exposure to potential litigation.

**(b) Impact of acquisition on planning**

**Group structure**

- The new group structure must be ascertained to identify the entities which will be consolidated into the group financial statements of Amber for the year ending 30 June 2002.

**Materiality assessment**

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- Preliminary materiality will be much higher, in monetary terms, than in the prior year. For example, if a % of turnover is a determinant of preliminary materiality, it will increase by 55% (based on estimate).
- The materiality of each subsidiary should be assessed, in terms of the enlarged group as at the planning stage. For example, any subsidiary contributing more than 10% of the group's assets and turnover (but not result!) is material and less than 5% (say) is not. This will identify, for example:
  - those entities which will require an audit-visit; and
  - those for which analytical procedures may suffice.
- If Socolla is particularly material to the group, Riebeck may plan (provisionally) to visit Socolla's auditors to discuss any problems shown to arise in their audit work summary (see group instructions below).

**Goodwill arising**

- The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and the period over which it is to be amortised.
- The assets and liabilities of Talc and Socolla, at fair value to the group, will be combined on a line-by-line basis and any goodwill arising recognised.
- The calculation of the amount attributed to goodwill must be agreed to be the excess of the cost of the acquisition over the fair value of the identifiable assets and liabilities existing at the date of acquisition (Talc – August 2001, Socolla – May 2002).
- Significant non-current assets such as properties are likely to have been independently valued prior to the acquisition. It may be appropriate to plan to place reliance on the work of expert valuers.

**Group (related party) transactions and balances**

- A list of all the companies in the group (including any associates) should be included in group audit instructions to ensure that intra-group transactions and balances (and any unrealised profits and losses on transactions with associates) are identified for elimination on consolidation.
- It should be confirmed at the planning stage that inter-company transactions are identified as such in the accounting systems of all Amber companies and that inter-company balances are regularly reconciled. (Problems are likely to arise if new inter-company balances are not identified/reconciled. In particular, exchange differences are to be expected.)

**On analytical procedures**

- Having brought in the operations of a group of companies (Talc) with similar activities may extend the scope of analytical procedures available. This could have the effect of increasing audit efficiency.

**Socolla on Income Statement**

- The effective date of the acquisition of Socolla may be so late in the financial year (only 4–8 weeks, say, before the year end) that it is possible that its post-acquisition results are not material to the consolidated income statement.

**Other auditors**

- Other auditors will include:
  - any affiliates of Riebeck in any of the countries in which Amber (as combined with Talc) operates; and
  - the unrelated auditors (of Socolla).





- Riebeck will plan to use the work of Socolla's auditors who are Chartered Certified Accountants. Their competence and independence should be assessed (e.g. through information obtained from a questionnaire and evidence of their work).
- A letter of introduction should be sent to the unrelated auditors, with Amber's permission, as soon as possible (if not already done) requesting their co-operation in providing specified information within a given timescale.
- Group instructions will need to be sent to affiliated and unrelated auditors containing:
  - proforma statements
  - a list of group and associated companies
  - a statement of group accounting policies (see below)
  - the timetable for the preparation of the group accounts (see below)
  - a request for copies of management letters
  - an audit work summary questionnaire or checklist
  - contact details (of senior members of Riebeck's audit team).

Accounting policies (Talc & Socolla)

- Whilst it is likely that Talc has the same accounting policies as Amber (because, as a competitor, it operates in the same jurisdictions) Socolla may have material accounting policies which do not comply with the rest of the group. Riebeck may request that Socolla's auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

Timetable

- The timetable for the preparation of Amber's consolidated financial statements should be agreed with management as soon as possible. Key dates should be planned for:
  - agreement of inter-company balances and transactions
  - submission of proforma statements to Riebeck
  - completion of the consolidation package
  - tax review of group accounts
  - completion of audit fieldwork by other auditors
  - subsequent events review
  - final clearance on accounts of subsidiaries
  - Riebeck's final clearance of consolidated financial statements.

**(c) Use of analytical procedures**

**At the planning stage**

- Analytical procedures must be used at this stage (sometimes called 'preliminary analytical review'). Riebeck's knowledge and understanding of Amber's business will be assisted by the accumulation of information. For example:
  - The 55% increase in turnover should be commensurate with the purchase of the Talc group.
  - There is a downward trend in the key performance indicator (ARPU has decreased by 8·2% for contract customers and 14·8% for prepaid customers).
  - The number of contract customers has increased by 49·8%, the number of prepaid customers by 260%. This should reflect the acquisition of Talc's customer base, market expansion and perhaps shift in customer preference from contract to prepay.
- Analytical procedures can also be used to identify areas of potential business and audit risk. For example:



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- Although the 56% increase in cost of sales is in line with turnover, distribution and administrative costs have increased by nearly 70% – if Amber is not realising the cost benefits it expected through synergy, this is a business risk (see (a)).
- Expenditure on R&D looks very low (0·36% of 2002 turnover – 0·49% for prior year). This could indicate a business risk e.g. Amber is not making sufficient investment in R&D (necessary in this industry). It could also indicate an audit risk – that Amber is capitalising development costs which do not meet the recognition criteria for an intangible asset (IAS 38 'Intangible Assets').

- Riebeck can use analytical procedures to assist in determining the nature, timing and extent of other audit procedures (i.e. audit strategy). For example, Riebeck might expect a high degree of disaggregation in available information (e.g. between the Amber and Talc companies). A detailed review of gross profit margins by European country may highlight those which require detailed substantive procedures (tests of details).
- Financial data (estimated June 2002) is already available for use at the planning stage. Riebeck should have prior knowledge of the reliability of such data (by considering how 2001's Actual compared with 2001's Estimated).

Substantive procedures

- Analytical procedures at this stage are optional. (Substantive analytical procedures ('SAPs') are based on the expectation that relationships which are known to exist may be expected to continue in the absence of clear evidence to the contrary. For example, the relationship between gross profit and sales revenue may be expected to remain constant unless there are changes in sales prices, sales mix and/or cost structure.)
- However, although the GP margin is almost constant for 2002 and 2001 – it is unlikely that Riebeck would use this for substantive purposes given:
  - the diverse nature of operations in its industry;
  - the multiple locations over which it operates; and
  - the fact that it is known that unit revenues are falling (due to market competition).
- Analytical procedures can themselves provide sufficient audit evidence where an item can be verified directly by reference to another (valid) item. For example, Riebeck may be able to substantiate the finance cost, depreciation and amortisation using a 'proof in total' or 'reasonable test'. The mechanics of this are that the expected value of the population (e.g. finance cost or depreciation) is:
  - calculated using base data (e.g. outstanding debt and % costs of debt or cost of assets and depreciation rates) which has been confirmed to be materially correct; and
  - compared with recorded value. Any difference is not expected to be material. Riebeck may find even such simple models to be very effective.
- Trend analysis (i.e. the comparison of current data with prior periods) may be particularly useful for analysing income (e.g. monthly revenue by customer type and market). Riebeck might expect that trends in the combined Amber and Talc are very similar whilst those in Socolla might be very different (e.g. because market penetration and growth may be less rapid). As ARPU is a key performance indicator, Riebeck might expect to find (or determine) comparable amounts in the financial statements of Amber's competitors. This could then be used to provide evidence concerning the completeness of recorded income. For example, (8,861 x 655) + (6,084 x 241) _ Kshs.7,270m (2001 – Kshs.4,700m). Recorded revenue is 4·3% (2001– 4·1%) more. This must be investigated (e.g. there may be sundry sources of revenue).





At the review stage

- Analytical review at this stage is required in forming an overall conclusion as to whether the financial statements as a whole are consistent with Riebeck's knowledge of the business. The review may also identify the need for further substantive procedures.
- Ratio analysis is particularly useful in testing the consistency of the inter-relationships of amounts disclosed in the financial statements. It is usual to compare ratios calculated at this stage with those of the preliminary analytical review.

## QUESTION 7

### (b) Lammergeier Group - auditor's report

- The report is confused. It is clearly headed 'Qualified opinion arising from disagreement ... ' yet the reasons for departure (from IAS 7) are 'sound and acceptable'. The heading is a statement of disagreement, the latter a statement of concurrence. If the auditor concurs with a departure the opinion should not be qualified.
- What is 'IAS 7'? This should be stated in full, i.e. 'International Accounting Standard 7 Cash Flow Statements'.
- It might be simpler/clearer to head the opinion paragraph 'Qualified opinion arising from omission of cash flow statement'.
- The auditors should not be expressing an opinion of Lammergeier's management in their report. Management's 'justification' should be set out in a note to the financial statements (e.g. in the accounting policies section). The auditor's report should clearly state that there is non-compliance with IAS 7. For example, 'As explained in note ... the financial statements do not contain a cash flow statement as required by [AS 7 (written out in full]'.
- It cannot be true that the departure 'does not impact on the truth and fairness ... '. The requirement to prepare a cash flow statement (and its associated notes) stems from the need to provide users of financial statements with information about changes in financial resources. If this information is omitted the financial statements cannot show a true and fair view.
- 'Except for [the non-preparation of the group cash flow statements and associated notes] .... ' is a qualified audit opinion. This contradicts Rook & Co's assertion that the matter 'does not impact on the truth and fairness ... '.
- If the departure from IAS 7 were justified it would assist the user of the financial statements to know precisely where the 'adequate disclosure has been made'. If the auditor wished to emphasise the matter, without qualifying the audit opinion, an emphasis of matter after the opinion paragraph should refer to the specific note where the departure is explained.
- The ground for non-compliance is 'the complexity involved'. This does not seem likely. IAS 7 offers no exemption on these (or any other) grounds.
- The fact that the audit opinion was similarly qualified in the prior year shows that the matter has not been resolved even after a year.
- It is possible that, having qualified on the prior year, it was an 'easy option' to qualify again in the same terms rather than draft a more appropriate opinion for the consecutive year.
- The 2003 opinion makes no reference to the fact that the matter is 'not new' and that the opinion was similarly qualified in the prior year.



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**QUESTION 8**

**1 Alakazam**

**(a) Potential risk areas**

**Chief executive**
As chief executive, Leon Izzardo holds a dominant position and the recent success (expansion) of Alakazam may be largely attributable to him. The appropriateness of the going concern basis may be questioned if Leon were to leave (say before the WAP phone rights are renewed or a replacement product found).

Also, the need for funds to finance the ongoing expansion may create management bias to overstate the company.s profitability (e.g. by understating amortisation of distribution rights, warranty provisions, etc).

**Growth**
Sales growth, resulting from the purchase of distribution rights, has resulted in business expansion (increasing the workforce and requiring new premises). All of which requires financing. There is a possibility that Alakazam is overtrading (i.e. entering into commitments which exceed its available short-term resources).
Accounting and internal control systems
The increase in administrative and accounts staff will facilitate greater segregation of duties and this should reduce control risk. It is expected that head office will have implemented new/improved control procedures, for example:
- centralised purchasing (implied by central distribution);
- centralised payroll; and
- credit control (new customer accounts).

However, the incidence of errors arising may be increased, as compared with last year, if the rapid expansion has put the accounts departments under pressure such that existing internal controls have lapsed. Also, errors arising may not be detected if, for example, new accounting staff have insufficient training or experience.

**Product**
Alakazam is heavily dependent on just one product to which the company has distribution rights for less than a year (say nine months) from now.

**Inventory could be overvalued due to:**
- a reduction in price (if product has to be sold more cheaply to maintain sales volume/market share);
- falling demand if the market is saturated;
- manufacturing defects;
- technological obsolescence/new models being introduced by a competitor.

**Trade receivables**
Trade receivables could be overvalued as the risk of bad and doubtful debts may be increased due to:
- laxity in creditworthiness checks (in the drive to expand the customer base);
- disputes arising from the manufacturing defects.





**Liabilities/Contingencies**
Liabilities associated with expenditure on sales warranty work may be understated, for example, if their extent as at the year end is not ascertained.

The financial statements could be materially misstated in respect of contingencies or post balance sheet events if they are not properly accounted for. In particular:
- adequate provision should be made for sales warranty work;
- contingent assets (e.g. if there is recourse to the supplier of the WAP phone over defects) should be disclosed;
- disputes with customers and the WAP phone supplier (over defects) resulting in litigation may require provision and/or disclosure of contingent liabilities.

**Going concern**
The going concern basis may not be appropriate because:
- the future of the company may be dependent on Leon Izzardo;
- working capital may be inadequate to deal with overtrading;
- the scale of operations is dependent on one product (the WAP phone) and supplier;
- sales are falling;
- manufacturing defects may result in loss of sales/customer goodwill.

**Intangible assets**
Intangible assets and profit for the year may be overstated in respect of any carry forward of distribution rights capitalised last year. Amounts involved are likely to be material and management will probably be biased in favour of carry forward (e.g. amounting to 6/24 × cost). This will be imprudent if, for example, future sales of the WAP phone are in doubt and the value of distribution rights is impaired.

**Conclusions**
Inherent risk is high as the financial statements may be materially misstated due to the likelihood of errors arising and the high degree of subjectivity involved regarding accounting matters (going concern, warranty provisions, inventory valuations, intangible assets, etc).

Control risk is likely to be low in some areas (e.g. purchases) but potentially higher in others (e.g. inventory).
To render detection risk low will require a substantive approach to the higher risk and judgemental areas (e.g. inventory valuation, warranty provision) though reliance will be placed on controls if appropriate (e.g. purchases and payroll).

Additional point
Foreign currency exchange risk arises on imported goods.

**Audit strategy**
Obtaining information
The permanent audit file should be updated in respect of:
- new premises purchased/rented;
- loan creditors/financing arrangements;
- significant new customers;
- new appointments of key personnel (e.g. in administration, servicing and distribution);
- changes in the accounting and internal control systems.



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**Recording the system**
Changes in the accounting system and internal controls may have been made piecemeal during the expansion and possibly informally and without adequate documentation.

It may be appropriate to make a new record of the systems rather than amend prior year narrative notes. Flowcharts could be prepared in respect of those parts of the system which are established and likely to remain so. The ongoing expansion and possible need to accommodate changes should be borne in mind.

**Materiality assessment**
Monetary materiality is likely to be much higher for the year to 31 March 2002 than for the prior year given:
- WAP phone sales for a whole year (prior year only six months);
- doubling of customer base;
- trebling of workforce;
- new premises.

**Tests of control**
Effective controls will be relied on where tests of control and reduced substantive procedures are, in combination, more efficient than a wholly substantive approach. Areas in which this is most likely to be appropriate include:
- purchases;
- payments to suppliers;
- payroll costs;
- receipts from retailers (trade customers).

**Accounting policies**
The appropriateness of capitalising distribution rights (assumed) must be substantiated by:
- agreeing client's schedule of costs to supporting invoices;
- discussing, with management, sales forecasts;
- monitoring after date sales of the WAP phone.

**Attendance at year-end physical inventory count**
To confirm the accuracy of recorded quantities, the physical count will be attended at the central distribution department. Particular attention will be given to:
- the quantity and condition of phones held in the servicing department;
- any deliveries accepted during the count; and
- the clients procedures for despatches to retail outlets during the count (if any).

**Analytical procedures**
Although the expansion of operations will significantly distort account balances with the prior year there will be scope for analytical procedures. In particular, the material correctness of recorded sales other than the WAP phones may be substantiated by a month-on-month comparison of turnover and review of gross profit margins.
The reasonableness of payroll costs may be ascertained by inflating prior year employee costs, by department (sales, distribution, servicing, administration), for the increase in the number of employees.

**Trade receivables**
A year-end circularisation of retailers will probably reveal disputed amounts in respect of defective products. The adequacy of Alakazam.s provision for after date credit notes must be carefully monitored.





The recoverability or otherwise of accounts in dispute should be confirmed by vouching receipts of after date cash.
Controls over acceptance of new customers should be reviewed to ensure creditworthiness checks are being performed as customer base increases.

**Warranty provision**
In addition to providing for credit notes issued to customers (in respect of faulty goods returned), provision should be made for costs incurred by the servicing department after the year end for phones sold prior to the year end.
It is likely that the client will not have much experience in exercising judgement in this area and may therefore be looking for guidance. Reliance on management representation, as to the adequacy of the provision, may therefore be inappropriate.

**Legal advice**
Communication with the company's legal adviser and possibly, also, an independent lawyer should be established as specialist evidence may be required in respect of:
- the legal interpretation of the agreement with the manufacturer especially regarding the defects;
- the legal interpretation of the conditions of sales warranty;
- legal opinion on the outcome of any litigation with the manufacturer or customers.

**Bank/loan creditors**
Confirmations will be required, so details of the company's bankers and other providers of finance must be ascertained in good time before the year end. Specifically, care should be taken to ensure that information is obtained on the following:
- title deeds held (e.g. to head office premises);
- dates planned for review/renegotiation of facilities;
- bills of exchange, letters of credit or other means of settling amounts due to the overseas supplier.

**Discussion with management**
Matters to be discussed with management include:
- developments in financing negotiations;
- basis of preparation and assumptions used in forecasts;
- whether Alakazam is involved in any litigation.

Assuming that there is no conflicting evidence that contradicts management.s representations, it may be appropriate to obtain written management representations.

**Additional points**
Substantive procedures on the inventory valuation should be aimed at ensuring the adequacy of the provision for slow moving, obsolete and faulty items.

A 'hot review' of the audit files should be scheduled given the high inherent and failure (i.e. going concern) risks associated with Alakazam.



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**(b) Proposed acquisition of Neodex**
**(i) Matters to be considered**

**As the requirement did not specify the nature of the principal matters to be considered (e.g. financial, operational, and strategic) there is a lot of scope for just 5 marks. What is important, is that they should be matters considered by the acquiring company.**

- Whether the planned .acquisition. is:
- for a controlling interest or 100% ownership;
- of Neodex.s shares, its business or its assets (see below). (Consolidated group accounts will have to be prepared if Neodex is acquired as a subsidiary.)
- The eagerness of the two parties to proceed with the negotiations. Alakazam is the company making the moves to acquire Neodex and the directors of Neodex may therefore have the .upper hand. in negotiating an acceptable offer price.
- Stefan and Georgio are relatively young and perhaps lacking in business acumen. Stefan, in particular, may be keen to see the DINS exploited by Alakazam for a faster and greater return than they could achieve on their own. .
- What is it that Leon Izzardo is trying to acquire for Alakazam? One motive for the acquisition is likely to be the DINS (and possibly Stefan.s new design). To secure new designs, the expertise of Stefan must be retained (e.g. by offer of share options) and motivated (e.g. by profit-related pay).
- Agreement must be reached with both shareholder-directors to acquire (at least a controlling interest in) the company. To buy all Neodex.s shares, the same offer may need to be made to both directors.
- Stefan may perceive his shareholding to be the more valuable (because of his intrinsic value to the company as the technical/design director). The offer to Stefan could be differentiated from that to Georgio Neratu by leaving Stefan with a shareholding.
- Benefits of synergy are unlikely to accrue (e.g. economies of scale) as Neodex is so small in all respects (e.g. assets,employees) in relation to Alakazam. However, there may be an opportunity to insource the manufacture and assembly of circuit boards.
- The form in which Stefan/Georgio will require consideration (e.g. cash and/or shares).
- The amount of investment needed in advertising DINS (and how soon) in order to increase sales.
- If substantial, cash (for consideration and a major advertising campaign) may have to be diverted from existing projects or raised from external borrowings.
- The acquisition may facilitate diversification and further growth if Stefan.s prototype is successful.
- Whether any interest in acquiring Neodex, rights to DINS or Stefan has been expressed by any other party.
- Given the recent fall in Alakazam.s WAP phone market, Alakazam is actively seeking opportunities to expand (and thereby reduce the risk of business failure).

**Additional points**

- Existing contractual arrangements for outsourcing of the circuit board . whether the supplier can meet increasing volumes. (Also the reliability of the supplier.)
- That Neodex is a new company which does not yet have a .name. will be reflected in the purchase price (i.e. lower).
- An assessment of demand for DINS needs to be made to confirm the potential for increased sales.
- An acquisition at this time could further increase the risk of company collapse (i.e. by adding further financial proessure to overtradingg, product defects, etc).



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**(ii) Implications of acquisition for conduct of audit**

As Neodex is so small in relation to Alakazam it is unlikely that there will be a significant impact on the resources (staff, time, etc) required to complete the audit. However, if Neodex is acquired as a subsidiary, Alakazam will need to prepare consolidated accounts. Assuming that the audit of Neodex is also transferred as a result of the acquisition, there will also be a need to liaise with the previous auditors (.professional etiquette.).

**Preparation of consolidated accounts may be for the first time as there is no reference in the Q to the existence of other group companies.**

The fair value of the tangible assets acquired (probably not much more than assembled units DINS and unassembled components) is likely to be significantly less than the purchase consideration. If fair value can be determined for development expenditure (e.g. in respect of the design of DINS and the new prototype) that meets the criteria for recognition as an intangible asset, it should be capitalised and amortised (rather than subsumed within goodwill on acquisition).

Assuming the acquisition takes place in early 2002, post-acquisition results will be immaterial to the consolidated income statement (to 31 March 2002). It is likely that Neodex will require audited financial statements for the 15 month period to 31 March 2002. If Neodex.s current auditors are retained (unlikely), the extent to which reliance can be placed on their work must be assessed.

Most of the background information required to plan the audit of items relating to Neodex will have already been obtained during the pre-acquisition review work. A substantive approach to relevant account balances (e.g. inventory of DINS) will be adopted as Neodex did not have systems suited to tests of control.

As Alakazam needs to invest heavily in promoting DINS, advertising expenditure around the year end may be material (some of which may be prepaid).

The acquisition of Neodex (i.e. DINS) may be a mitigating factor when assessing the doubts surrounding the going concern status of Alakazam.

Additional point

- As increased audit work will result in some increase in audit fee, the total recurring fee for Alakazam should be reassessed. If it now exceeds 10% of gross practice income the assignment should be kept under review and additional safeguards put in place (e.g. files subjected to a second partner review).

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# TOPIC 9

## ACCOUNTING AND AUDITING STANDARDS

### QUESTION 1

**(a) The main objectives usually associated with audit committees include;**

i) Increasing public confidence in the creditability and objectivity of published financial information including unaudited interim statements
ii) Assisting directors (particularly non executive directors) in meeting their responsibilities in respect of financial reporting
iii) Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

It is recommended that companies should have a committee of the board called the auditing committee. This would consist of at least three non-executive directors with written terms of reference which Cleary deal with its authority and duties.

- An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards
- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditor's examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc.
- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non- executive members of the audit committee can be suitably independent may be difficult to achieve.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships





with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

**(b) The ban on advertising accountancy services in Kenya is not sustainable.**

- Developments in the developed countries have led to accountants advertising their services in several countries.
- The arguments for advertising include:
- Increasing awareness of the services provided by accountant's hence increasing business. Eliminating the quacks or those who are not licensed because the public will know who is licensed and who is not.
- Giving clients a wide choice
- Enhancing competition hence leading to provision of higher quality services at lower costs and making the services of accountant more affordable to small enterprises.

However it has been argued that advertising will lead to unfair competition and unethical adverts claiming superiority over others. This would dent the image of the profession.

However these events have not occurred in these countries which advertise and therefore since the movement globally is towards advertising it probably a matter of time before advertising is allowed in Kenya.

Failure to make it legal will only promote unethical non standardized process which will actually age the reputation of the profession.

**(c) Specific Actions which firms can take to minimize audit risk**

- Incorporation into limited liability companies where the laws allow
- Introducing disclaimers in their audit reports and limiting the circulation
- Taking professional indemnity insurance
- Adherring to professional guidelines strictly.

*DECEMBER 2004 QUESTION FOUR*

### QUESTION 2

**a) The composition of the audit committee.**

It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non-executive members of the audit committee can be suitably independent may be difficult to achieve.

**b) The main objectives usually associated with audit committees include;**

- Increasing public confidence in the creditability and objectivity of published financial information including un audited interim statements
- Assisting directors (particularly non executive directors) in meeting their responsibilities in respect of financial reporting



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- Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards
- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditor's examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc.
- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

c) The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

*DECEMBER 2000 QUESTION FIVE*

QUESTION 3

**(a) Development, role, and authority of ISAs**

i) ISAs set out the basic principles and essential procedures that auditors should follow in the conduct of an audit of financial statements.
ii) Auditing Standards are in bold type. The grey type found in rSAs provides guidance on the application of ISAs.
iii) International Standards on Auditing are set by the International Auditing Practices Committee (JAPC) of the International Federation of Accountants (IFAC). The rAPC is made up of representatives of the profession who are members of IFAC.
iv) ISAs and other documents issued by the IAPC are developed using a process of exposure and consultation in order to obtain consensus and wide-spread acceptance of standards.



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Consultation is with interested parties outside the profession, as well as within the profession itself
v) ISAs apply to all audits of financial statements that are expressed in true and fair, fair presentation, or similar terms.
vi) ISAs are developed with due regard for developments in national standards as described in (c) below.

**(b) The role of the ICPAK in the regulation of auditors**

i) Auditors are regulated differently in different countries. In some countries governments regulate auditors directly, or through government organisations, I n other countries the
ii) profession is self-regulating. in most cases, there is some combination of self-regulation and government regulation.
iii) The professional bodies regulating auditors in the Kenya include the ICPAK. There is a strong tradition of self-regulation in the Kenya which is not the case in, for example, certain European countries where government regulation is more direct.
iv) Professional bodies such as the ICPAK, like other regulators, seek to uphold professional standards, to investigate complaints against auditors, and to assist auditors in the performance of their duties. They have both investigative powers and sanctions against auditors who do not comply with professional standards. These include fines, exclusion from membership, and the withdrawal of the license to audit (audit registration). Members of the ICPAK are bound by its Rules of Professional Conduct.
v) The ICPAK encourages high professional standards by setting academic requirements for those wishing to study for the examinations, by setting the examinations and by requiring additional experience of those who wish to practice as auditors.

**(c) How ISAs and national standards influence each other**

i) In a global market-place it is increasingly important that Auditing Standards are harmonized across the world, particularly for multinational companies. It is also important that Auditing Standards are applied consistently. Over the last ten years, standard setters in those countries where the profession is mature have sought to harmonize their own standards with International Standards, and to influence International Standards.
ii) In many countries, all new national Auditing Standards contain a statement to the effect that compliance with the national standard will ensure compliance with the relevant International Standard in all material respects, if that is the case, or it will explain the differenco(s).
iii) It is not always possible for local Auditing Standards to be the same as International Standards because of local legal requirements. Nevertheless, a number of countries have accepted International Standards in their entirety, or have accepted them subject to some minor local variations. International Standards are thus extremely useful for countries where the profession is not strong and where government does not seek to detail Auditing Standards, and where there are few resources to develop local standards.
iv) Standard setters in countries where the profession is mature make a significant contribution to the development of ISAs by providing representatives to sit on IF AC Committees and working parties and by providing the resource to help draft standards. National standard setters comment on consultation papers and exposure drafts issued by the JAPC and help summarise responses on certain projects.
v) ISAs only have force internationally if they have the support of those countries who lead the profession internationally. It is therefore essential for both national standard setters and international standard setters to take account of each other's work.



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**QUESTION 4**

Dear Carmen,
Thanks for your letter; it was really nice to hear from you.
I'm going to set out in my letter the queries you raised regarding the regulatory framework which applies to auditors.

a) The due process of the IAASB involved in producing an ISA
ISAs are produced by the international Auditing and Assurance Standards Board, IAASB, which is a technical standing committee of the International Federation of Accountants, IFAC.
Initially an exposure draft is produced for consideration by the IAASB. If this is approved, it is circulated to the member bodies of the IFAC (such as ACCA) and any other interested parties. It is also published on the IAASB's website. These bodies make comments on the exposure draft which is then amended as necessary. The exposure draft is then re-issued as an ISA or an International Auditing Practice Statement, IAPS.

b) The overall authority of ISAs and how they are applied in individual countries ISAs must be applied in the audits of historical financial information.
ISAs contain auditor's objectives, basic principles and requirements (including essential procedures] together with related guidance in the form of explanatory and other material. The whole text must be considered in order to understand and apply the basic principles and essential procedures.
ISAs do not override the requirements for the audit of entities in individual countries. To the extent that ISAs conform to local regulations in regard to a particular subject, the audit in that country in accordance with local regulations will automatically comply with the ISA on that subject. Where local Regulations differ from or conflict with ISAs, member bodies should comply with the obligations of members in the IFAC constitution, i.e. encourage changes in local regulations to comply with ISAs.

c) The extent to which an auditor must follow ISAs
There may be exceptional circumstances under which the auditor may judge it necessary to depart from an ISA in order to achieve the objective of an audit more effectively. In this case, the auditor must be-prepared to justify and document the reason for the departure. This situation is likely to be the exception rather than the rule.

d) The extent to which ISAs apply to small entities
ISAs apply to the audit of financial information of any entity, regardless of its size. However, small entities possess distinct characteristics, such as a lack of segregation of duties, which mean that auditors must adapt their audit approach when auditing the financial statements of a small company. This is likely to include a substantive-based audit approach and more reliance on written representations, for example.
The IAASB published a 'questions and answers' document in August 2009 which highlights how the design of the clarity ISAs enables them to be applied in a manner proportionate with the size and complexity of an entity. This publication is helpful for those firms auditing small companies.

The object of a superior man is truth.

Confucius.





# TOPIC 10

# CORPORATE GOVERNANCE

**QUESTION 1**
**(b) Evolution of the role of the audit committee**

- Traditionally, the focus of the audit committee was on historical elements of corporate reporting through its review of annual financial information, mainly the company's financial statements. For several years, the audit committees of publicly traded companies have been under pressure to be accountable in their role as financial stewards. It is no longer enough for the audit committee to focus its attention solely on the past. The paradigm shift for the audit committee comes when it focuses on the future by being attuned to organizational changes that can affect overall control and risk management process.
- The audit committee must also play a preventive role in a company's management control system and ensure that proper attention is paid to control tools and policies that will prevent financial or operational disasters.
- There has been an erosion of confidence in the process of corporate financial reporting and auditing. This has placed pressure on corporate management for increased responsibility, accountability and supervision. Audit committees have evolved from informal committees with few defined responsibilities to what they are today - critical committees with growing responsibilities. In recent years, the roles assigned to audit committees have been given greater importance by cases of corporate impropriety, financial market crisis, management fraud and bank failures which have received widespread publicity.
- Moreover, the changing corporate globalization environment has required that more attention be paid to discovering irregularities and detecting fraud, taking into account that the audit committee must adopt a professional approach and be objective in the discharge of its objective/responsibilities. As a consequence, the responsibility of the audit committee is also to provide assurance that the corporation is in reasonable compliance with the relevant laws and regulations, is conducting its affairs ethically" and is maintaining effective control over conflict of interest with the organization
- Consideration changes are occurring in the audit committee approach, which was previously limited to providing reference material and guidance
- Given the technological progress, for instance, the advent of the internet users or corporate financial reporting are also much more attuned to environmental changes.
This requires that members of audit committee should focus more on the corporate disclosures of more timely and transparent information. The members of the audit committee are required to exercise scrutiny as part of overall diligence.

*JUNE 2012 QUESTION TWO B*

**QUESTION 2**

**a) Reasons why the audit firm will need to communicate with the audit committee**

- The audit committee is charged with the responsibility of reviewing the internal control procedures. The auditor needs to be in constant communication with the audit



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committee advising them on shortcomings of the internal controls and making recommendations where possible while the audit committee looks at the implementation of any controls and advising the auditors on any new controls that are implemented.

- The audit committee provides an independent reporting channel for the internal audit function which is critical to the external auditor when it comes to audit of financial statements.
- The external auditor is accorded an opportunity to discuss problems and other issues relating to the audit.
- The audit committee is responsible for agreeing the scope and nature of work to be carried out by the external auditors, hence the need to continuously liaise with them.

b) **Requirements of corporate governance before listing**

- Independence and oversight or auditors should be ensured. The firm should understand that the auditors need to be as independent as possible for them to be able to remain as objective as possible in their work.
- Establishment of a two tier board or full board of directors.
- The audit committee needs to be given power to act as it becomes effective in its operations. The mere forming of the audit committee is not sufficient. It needs mandate to act. The audit committee should be staffed with non-independent non-executive directors.
- Evidence that the firm is keen and also safeguards the interests of stakeholders, since corporate failure disadvantages all and only competitors stand to gain.
- The management needs to ensure that there is a sound system of internal controls.

c) **Threats that affect the auditors independence and measures to address the risks**

- Familiarity threat

  The audit manager has worked on this engagement for four years. This might lead to a sympathetic relationship between the auditors and the client.

  To mitigate this risk there is need to rotate the audit staff especially the audit partners and the audit manager to ensure they do not become too familiar with the client.

- The audit manager has a direct financial interest in the firm since he just inherited some 6% of Siporting Ltds share capital. This is likely to make the auditor act in a manner as to safeguard his investment or could use information obtained during the audit for self-gain. To mitigate this he should step clown as the audit manager or dispose the shares held in Siporting and disclose this fact adequately.
- The auditors' offer tax services to the firm, the tax authorities have disputed some of these figures although it is not explicitly stated Siporting may be hesitant to pay the auditors their fee. This creates undue influence on the auditors and their independence is impaired. The auditors are also faced with the threat of self-review since they will be expected to audit the tax amount later.

  The audit firm should consider declining this engagement and only focus on audit work.



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- Self-review threat.

  The auditors offer more than one service to the client that all relate to the final audit of financial statements. The auditors prepare the financial statements, offer taxation services among other services. The auditor cannot objectively expose his own failures or errors during the audit of work that he did.

  The auditors should drop some services and concentrate on offering a particular service only so as to reduce the threat on self-review which impairs their independence.

- Advocacy threat
  The invitation to attend an evening reception where the listing arrangements will be presented to banks and other shareholders will create an advocacy threat on the part of auditors as they will seem to provide an assurance on some of the documents presented during the reception.

  The auditors should turn down the offer to attend the reception and clearly provide a statement disclaiming liability in case any of their work is relied upon by other than the firm to make a decision about the firm, be it investment or otherwise.

*DECEMBER 2010 QUESTION THREE*

**QUESTION 3**

i) Corporate governance refers to the system by which companies are directed and managed. It's concerned with the systems and structure that are put in place to ensure accountability, responsibility and transparency in directing the affairs of the firm.
ii) Role of audit committee in corporate governance

a) Review the interim and annual financial statements before submission to the board particularly focusing on: -

   i) Any changes in accounting policies
   ii) Major judgmental area such as accounting estimates e.g. provision
   iii) Significant adjustment arising from the audit.
   iv) Going concern assumption.
   v) Compliance with accounting standards and other legislations.

b) Consider and recommend the appointment, remuneration and questions on dismissal or resignation of the external auditor.
c) To discuss with the external auditor by the audit on the ration and scope of the audit and to ensure coordination where more than one audit firm may be involved.
d) To discuss problems and reservations arising from the interim and the final audit and any matters the audits may wish to raise and this may be done in the absence of the executive directors
e) To review the external auditor's management letter and the management responses.
f) Where there is an internal audit function the account reviews the entire audit programme and ensures there is coordination between the external and internal auditor.
g) Provide the external auditor with a channel of communication and to be available for consultation.
h) Monitor the progress of the audit and to ensure that it's conducted in an independent manner.

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**Internal audit**

a) Review compliance with the laws which are crucial to corporate governance
b) Internal audit has the responsibility of carrying out investigations within the firm on matters of fraud.
c) Risk assessment within the firm
d) Reviewing non-financial controls to ensure interests of stakeholders are considered

*JUNE 2010 QUESTION FIVE A*

**QUESTION 4**

**(a) Threats to independence**

- Advocacy threat

It is likely to be created if the auditor attends an evening reception where listing arrangements will be presented to the bank and other shareholders.

To mitigate against this the auditors should not honour the invitation.

- Direct financial interest

The audit manager has inherited some 5% of Notary's share capital. He therefore has direct financial interest in the firm. He may thus act in a manner as to safeguard his interests.

To mitigate against this risk he should step down as the audit manager or dispose the shares held in Notary and disclose this fact adequately.

- Undue influence.

Notary has made it clear that they will only pay the firm the fee for taxation services after the tax liability is confirmed with the tax authorities. This is a concern to the auditors because they mayor may not lose the client. The auditors' independence is impaired due to undue influence. This can be mitigated by the auditors receiving a percentage of the fee prior to commencement of the job and other percentage paid
upon completion of the job.

- Self-review threat

On the part of the auditors since they offer more than one service to the client that all relate to the final audit of financial statements. The auditors prepare the financial statements, offer taxation services among other services. The auditor cannot objectively expose his own failures or errors during the audit of work that he did.

The auditors should drop some services and concentrate on offering a particular service only so as to reduce the threat on self-review which impairs their independence.





- Familiarity threat

The partners have served for four years and the audit manager has worked on this engagement for two years. This might lead to a sympathetic relationship between the auditors and the client as a result of familiarity.

To mitigate this risk, there is need to rotate the audit staff especially the audit partners and the audit.

**(b) Measures to meet corporate governance requirements**

- Corporate governance is the process and structure used to direct and manage the business and affairs of the corporation with the objective of enhancing shareholder value, including ensuring the financial viability of the business, while taking into consideration the interests of other stakeholders.
- The firm needs to undertake the following actions

i) Ensure the independence and oversight of auditors. The firm should understand that the auditors need to be as independent as possible for them to be able to remain as objective as possible in their work.
ii) The audit committee needs to be given power to act as so as it becomes effective in its operations. The mere forming of tile add it committee is not sufficient and needs mandate to act. The audit committee should be staffed well with independent non-executive di rectors.
iii) The management needs to ensure that there is a sound system of internal controls. The management should also have evidence about the adequacy of the design and effectiveness of internal controls including their implementation and operation.
iv) The management should put in place explicit sign off procedures of financials by the CEO

**(c) Importance of auditor liaising with the audit committee**

- The audit committee is charged with the responsibility of reviewing the internal control procedures. The auditor needs to be in constant communication with the audit committee advising them on shortcomings of the internal controls and making recommendations where possible while the audit committee looks at the implementation of any controls and advising the auditors on any new controls that are implemented.
- The audit committee provides an independent reporting channel for the internal audit function which is critical to the external auditor when it comes to the audit of financial statements.
- The audit committee is responsible for agreeing the scope and nature of work to be carried out by the external auditors, hence the need to continuously liaise with them.
- The external auditor is accorded an opportunity to discuss problems and other issues relating to the audit and other issues that the auditor may wish to discuss with the audit committee.

*AUGUST 2009 QUESTION THREE*

**QUESTION 5**

a) **Objectives of the audit committee**
- To improve the quality of financial reporting e.g. reviewing the statements.
- To create a climate of discipline and control which will reduce the chance of fraud?
- To help the finance director by providing a forum in which he can raise issues of concern.



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- To provide a framework in which the external auditor can assert his independence incase of a dispute with the management.
- To strengthen the position of the internal audit function by providing a greater degree of independence.
- To increase public confidence in the objectivity and credibility of the financial statements.

b)

1. Review the interim and annual financial statements before submission to the board particularly focusing on: -
   i) Any changes in accounting policies.
   ii) Major judgmental area such as accounting estimates e.g. provisions
   iii) Significant adjustment arising from the audit
   iv) Going concern assumption.
   v) Compliance with accounting standards and other legislations.
2. Consider and recommend the appointment remuneration and questions on dismissal or resignation of the external auditor.
3. To discuss with the external auditor by the audit on the ration and scope of the audit and to ensure coordination where more than one audit firm may be involved.
4. To discuss problems and reservations arising from the interim and the final audit and nay matters the audits may wish to raise and this may he done in the absence of the executives directors.
5. To review the external auditor management letter and the management responses.
6. Reviewing the management's statement of ICS
7. Where there is an internal audit function the account reviews the entire audit programme and ensures there is coordination between the external and internal auditor.
8. Provide the external auditor with a channel of communication and to be available for consultation.
9. Monitor the progress of the audit and to ensure that it's conducted in an independent manner.
10. Review major finding of internal investigations and the management responses e.g. suspected fraud.
11. Assist the executive director in the strategic director of the company.
12. Advice the board on the best practices to be adopted so that the company can achieve its objectives.

c) **Advantages of Audit Committees**

i) By virtue of its existence the audit committee makes the executive directors be aware of their duties and responsibilities.
ii) The audit committee could be a deterrent to commission of illegal acts by executive directors and may discourage them from behavior in ways which is pre-judicial to the interest of the shareholders.
iii) They enhance the efficiency and effectiveness of the company operations.
They enhance the credibility and trust that company be placed on the financial statements.
iv) They strengthen the independent position of the external auditor.
v) They improve communication between directors, auditors and management in general.
vi) They strengthen the role of the non-executive directors.
vii) They improve the quality of the accounting and the internal audit function.
viii) Where illegal prejudicial acts have been carried out by the executive director. The audit committee provides and independent body to which the auditor can turn. In this way the problem can be resolved without the auditor having to review the matter to the shareholder either in the report or the annual general meeting.



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**Disadvantages of the Audit Committees**

i) They lead to increase operational cost.
ii) They are difficulties in selecting sufficient non-executive directors.
iii) It may encroach on the managements responsibility.
iv) It may split the board and create conflict within the organization.
v) They will be powerless if they cannot enforces their recommendations or reports.
vi) Since the finding of the audit committees are rarely made public it's not always what clear what they do or how effective they have been in doing it.
vii) Established and formalized reporting procedures in the company may dissuade the auditor from raising matters on judgement and only report on matters of fact.

d) **Relationship between the audit committee and the external auditor,**

1) The audit committee minimizes the audit risk. This is because the one of their duties is to consistently monitor the effectiveness of the IGS :111d they also strengthen the internal audit function.
2) The audit committee discusses any intended qualification in the audit report with the external auditor.
3) The committees discuss any problems in the accounting problem of contagious issues with the auditors.
4) The committee discusses the contents of the management letter with the external auditor.
5) The audit committees provide a forum of liaison between the external auditor and the finance director.
6) The committee helps the auditor obtain information that he requires and resolves any problem that they may encounter.
7) The committee deals with any serious reservations the auditor may express about records, the control environment, accounts, information published in the accounts and the quality of the company management.
8) The audit committee recommends the appointments and remuneration of the external auditor.
9) The committee also reviews the dismissal and resignation of the external auditor.
10) It discusses with the external auditor at the start of the audit on the nature and the scope of the audit.

*JUNE 2008 QUESTION TWO*

**QUESTION 6**

**a) BCD Stores Ltd is a high risk audit client in view of the problems associated with**

i) Inventory misappropriation by employees and customers
ii) Slow moving and damaged goods, work less than cost.
iii) Incomplete recording of sales when customers pay by cash

The above are areas of high audit risk and as the manager responsible for the audit, I would consider the following matters and carry out the necessary audit work before the commencement of detailed audit work;

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**Matters to be considered;**

i) The significance and materiality of the audit risk areas
ii) The relevance of the knowledge gained in previous audits and whether any changes have occurred that may affect the relevance of the information to the current audit
iii) Since BCD has high audit risk areas, I will consider the following logistical issues staffing of the audit- level of qualification, relationship with audit staff, availability, special correct level of experience
   - Client management
   - Locations of the client considering distance to be travelled by audit staff, mobility, determine which location to visit, staff allocations.
   - Deadlines, considering the key dates which the audit team will need to know such as date of inventory count, main audit visit, reviews by managers, draft accounts, date when audit report is signed and date of AGM.
iv) Consider the use of information technology
v) Consider time budgets
vi) Consider other objectives of the audit in addition to the expression of an opinion.

**The audit work to be carried out includes;**

i) Review client acceptance and continuance relationships and for this specific audit engagements and ethical clearance.
ii) Determine adequate staffing of this audit assignment
iii) Hold meetings to discuss the risk of material misstatement In the areas of risk and its implications for the financial statements.
iv) Determine an appropriate audit strategy. In this audit, a combination of tests of control and extensive substantive testing will be required
v) Review stock taking instructions by the client for adequacy, staffing of the stock take and recommend changes as appropriate.
vi) Review stock taking procedures for identifying obsolete and damaged stock
vii) Discuss with the client and the audit staff to agree on timings for interim visit, final visit and stock take data.
viii) Allocate adequate resources for this audit
ix) Prepare the overall audit strategy and audit plan, document it and communicate with the relevant audit staff
x) Review the internal audit, and decide whether to rely on its work.

**(c) Procedures to be carried out to control the audit**

i) Communication to the audit staff of the engagement details and ensuring that all logistical arrangements are complete
ii) Ensure that staff follow the detailed audit plans especially in the high audit risk areas.
iii) Review the audit plans and the ICE and ICQs for completion
iv) Consult as necessary with the engagement partner and the clients management in case of any difficulties.
v) Ensure that stock taking instructions are followed, be present at some locations during the stock take and ensure that I test the stock sheets for accuracy.
vi) Review the work done by the internal audit department if we decided to rely on it.
vii) Ensure that deadlines are being met and if not, consult with the client and engagement partner.

*DECEMBER 2004 QUESTION FOUR*





**QUESTION 7**

**a) The composition of the audit committee.**

It is recommended that a majority of the non-executive directors on the committee should be independent of management. The notion that the non-executive members of the audit committee can be suitably independent may be difficult to achieve.

**b) The main objectives usually associated with audit committees include;**

i) Increasing public confidence in the creditability and objectivity of published financial information including un audited interim statements
ii) Assisting directors (particularly non-executive directors) in meeting their responsibilities in respect of financial reporting
iii) Strengthening the independent position of a company's external auditor by providing an additional channel of communication.

An audit committee has various responsibilities which include: -

- Review of a company's internal control procedures
- Review of the internal audit function. The audit committee providing an independent reporting channel
- Review of the company's current accounting policies and possible changes resulting from the introduction of new accounting standards
- Review of regular management information (e.g. monthly management accounts).
- Review of annual financial statements presented to the shareholders
- Review of the results of the external auditor's examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Procedures for reviewing published interim (preliminary) statements, draft prospectus, profit forecasts etc.
- Receiving and dealing with external auditors. Criticisms of management and ensuring that recommendations of internal and external auditors have been implemented.
- Recommending nomination and remuneration of the external auditors.

c) The relationship between the audit committee and the external auditor should be close such that the auditor should have unrestricted access to the committee. The auditor should present his findings regarding any fraud involving the management to this committee.

Ideally the audit committee should comprise of persons who have a suitable range of professional and business skills, sufficient knowledge of the business and yet have not developed close relationships with the main board.

They should have had no recent actual movement with the direct management of the organization, thus their judgment should be impartial free from influence and therefore unbiased.

*DECEMBER 2000 QUESTION FIVE*



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QUESTION 8

The OECD (Organization for Economic Cooperation and Development) and World Bank are actively involved in initiatives to promote corporate governance practices (e.g. holding an annual forum on the subject). In 1999, the OECD issued a set of Corporate Governance principles which, although non-binding, reflect the concepts of:

- The rights of shareholders
- The equitable treatment of stakeholders
- The role of stakeholders
- Disclosure and transparency; and
- Board responsibilities

These principles are now being promoted as framework for dialogue and consultation with emerging and transition economics with the aim of improving corporate governance practices.

Further in June 2000 OECD issued governance guidelines for multinationals that provide voluntary principles and standards for responsible business consistent with applicable laws. The International Forum on Accountancy Development (IFAD) is an initiative of IF AC and the World Bank. Its vision is to achieve a rational framework of reporting on the performance of economic entities, which serves the objectives of issuers and users across the world. This vision calls for inter alia, improving corporate governance practices using the OECD principles of corporate governance as a point of reference.

**Need for IASs**
The need for a uniform set of international accounting standards to provide for the transparency and consistency of financial reporting is evident in that IOSCO (the international organization of securities commissions) endorsed 30 International Accounting Standards for cross border listings.

Although these are not (yet) global standards, it is envisaged that IASs will become the international (i.e. global) standards and will not require reconciliation to US GAAP.

**Needs for ISAs**
The auditing profession plays a key role in both national and international regulation and the development to transparent international standards on auditing (ISAs) provides a high level of assurance on the reliability of financial reporting.

•

ISAs and International Auditing Practice Statements (IAPSs) have been formulated by IFAC through its international auditing practices committee (IAPC). A significant number of IFAC members use the ISA as a basis for developing their own national standard. IAPC is now working with [OSCO for endorsement of ISAs.

**Need for corporate governance standards**
Corporate governance may be defined as the ethical corporate behavior by directors or others charged with governance in the creation of wealth for all stakeholders. It is about how these persons:

- Provide stewardship over the business of an entity to achieve corporate objectives:
- Balance the corporate objectives with the expectations of society; and
- Provide accountability to stakeholders.





The need for governance has increased as primary stakeholders have become more removed from management and the control of the entities they own. The use of outside directors in governance roles has been shown to provide protection to entity stakeholders. The growth of global capital markets and the significant frauds which are being perpetrated in these markets has put this need on a global scale. Corporate governance can counter financial statement fraud, corruption and money laundering.

If investors are to invest, stamping out corruption (for example) is important. An infrastructure is therefore needed for regulation, corporate governance disclosure and transparency.

The importance of the role of corporate governance is reflected in the IAPCs (SA 260. Auditors are required to communicate audit matters of governance interest to those charged with corporate governance on a timely basis. That the ISA requires the auditor to identify those responsible for governance, when the entity has not, emphasizes the need for governance systems to be established.

It has widely been reported that had corporate governance and public governance existed in Southeast Asia. then the economic crises that occurred in 1997 may have been avoided (because the speculators would not have such a free hand as they did).

**Arguments for global corporate governance standards**

Corporate governance on a national basis is appropriate when investing and financing by companies is on a national basis. However, a set of global rules should be applicable, as a minimum, to entities listing shares or obtaining financing in the public capital markets outside of their national boundaries. Requiring companies who participate in global capital markets to follow global rules will provide greater protection to global investors. Corporate governance will still be required at a national level. The use of Global Shares by global business enterprises .increases the need for corporate governance rules to be global. Global shares (i.e. the same form of shares for listing in a home country and a non - home country) enable virtually seamless cross border trading. As their use becomes more widespread, global stakeholders will need higher quality global accounting auditing and corporate governance standards.

Regulators are national, not international, so international consistency is needed to avoid regulation arbitrage. Global standards are necessary because national and international standards will not converge of their own volition. Local subsidiaries of international groups tend to be content (e.g. on cost grounds) to comply with lower local standards (e.g. accounting and auditing) and not adopt the higher standards of their parent's location.

Companies in some countries (e.g. ill India) have been advised not to globalize until there is a framework for good corporate governance. It is therefore asserted that global standards are key to developing countries' prospects for sustainably mobilizing capital for economic growth. Developing countries can further benefit by imitating the models and systems of another - rather than incurring the costs of developing their own models.

There does not have to be a "one size fits all" approach to global standard because there are universally recognized standards that can provide benchmarks (e.g. responsibility, accountability, fairness and transparency). If universal principles of transparency and objectivity (for example) can support international accounting and auditing frameworks, then a global corporate governance model can cater for different legal structures and cultural identities.



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OECDs voluntary code provides a point of reference for multinationals, which are encouraged to:

- Contribute to economic, social and environmental progress
- Respect the human rights of those affected by their activities
- Encourage local capacity building
- Encourage human capital formation (e.g. by creating employment opportunities and through training programs)
- Refrain from seeking/accepting exemption from environmental, health and safety, equal opportunities and labor legislation, etc.
- Support and uphold good corporate governance (principles and practices)
- Abstain from improper involvement in local political activities

**Arguments against global corporate governance standards**
Development of corporate governance and its implementation needs to be at a rational level because regulators are national and it is not appropriate, given the need to respect diverse cultures and legal structures, to prescribe a global standard. For example:

- Concern in the US is for increasing shareholders value
- Continental Europe's economic philosophy is creating employment
- In Japan companies work with the government towards the national strategy

Many people fear that global corporate governance standards may attempt to impose an Anglo American business model on developing countries. Corporate governance and the composition of boards should suit the local business environment to encourage economic success.

JAPC has established as a principle that auditors determine the relevant persons who are charged with governance responsibilities. However, that there may be no such persons suggests that the needed for governance is not yet proven at a national level.

Global standards are necessary because they emerge eventually by a natural process of convergence. For example, International Financial Reporting Standards (IFRSs) have been issued by the international Accounting standards board in place of separate international accounting standards (IASs) and UK Financial Reporting Standards (FRSs) since the end of2001

International standards are not global standards. If accounting and auditing standards have only reached an international level then the need for corporate governance standards at the present time is only international -- not global.

**Conclusion**

A global corporate governance framework is essential for high quality financial reporting and auditing standards to be interpreted used and enforced consistently throughout the world.

**Alternatively**

Accounting standards have been implemented on a nation-by-nation basis before the international acceptance by IOSCO of international accounting standards. Auditing standards are following suit. The OECD principles are very general and as the need for global corporate governance standards is apparent, the initiatives to create them will continue to emerge.





**QUESTION 9**

**Becher Construction**

| | Report |
|---|---|
| To: | Audit Committee Becher Construction |
| From: | Internal Auditor |
| Date: | xxxxxxxx |
| Subject: | Meeting Corporate Governance 'Best Practice' |

**(a) Corporate Governance**

Corporate Governance concerns the ways that a company is operated and directed. It encompasses the following key aspects:

- Operation of the Board and Audit Committee
- Overall control and risk management framework

Corporate Governance has become increasingly important to all organizations, particularly those with a stock exchange listing which are subject to the requirements of the Combined Code, Cadbury and Turnbull reports.

The Turnbull requirement requires that companies have an ongoing process for identifying, evaluating and managing the company's key risks that it is regularly reviewed by the board and accords with guidance. Breach of these requirements could result in not only qualification in the annual accounts but damage to the company's reputation.

**(b) Requirements of Corporate Governance**

Becher need to ensure that the following key requirements are met:

- Evaluate risks within the organization, The key risks across the organization need to be identified, measured and reported. In many organizations, this has involved identifying the top 20 or so risks, which are then fully co-ordinated by the Board and Audit committee.
- Consider the nature and extent of the risks regarded as acceptable. There needs to be a clear understanding of the 'risk appetite' of Becher as well as the nature and extent of the top risks.
- The threat of such risks realizing assessing both the impact and likelihood.
- The ability to reduce incidence and impact if risks arise. This will include a review of the appropriate contingency arrangements are in place.
- Costs and benefits relating to operating relevant controls will need to be considered.
- Corporate Governance concerns the culture of the organization not just from its risk appetite but also the risk awareness and understanding across the organization. The Board and Audit Committee need to asset the tone and appropriate supporting mechanisms need to be in place, including appropriate training, policy and procedures.
- Regular reporting to demonstrate that risks are being managed on an ongoing basis.



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(c) **Role of internal Audit**

Turnbull says that an objective and adequately resourced internal audit function should be in a position to provide the Board with much of the assurance it requires regarding the effectiveness of the system of internal control.

Internal Audit's main role is normally to evaluate risk and monitor the effectiveness of the system of internal control. Turnbull sets out the requirements for an organization and these have a key bearing on how internal audit should operate.

The role of internal audit will depend on the nature and type of organization and what other risk type functions are in existence within the company.

Key steps for internal audit will be to:

- Review the companies measures to achieved corporate governance
- Ensure that Internal Audit's operation is consistent with the major risks facing the organization produce analysis and opinions of the effectiveness of the organization's control mechanisms, including regular information to the Board and Audit Committee.

(d) **Role of the Audit Committee**

The role and importance of the Audit Committee has increase as the corporate governance requirements have increased. The audit committee must have at least three non-executive directors.

The audit committee should:

- Assess the framework for corporate governance within the company, including the risk policies and measures being taken to achieve requirements
- Review the top 20 risks established, including the impact and likelihood
- Require regular reporting from internal and external audit and any other review bodies, showing how the risks are being managed
- Received and review internal audit assignment reports and follow up information
- Discuss and consider any concerns of directors and internal audit
- Review annual financial statements and the result of the external auditors' examination to ensure that the auditors have performed an effective, efficient and independent audit.
- Receive and deal with external auditors' criticism of management and ensure that recommendations of internal and external auditors have been implemented.

(e) **Types of regular reporting**

Types of regular reporting that could be: produced for the audit committee include:

- Listing of current top risks and up-to-date assessment of impact and likelihood
- Reports on control risks including how they are being managed
- Details of nay issues/concerns that have arisen
- Audit reports issued and impact on corporate governance
- Information on follow up on outstanding risks and findings from reports



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# TOPIC 11

# CURRENT ISSUES AND DEVELOPMENTS

**QUESTION 1**

(b) Under ISA 250 the auditor has a responsibility to recognise any non-compliance with laws and regulations that may materially affect the financial statements. The following are examples of cases where financial statements might be materially affected by social and environmental issues.

- Impairment of assets for example a new environmental Jawor regulation is introduced that might lead to impairment of assets.
- Contingent liability - a company may need to disclose contingent, liabilities in the financial statements when the expenses related to environmental matters cannot be estimated.
- Provisions - The company needs to make a provision for all the expenses related to environmental matters to be paid in next financial year.
- Going concern - In extreme situations, non-compliance with certain environmental laws and regulations may affect the ability of an entity to continue as a going concern. This may need to be disclosed while preparing financial statements.
- Development costs - If an entity develops any technology that would be environmentally friendly and would help to reduce pollution the estimated costs, need to be disclosed in the financial statements.

*JUNE 2012 QUESTION ONE B*

**QUESTION 2**

**a) Objectives of forensic investigation**

i) Forensic investigation can be used to assess financial data with intention of identifying fraud.
ii) Assists in legal proceedings by testifying as expert witnesses
iii) It can also be used in making written valuation on financial or economic loss suffered by a firm.
iv) Forensic auditing can be used as a basis of educating firms regarding measures to prevent fraud.

**b) Procedures to undertake in carrying out forensic investigation.**

i) A list of all employees before the factory was closed down should be obtained. This list should include the salaries that were paid to them before closure.
ii) The mathematical accuracy of the above should be confirmed including bank accounts and the actual amounts transferred to the accounts.
iii) The payroll should be reviewed to ascertain that these employees were included.
iv) Their details should be extracted from the payroll including salaries made to them
v) Request the bank to provide information for amounts transferred from the company's bank account to other bank accounts for the last 9 months. The purpose for doing so is to check if there are any trends that are not usual as regards movement of cash to other account.
vi) Interrogate the persons responsible for authorizing salary payments including those in charge of salary processing. Find out from them if they were aware of any irregularities during this time.

*DECEMBER 2011 QUESTION ONE A& B*



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**QUESTION 3**

Explain the approach that an auditor would follow in undertaking value for money audit in a public sector organization.

i) Gain an understanding of the public sector organization in terms of its various systems, goals, mission and vision.
ii) Undertake studies that are geared towards improvement of economy, efficiency and effectiveness of the public sector organization.
iii) Prepare statistical profiles of similar organizations in the public or private sector.
iv) Compare this data with the organization under question.
v) Identify performance gaps and give recommendations for improvement.
vi) Encourage the public sector organization to adopt the recommendations and put them in practice with better rating in terms of economy, effectiveness and efficiency.

*DECEMBER 2009 QUESTION FIVE A II*

**QUESTION 4**

**b) Forensic auditing**

- This is the process of gathering, analysis, and reporting on data, in a pre-defined context, for the purpose of finding facts and/or evidence in the context of financial or legal disputes and/or irregularities and giving preventative advice in this area.

Application to fraud investigations are;

**1. Litigation support**

This includes assisting counsel in investigating and assessing the integrity and amount relating to such areas as loss of profits, construction claims, product liability shareholder disputes, bankruptcies, and breach of contract

**2. Insurance claims**

A forensic accountant may be called upon to assist in the preparation and subsequent assessment of insurance claims on behalf of the insured and the insurer. The more significant areas relate to the calculation of loss arising from business interruption and personal injury matters,

**3. Fraud investigation.**

Forensic auditing can be applied in fraud investigation cases, for instance, tracing funds, asset identification and recovery, due diligence reviews.

**4. Criminal matters.**

In criminal matters, accountants and auditors as expert witnesses are increasingly important in court cases.





**5. Corporate investigations.**

The forensic accountant assists in addressing allegations ranging from kickbacks and wrongful dismissals to internal situations involving allegations of management or employee wrongdoing.

The Companies Act 1989 requires the Recognized Supervisory Bodies (such as the Association of Chartered Certified Accountants) to have rules and practices as to the technical standards to be applied in company audit work and as to the manner in which these standards are to be applied in practice.

*AUGUST 2009 QUESTION FOUR B*

**QUESTION 5**

**Regulation and Professionalism**
The purpose of this question is to examine students on current and potential changes in practice within the profession.

(a)
(i) Auditing standards are set by the IAASB. ICPAK adopts all of the auditing standards promulgated by the IAASB. Failure by auditors to comply with auditing standards lends them open to disciplinary action by their own accountancy body.

The Companies Act 1989 requires the Recognized Supervisory Bodies (such as the Association of Chartered Certified Accountants) to have rules and practices as to the technical standards t be applied in company audit work and as to the manner in which these standards are to be applied in practice.

Each Recognized Supervisory Body adopts auditing standards in order to meet the Companies Act requirement, and each body is required to have arrangements in place for the effective monitoring and enforcement of compliance with those standards. Failure to apply relevant auditing standards is a factor which an RSB will take into account when deciding whether persons are fit and proper to be eligible for appointment as company auditor.

(ii) Currently the responsibility within a company for the prevention and detection of fraud rests with management. As part of their business responsibilities, the directors of a company have a fiduciary duty to safeguard he assets.

The Cadbury Committee has recently recommended that the auditor should check that the board of a company has established a system which ensures compliance with legal requirements. The auditor is not responsible for preventing fraud but audit procedures should be designed to give the auditor a reasonable expectation of detecting any material misstatements, whether intentional or unintentional in a company's financial statements. This responsibility is set out in SAS 110 Fraud and error (January 1995).

(iii) The auditor should always strive to be objective in his professional judgment. He should not only be independent in fact but he must be clearly seen to be independent in practice. The RSDs has no objective in principle to a practice providing services to a client, additional to the audit.



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Care must be taken not to perform management functions or make management decisions. The auditor should not assist in the preparation of financial statements for public company clients unless the work is of a routine clerical nature or in emergency situation. Any fee paid to the auditor for non-audit work should be shown in the financial statements in addition to amounts paid for audit work.

Under the provisions of the Companies Act 1962, an auditor may not be an officer or employee of a client company. Thus it is necessary for the auditor to ensure that he does not make executive decisions.

For example if he recruits key financial and administrative staff, it could be construed as the performance of a management function. The auditor's objectivity may be threatened in such situation and he should be careful that he is not seen as acting as anything other than an independent adviser.

(iv) Under the Companies Act 1985 (s385),a company shall at each general meeting of the company at which accounts are laid, appoint an auditor to hold office from the conclusion of that meeting until the conclusion of the next general meeting at which accounts are laid.

The ethical guidance issued ICPAK does not specifically deal with the length of audit appointments. However, the auditor should always be aware of any potential threat to his independence which may because by an audit appointment which has lasted for a disproportionate length of time.

(b)

(i) Auditing standards are set by the Auditing Practices Board whose members are mainly drawn from the members of the auditing profession. The disciplinary procedures applied against an auditor for non-compliance with an auditing standard are enforced by the professional bodies of accountants. Thus politicians have criticized this self-regulatory procedure believing it to be open to abuse and lacking independence.

The argument put forward is that the consequences of auditing affect society and therefore in order to ensure that audits achieve social goals, auditing standards should be set by an independent body.

(ii) It is quite apparent from the press and audit research that the public believe that the auditor should and in fact does search for fraud during the conduct of an audit. In view of the recent scandals, particularly BCCI and the Maxwell affair, the public expectation of the extent of an audit has increased.

It is not surprising, given the nature of these scandals that the public finds it difficult to accept that an auditor has no responsibility for the detection and reporting of fraud, especially when one sees the high social cost of these scandals.

(iii) Audit firms do not act exclusively in the capacity of auditors for their clients. Audit work is in some cases, not the main business of audit firms. Auditors provide many other services to their clients including tax advice, brand name valuation and recruitment advice.

Audit firms are dependent upon the fees earned from non-audit services, and this dependency can affect the auditors' attitude to the audit. If an audit firm loses the audit, the financial loss



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to the auditors can be significantly more than just the audit fee he provides other services to the client. Thus a significant amount of pressure can be exerted upon the auditor if he supplies other services to the client.

A significant amount of an auditor's fee income derives from non-audit work and in an environment where the audit work is declining; fees for other services are becoming increasingly important.

(iv) It has been argued that the long term nature of the company audit engagement can lead to a loss in auditor independence due to an increasingly familiarity with the company's management.

In many Europe countries, the audit appointment has, by law, to be terminated after a fixed number of years. If the audit appointment was for a fixed minimum period, then auditors would not be under the same pressure to maintain their client base if they know that their relationship with the company was for a limited period, and that audit appointments would be rotated.

*DECEMBER 2004 QUESTION FIVE*

**QUESTION 6**

a) The three 'Es relate to economy, efficiency and effectiveness in value for money audits.
**Economy** relates to the attainment of the appropriate quantity and quality of physical, human and financial resources (inputs) at the lowest cost.
**Efficiency** is the relationship between goods or services produced (outputs) and the resources used to produce them. An efficient process would produce the maximum output for any given set of resource inputs, or would have minimum inputs for any given quantity and quality of product or service provided.
**Effectiveness** is concerned with how well an activity is achieving its policy objectives or other intended effects.

(b) (i)

| Internal control deficiency | Recommendation |
|---|---|
| A clerk transfers information from the order requisition to an order form. This could result in errors in orders being made after the buyer has authorized the requisition. | The order from should be signed off as authorized to confirm that the details on the requisition match those on the order form |
| The order requisition is thrown away once the chief buyer has authorized it. Any subsequent queries on orders cannot be traced back to the original requisition. | The order requisition form should be retained with the order form in case of query or dispute regarding items ordered. |
| No copy of the order form is retained by the ordering department. This means that goods could be ordered twice in error or deliberately, it also means that queries on deliveries cannot be chased up. | A three-part pre-numbered order form should be used and one copy should be retained by the ordering department with the requisition-form. |
| The Goods Inward Department does not retain a copy of the Damaged Goods note. If the note is lost on the way to the ordering department, or there is a query, the Goods Inward Department | Four copies of the Damaged goods note should be retained. One copy could be retained by the Goods Inward Department, one sent to the ordering department, one to the department who requested |

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| | |
|---|---|
| has no record of goods returned. | the goods, so they are aware that there will be a delay and one to the supplier. |
| **Internal control deficiency** | **Recommendation** |
| The ordering department does not keep a record of goods received, so is unable to confirm which orders are closed or to chase up suppliers | The Ordering Department should match orders to GRNs and mark orders as closed once all goods have been received. |
| The goods inward department files GRNS in order of the supplier's goods reference. This could make it difficulty to find a GRN at a later date if the department is not aware of the suppliers reference | GRNs should be filed in number. |
| **Additional deficiency** | **Recommendations** |
| There is no delegated level of authority for authorizing order requisitions - the chief buyer has to authorize all requisitions. This is not an efficient use of chief buyer's time. | A delegated level of authority should be introduced for the authorization of order requisitions. |
| Purchasing clerks place orders for goods from each individual order and some of these will be for duplicate items. Any volume discounts for ordering bulk items would therefore not be obtained and this shows lack of economy | Orders should be reviewed on a daily or weekly basis so that orders for the same item from different departments can be aggregated to take advantage of volume discounts |
| The copy of the GRM sent to the accounts department 6oss via the ordering department which delays the checking of the GRN to the order. This is insufficient. | To provide an earlier verification of whether goods relate to valid orders, a copy of the GRN should be sent directly to accounts. |
| GRN are filed in part number order which will prove inflow when a GRN needs to be located and retrieved as is the GRN number which is most likely to be known (due to cross referencing to invoices for example) | GRNs should be filed in GRN number order to make them easier to find |
| The structure of the department could be improved there is just one buyer and five purchasing clerks. This could cause problems when the buyer is on holiday, sick or leaves permanently. It may indicate inefficiency | The department's staffing Structure should be reviewed with a view to training one of the purchasing clerks to fill the buyer's role in instances of holiday or sickness. |
| There is inefficiency communication to the department created the purchase requisition on how the order is progressing. They do not know that their order has been made and would | A tracking system should be developed for orders so that the department that made the requisition can confirm when their goods have been ordered, the expected delivery date and then find out about any problems with the delivery. |

**b) MonteHodge**

Reasons for an internal audit department

There is a lack of internal control systems in place but an internal audit department could look at existing procedures and systems and make lots of useful recommendations to tighten up controls,

The internal audit department could make lots of useful recommendations in respect of good corporate governance, even though the company is not required to comply with corporate governance guidelines. If the directors did decide to float the company in the future, it would have to comply with such guidelines





The external auditors might be able to rely on internal audit work undertaken by the company's Internal' auditors and this in turn could result in a reduced audit fee.

The company will have to comply with financial services regulations in the future so an internal audit department could undertake work to ensure that it is complying with all required legislation and regulations.

The presence of an internal audit department within the company would present positive images to clients of the company.

The internal audit department could review the systems in place such as the stock market monitoring system and assess whether upgrades are required.

The internal audit department could provide benefit to the financial accountant, who is net qualified, in the areas of accounting regulations and the internal control system, for example

**Reasons against an internal audit department**

Setting up an internal audit department from scratch could prove expensive in terms of both time and money. The company will incur recruitment costs and the cost of additional staff salaries.

The company does not have to have an internal audit department in place as it is not listed and therefore under no obligation to comply with recommended codes of corporate governance such as the UK Corporate Governance Code.

The company's shareholders consist of six members of the same family. There is therefore not the same requirement to provide assurance on systems and internal controls as there would be to shareholders in a public company.

Many accounting systems are not necessarily complex so the directors may not see the need for another department to review their operations.

The directors and senior management may feel threatened by the presence of internal auditors looking at systems and controls.

Lift up your eyes, ye sons of light,
Zion's city is in sight; There our
endless home shall be, There our
Lord we soon shall see.

Cennick.



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NOTES

## ENVIRONMENTAL AND SOCIAL AUDIT

Environmental audit is a systematic process of obtaining and evaluating evidence on environmental impact of the entities activities with a view of making recommendations.

The audit seeks to assess how well the organization is performing in safeguarding the environment and whether it complies with environmental policies.

Environmental matters are sensitive as there exists laws and legislation regarding environmental protection.

Examples of environmental matters.

1. Pollution control
2. Keeping the waste at minimum
3. Conservation of energy
4. Recycling of products .
5. Using environmentally friendly materials.

Steps in an environmental audit

1. Obtaining an understanding of" the client balance sheet and activities.
2. Obtain an understanding of various environmental laws that may be affecting the balance sheet.
3. Obtain a copy of the companies' environmental policy.
4. Asses whether the policy is likely to achieve objectives such as meeting the legal requirements satisfying the customers and suppliers.
5. Test implementation adherence to the policy by discussion, observation, walkthrough tests
6. Write a summary report of the findings together with recommendations.

## SOCIAL AUDIT

It's an investigation of the company as a member of the community.
It involves;

1. Establishes whether the organization engages in social responsibility activities.
2. Establishing whether the organization has a rationale of engaging in such activities.
3. Establishing whether all the current environmental programmes and social actions are congruent with the mission of the company.
4. Assessing objectives and priorities relating to this programs
5. Evaluating the companies' involvement in such programs in the past, present and future.





**Lines of enquiry in social audit**

**1. Companies policy**
Questions to consider here include;
(a) Does the board recognize the need for social responsibility?
(b) What problems or pressure exist in relation to social responsibility.

**2. Community relations**
Questions to consider include;
(a) Dues the board have a constructive relationship with the community')
(b) Does a non-favorable image have a practical implication?

**3.Relationship with the employees**
Questions to consider include;
(a) Are employees given leave?
(b) Are there health and safety programs.

**4.Customer relations.**
Questions may include;
(a) Are customers grievances handled promptly?
(b) Is there a customer relations or care department.

**5. Pollution,**
Questions include;
(a) When was a comprehensive study made of present and future pollution')
(b) Is there monitoring on pollution.
(c) What is the cost and research and development to improve

**6. Minority group**
Questions include;
(a) Women are they discriminated against.
(b) Are physically and mentally challenged people given an opportunity?

**Effects of social and environmental issues on statutory audits**

1. At the planning stage they affect risk assessment
2. During the audit substantive tests will be performed on items such as provision of contingent liabilities research and development cost, cost of clean up etc.
3. During audit conclusion social and environmental matters may affect assessment of the going concern.

## VALUE FOR MONEY AUDIT

Examination of the 3 E's i.e.

- Economy
- Efficiency
- Effectiveness

**Economy**-how the firm obtains its input in terms of cost.
**Efficiency**-ratio of output to input

**Effectiveness**- are the activities relevant to the attainment of the companies objectives.



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Value for money audit can be done by external or internal auditors.

**Economy**

This is concerned with securing appropriate quantity and quality of physical human and financial resources at the lower cost

**Efficiency**

It's the ratio of output to input. It focuses on achieving the highest possible output using the minimal amount of input.

**Effectiveness**

It's concerned with how the management its achieving it objectives.

**Procedures for preparing value for money audits**

1) Define the terms of engagement as appropriate in an engagement letter. The auditor should discuss all the relevant issues including the scope right of access to records, types of reports to be used, basis of charging the fees.
2) Planning- where such an audit is being carried by an internal auditor it will be a routine function and therefore planning will entail reviewing the prior years working papers. If however the value for money audit is carried out by an external auditor then planning will entail the following;

   (a) Gaining a proper understanding of the organization by reviewing the set of objectives.
   (b) Perform H risk assessment and understand the control environment.
   (c) Develop the audit strategy.

3) Document the plan in terms of the audit staff requirements, procedures to be performed and timing of each procedure.
4) Examination-those examinations should confirm that [he targets or value for money are being achieved by reviewing the existence and soundness of the following:

   a) Any budgetary control policies
   b) Personnel policies e.g. such as those relating to compensation of staff.
   c) Asset management programs e.g. plant maintenance programmes
   d) Any arrangement to take advantage of economies of scale e.g. during procurement of goods.
   e) Control environment i.e. the attitude of the management or value for money issues.

5) Conclude by issuing a report which should include recommendations for improvement.

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