CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P4: AUDIT AND ASSURANCE

THURSDAY 6 MARCH 2014

TOTAL MARKS: 100 TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:

   Section A: One compulsory question.

   Section B: Four Optional Questions. Attempt any three (3).

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must NOT appear anywhere on your answer booklet.

4. Do NOT write in pencil (except for graphs and diagrams).

5. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

6. All workings must be done in the answer booklet.

7. Present legible and tidy work.

8. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A

QUESTION ONE

This question is compulsory and must be attempted.

(a) Cases of money laundering are on the increase in the business world today. Accountants have a duty to help identify money launderers and report any money laundering activities of their clients to relevant authorities. Accountants need to carry out procedures such as know your client procedures so that they do not offer professional services to companies or individuals involved in money laundering.

Required:

(i) Explain the term 'money laundering'. Illustrate your answer giving examples of money laundering offences, including those that could be committed by the accountant. (6 marks)

(ii) Explain the policies and procedures that a firm of accountants should establish in order to meet its responsibilities in relation to money laundering. (6 marks)

(b) Analytical procedures are a useful tool used by the auditors in the audit of financial statements.

Required:

(i) Describe what is meant by analytical procedures. (3 marks)

(ii) Briefly explain the use of analytical procedures in the audit of financial statements. Your answer should include the use of analytical procedures at the various stages of an audit. (5 marks)

(c) ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* gives guidance to auditors as regards risk in the client company.

You are the audit senior on five audits of your firm. In accordance with the ISAs you have just completed the risk assessment of five of your clients as part of audit planning. You assigned five senior audit assistants to assess the risks in each of the five clients. Below are the main risks identified and you are expected to design appropriate audit procedures to be conducted during the audit in response to the risks.

Client one risk:

Client manufactures and sells beds and it gives a two year warranty on the beds. This gives rise to a provision at the year end, the measurement of which involves a high degree of judgment, and therefore carries a risk of misstatement. This risk is increased by the fact that loan agreements are profit related and there is an incentive to manipulate areas of the financial statements based on judgments.

Client two risk:

The client is a paint manufacturer who sells paints to retailers such as hardware shops. The company has large stocks of paint which were manufactured over five years ago. The potency period for paint is two years after which it is considered obsolete. There is a risk that inventory figure at the period end may be misstated.

Client three risk:

A review of the revenue of this client revealed that the sales figures rise significantly at the end of each month. Customers are given extended credit and the credit limit is not considered for sales towards month end. It was also observed that the number of credit notes raised in the first week of each month was higher than at other times of the month. There is a risk that sales revenue may be misstated as well as the receivables.

Client four risk:

This client engages contractors to carry out various works on its behalf. The contractors are required to invoice at the end of each month for work carried out in that month. There has been a noted delay in contractors submitting invoices with the majority submitting invoices at the end of the following month.

Client five:

A review of the financial statements for the previous year of this client revealed that there is a figure of K25m described as a contingent liability. Management stated that this contingent liability arose from a legal suit from a contract entered into between the company and a third party. On further enquiry it was discovered that this case is still active in the courts of law. The case started in 2007 and all along it has just been disclosed as a contingent liability.

Required:

(i) Explain and differentiate between business risk and audit risk. (5 marks)

(ii) State the overall responses that the auditor has in response to assessed risks of a client according to ISA 330 *The auditor's responses to assessed risks.* (5 marks)

(iii) For each of the five (5) client risks above, describe the audit procedures that the auditor will undertake. (10 marks)

(Total: 40 marks)

SECTION B

There are four (4) questions in this section. Attempt any three (3).

QUESTION TWO

(a) ISA 550 *Related parties* gives guidance on related parties and transactions with related parties. Management is responsible for the identification and disclosure of related party transactions in the financial statements.

Required:

Explain what is meant by related parties and related party transactions stating why these pose a high risk for the statutory auditor. (4 marks)

(b) ISA 705 *Modifications to the opinion in the independent auditor's report* gives guidance to the auditor when issuing a modified audit opinion.

You are the audit manager on four of the clients of your audit firm. The audit seniors for these four audits have submitted the working papers for your review and on your request they have also submitted draft audit reports based on the evidence gathered.

Extracts of the proposed audit opinions for each of the four clients are given below:

Silver Ltd

The year-end of Silver Ltd is 30 September. Silver Ltd planned to conduct a physical inventory count on 30 September 2013. An electrical fault in the warehouse caused a fire which destroyed 40% of the inventory together with all the inventory records. Silver Ltd could not reliably determine the value of the remaining stock as all cost records were destroyed and they could only estimate stock values based on selling prices and profit margins for each line of inventory. The audit senior stated that he was not able to obtain any reliable evidence on the value of inventory which he considered material to the financial statements.

The audit senior has recommended that a qualified audit opinion should be issued with an emphasis of matter paragraph. (4 marks)

Bronze Ltd

The year-end of Bronze Ltd is 31 December. In mid-February before the finalization of the audit, one of the major customers of Bronze Ltd went into liquidation. At a meeting with all creditors of Bronze Ltd the liquidator announced that all creditors would only get 20% of the amounts that Bronze Ltd owes.

Bronze Ltd refused to amend the receivables figure arguing that as at the period end the major customer owed Bronze Ltd the amount outstanding.

The audit senior agreed with the accounting treatment of Bronze Ltd and recommended that an unmodified audit opinion be issued. (4 marks)

Gold Ltd

Gold Ltd is a retailer of cloths at one of the leading shopping malls in the city. The company stocks a range of clothes and has the latest fashions in stock at all times. Any stocks that get out of fashion are written down in the financial statements.

Gold Ltd imported a large quantity of clothes in November hoping to take advantage of the festive season with an expectation of increased sales. Sales were not as high as expected and at the year-end on 31 March 2013 Gold Ltd still had high volumes of clothes most of which will be sold at less than cost.

During the audit it was established that Gold Ltd valued its entire inventory at cost and they were not willing to value the inventory at net realizable value.

The audit senior has recommended that the audit opinion should be modified by way of a disclaimer of opinion. (4 marks)

Quartz Ltd

Quartz Ltd is in the construction industry and it acquires pieces of land on which it builds houses for resale. During the audit of tangible non-current assets, it was established that the value of eight housing units constructed for resale was included in tangible non-current assets instead of inventory. The value of these housing units represents 80% of the total assets of Quartz Ltd.

The audit senior in charge of this audit recommended that qualified opinion be issued clearly stating that except for the value of the eight units the financial statements show a true and fair view. (4 marks)

Required:

Comment on the suitability of the recommended audit opinions clearly stating the arguments for or against the recommendation. (16 marks)

(Total: 20 marks)

QUESTION THREE

(a) The objective of the auditor is to test for over and understatement of figures in the financial statements. Auditors do not test the same entries for both over and understatement. Testing for both over and understatement would not be cost effective for the auditor.

The primary tests are to test assets and expenses for overstatement and to test liabilities and income for understatement. Through the principle of directional testing, transactions are tested for both understatement and overstatement.

Required:

Describe directional testing and demonstrate how transactions are tested effectively for both over and understatement using directional testing. (4 marks)

(b) You are the audit manager in your firm of chartered accountants. You partner has called you for an urgent meeting. The partner has informed you that your firm is being threatened with litigation by one of your major audit clients. He informs you that he has received a letter from the managing director of this client in which the client has stated that they have discovered a fraud which will result in huge losses to the company and they attribute this to negligence by your firm. A number of suppliers have also threatened to sue your client for losses suffered but your client has indicated that he has advised the suppliers to instead sue your firm directly as the audit had been negligently performed.

At an extraordinary general meeting the shareholders approved management's recommendation that the company should sue your firm.

Your partner has indicated to you that you will be appointed quality champion in your firm and you will be in charge of quality throughout the firm. He has suggested that as a matter of urgency a training session be arranged for all staff at which matter of quality should be discussed.

Your training should focus on highlighting the provisions of ISCC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* and ISA 220 *Quality control for an audit of financial statements.*

Your partner has also asked you for advice on the intended litigation against your firm.

Required:

(i) Advise your partner on the validity of the intended litigation by the client company and the suppliers who have been advised to sue directly. (8 marks)

(ii) Prepare training notes for the proposed training explaining the quality control requirements per ISQC 1 and ISA 220. (6 marks)

(iii) Explain two (2) methods that your firm may use to reduce its exposure to litigation arising from professional negligence. (2 marks)

(Total: 20 marks)

QUESTION FOUR

(a) An extract from the draft audit report of one of your firm's clients reads as follows:

'We have audited the financial statements of Zambezi Plc which comprise the statement of financial position as at 31 December 2013 and the statement of comprehensive income, the statement of changes in equity and statement of cash flows for the year then ended, and notes to the financial statements, which include a summary of significant accounting policies and other explanatory notes set out on pages 15 to 48.'

Your partner has requested you to go through the 'other information' contained in the financial statements as prepared by the client's management to confirm that it is consistent with the financial statements and other audit evidence obtained.

During the review of the other information, you come across a matter that is inconsistent with the financial statements and which in your view should be amended. Management has not accepted your recommendation that the other information be amended so that the inconsistence is removed.

Required:

(i) Discuss the responsibilities of your firm as regards other information contained in the draft financial statements on pages 1 to 14. (5 marks)

(ii) Give four (4) examples of matters that may be contained in the other information in the draft financial statements and state the action your firm will take in view of the refusal by management to amend the other information. (4 marks)

(b) An extract from the draft statement of financial position relating to inventory shows the following details:

	Km
Raw materials	979
Finished products	1 021
Total	2 000

The total assets in the draft statement of financial position amount to K3.143m and the profit after tax for the same period is K3.450m.

Required:

(i) Discuss the meaning of cut off in relation to inventory and state the audit procedures that should be undertaken to confirm this assertion. (3 marks)

(ii) Explain the main reasons why statutory auditors are concerned with misstatements of the inventory figure in the financial statements. (2 marks)

(iii) Describe three (3) financial statement assertions relating to the figure of inventory and state the audit procedures that should be undertaken to test the assertions. (6 marks)

(Total: 20 marks)

QUESTION FIVE

(a) Reliable Ltd is a cement manufacturing company which has been operational for the last ten years. The company is located in an area that has seen an increase in the population.

The company acquired 100 hectares of land located ten kilometers away from the factory. Raw material in the manufacture of cement are extracted from this land and transported by road to the factory. The road passes through a highly populated area of the town in which the factory is located. The company emits toxic substances from its processes and these are evident from the effect on the vegetation within the location of the factory.

There is legislation with regards to emissions of toxic substances into the atmosphere and there is a maximum limit of emissions that should not be exceeded. A new law has been passed that requires all companies that cause damage to the environment through activities such as mining and quarrying to restore the environment at the end of their business activities. Further, the company is subject to the factories act which specifies minimum requirements as regards health and safety of workers and non-adherence with these rules could result in the operating license being revoked.

As part of its social responsibility the company has been supporting the local football league and also giving annual grants to the local health facility. The company has further committed itself to sponsoring 100 vulnerable children to institutions of higher learning in the next three years.

Required:

(i) Using the information in the scenario, describe the relevance of social and environmental matters to the auditor and state how they could impact the financial statements of a client company. (6 marks)

(ii) Suggest performance indicators that could reflect the extent to which Reliable Ltd meets the social and environmental responsibilities it has set for itself. (4 marks)

(b) Your firm of chartered accountants is the principal auditor of the Mafuta group of companies.

The group consists of five subsidiaries and a head office all located in five different countries in central Africa. Each of the subsidiary companies prepares its own annual financial statements in the local currency of the country they are based. Three of the subsidiaries have 31 March as their year end and the other two 31 December as their year end.

At the year end the individual subsidiary financial statements are converted in a common currency the US$. The consolidated financial statements are prepared as at the end of December and necessary adjustments are made in view of the different year ends. All but one of the subsidiaries comply with international financial reporting standards.

Each subsidiary is free to appoint external auditors of its choice and currently each of the five subsidiaries is audited by a different audit firm.

Required:

(i) Discuss the risks inherent in the audit of the consolidated financial statements of the Mafuta group of companies. (6 marks)

(ii) Discuss the meaning of significant components and state the extent of the work that the principal auditors will undertake on the financial statements of a significant component. (4 marks)

(Total: 20 marks)

END OF PAPER

SUGGESTED SOLUTIONS

SOLUTION ONE – P4

a) Money laundering:

i. **Meaning of money laundering**:

Money laundering is the process by which criminals attempt to conceal the true origin and ownership of the proceeds of their criminal activity, allowing them to maintain control over the proceeds and, ultimately, providing a legitimate cover for their sources of income.

Money laundering has three stages as follows:

Placement:

This is the process of getting the money into the system in the first place. This could be by making bank deposits, or through a business front being a legitimate business used to launder money.

Layering:

This is the use of lots of different transactions to create so many layers of transactions between the initial placement of dirty money and the money that is taken out at the end, which it is difficult to trace.

Integration:

This is the extraction of funds from the laundering system, and integrating them back into the world of legitimate and usable money.

Examples of money laundering offences:

- Handling proceeds of criminal activities.

- Arranging the acquisition or use of criminal property. This may include becoming involved with tax evasion.
- Tipping off – when the Money Laundering Reporting Officer (MLRO) or any individual discloses something that might prejudice any investigations.

ii. Policies & procedures accountants should establish:

Appoint a Money Laundering Reporting Officer (MLRO) and implement reporting procedures

The MLRO should have a suitable level of seniority and experience. Individuals should make internal reports of money laundering to the MLRO. The MLRO must then consider whether to report to the Drug Enforcement Commission, and document this process.

Train individuals:

Train individuals to ensure that they are aware of the relevant legislation; know how to recognize and deal with potential money laundering, how to report suspicions to the MLRO, and how to identify clients.

Internal procedures:

Establish internal procedures appropriate to forestall and prevent money laundering, and make relevant individuals aware of the procedures.

Procedures should cover:

- Client acceptance
- Gathering 'know your client' (KYC) information
- Controls over client money and transactions through the client account.
- Advice and services to clients that could be of use to a money launderer.

Verify client identities:

The firm must be able to establish that new clients are who they claim to be. They should verify the identity of new and existing clients, and keep the evidence of this on file – typically, copies of evidence such as passports, driving licenses and utility bills. For a company this will include identities of directors and certificates of incorporation.

Record keeping:

Maintain records of client identification, and any transactions undertaken for or with the client. Special care needs to be taken when handling client's money to avoid participating in a transaction involving money laundering.

Conclusion:

There are a number of ways that the accountant could become involved in money laundering. It is important that a firm has adequate procedures in place to ensure that it does not fall foul of money laundering legislation, and that it ensures that these procedures are adhered to.

b) Analytical procedures:

i. Meaning of analytical procedures:

Analytical procedures consist of the evaluations of financial information made by a study of plausible relationships among both financial and non-financial data.

Analytical procedures encompass the investigation of identified fluctuations and relationships that are consistent with other relevant information or deviate significantly from predicted amounts. Basically using analytical procedures involves calculation of ratios and an analysis of the meaning in the changes in the ratios computed.

ii. Use of analytical procedures:

At the planning stage of the audit:

Analytical procedures can be used at the planning stage of the audit. ISA 315 requires the use of analytical procedures during the risk assessment stage. Analytical procedures are used by the auditor to gain an understanding of the entity.

During the substantive stage of the audit:

Analytical procedures are an efficient tool used by auditors at the substantive audit stage where the objective is to detect material misstatements in the financial statements. Comparisons of figures between the expected figures or trends with the calculated amounts based on analytical procedures. These will highlight where misstatements are likely to exist.

At the review stage of the audit:

At the review stage analytical procedures are used to determine whether the financial statements make sense. Calculation of key ratios is done and any unusual ratios or fluctuations are investigated further.

c) Risks:

i. Business risk and audit risk:

Risk can be explained as the chance that something that is undesirable may happen.

Business risk:

Business risk is related to the business and looks at issues that would affect the business. Management is responsible for putting in place a risk

management system so that they identify the risks that would affect the operations of the business and respond appropriately.

Audit risk:

Is risk is the risk that the auditor expresses an inappropriate audit opinion when the financial statements are materially misstated. Audit risk focuses on the financial statements and comprises of inherent risk, control risk and detection risk.

Responses to audit risk:

- Emphasizing to the audit staff the need to maintain professional skepticism.
- Assigning additional or more experienced staff to the audit team.
- Providing more supervision on the audit.
- Incorporating more unpredictability into the audit procedures.
- Making general changes to the nature, timing or extent of audit procedures.

ii. Audit procedures for risks identified:

Client one

- Establish the amount provided for warranty at the period end.
- Establish the basis of the amount provided and the assumptions made by the accountants.
- Re-perform the calculations made and establish the level of warranty costs in the year and compare with the previous provision.
- Review the level of repairs/replacements post year end and use these to assess the reasonableness of the provision.

Client two

- Review client inventory count instructions and ensure clear on identification of slow and obsolete items.
- Attend inventory count at the period end and assess extent of obsolete paints.
- For a sample of inventory lines confirm valuation to ensure that valued at lower of cost and net realizable value.
- Examine any post year sales for sample of items to determine the net realizable value.

Client three

- Enquire from management the reason for sudden increase in sales revenue at month end.
- Examine a sample of invoices and ensure revenue is recorded in the correct period.

- At the period end get details of the last invoice and delivery notes and ensure they are processed in the correct period.(cut off)
- Get sample of credit notes raised and establish reason for reversals and if not satisfactory discuss with management.
- Circularize receivables at the period end to obtain third party evidence on the year end balances.

Client four

- Obtain details of accruals made at the period end.
- Examine post year end payments and determine which one are related to the previous year to help determine reasonableness of management's accruals.
- Review invoices and payments after the year end, and if they relate to the work done before the year end ensure that they are included in accruals.
- Consider circularizing payables and confirm balances at the period end.

Client five

- Obtain management representations concerning this amount.
- Go through previous year working papers and establish reason for contingent liability.
- With the permission of the client discuss with the lawyers of the client and find out their views.
- Based on findings on the matter evaluate if it meets criteria in IAS 37 in which case needs to be provided for.
- May wish to seek legal advice from independent lawyer.

SOLUTION TWO

a) Related parties and related party transactions:

Related parties:

Person may be related to the entity:

- Could be individuals or persons or close members of that person's family
- Who is related to the reporting entity and that person:
  - Has control or joint control over the reporting entity,
  - Has significant influence over the reporting entity or
  - Is a member of the key management personnel of the reporting entity or of a parent of the reporting entity.

An entity is related to a reporting entity:

- Entity and reporting entity members of the same group.
- One entity is an associate or joint venture of the other entity.
- Both entities are joint ventures of the same third party.

Related party transactions:

These are transfers of resources or obligations between related parties, regardless of whether a price is charged.

Why related party transactions high risk:

- Because usually they take place at no price at all and hence difficult to establish from an audit.
- Related parties are difficult to identify and are not self-evident to the auditors.
- These could be transactions with a party that the auditors could not reasonably be expected to know is a related party.
- Active steps can be taken by management to conceal either the full terms of a transaction, or that a transaction is, in substance, with a related party.
- The corporate structure is complex to determine related party relationships and related party transactions.

b) Silver Ltd

The form of modification that should be given in this case will depend on two factors. The materiality of the matter and whether it is pervasive to the financial statements. The question states that the matter is material but it does not state whether or not the matter is pervasive.

In the event that the matter is material and not pervasive, the appropriate opinion would be a qualified report with an except for opinion.

If the matter is both material and pervasive then the opinion will be an adverse opinion stating that the financial statements do not show a true and fair view.

Conclusion:

The use of a qualified opinion and an emphasis of matter as suggested by the audit senior is wrong. An emphasis of matter paragraph is not a modification of the audit report.

Bronze Ltd

The event of a large customer of Bronze going into liquidation after the year end is an adjusting event subject to the provisions of IAS 10 *Events after the reporting period.*

The fact that the customer has gone into liquidation and the amount to be settled to creditors determined gives additional information of the conditions that existed at the period end. There is need to make a provision for the amount that may not be collected from this customer.

Under ISA 560 the auditor has a responsibility under ISA 560 Subsequent events to identify any such events and ensure they are correctly accounted for by management. Management's refusal to make a provision is not correct and the auditor should ensure correct treatment of this event.

Conclusion:

The audit senior is not right in suggesting that an unmodified opinion be issued. If management insist that they cannot amend the provision at the period end, depending on the materiality and pervasiveness of the matter the auditors should consider modifying the audit opinion.

Gold Ltd

IAS 2 *Inventories* requires that inventory should be valued at the year end at the lower of cost and net realizable value. The standard recognizes the fact that if inventory is overvalued then this will result in a direct overstatement of profits.

Since it is clear that Gold Ltd will not be able to sell the clothes at more than cost then the closing items should be valued at the net realizable value.

Further, the auditors have gathered sufficient appropriate audit evidence and therefore cannot use a declaimer of opinion which is only used when the auditor has not obtained sufficient appropriate audit evidence.

Conclusion:

The audit senior is wrong in suggesting a disclaimer of opinion should be used. Depending on the materiality and pervasiveness of the matter, the appropriate opinion will either be qualified or adverse.

Quartz Ltd

Capitalizing houses meant for resale is an error of principle and will cause misstatements of the financial statements. The value of the houses in question accounts for 80% of the total assets and so the matter is material.

The value of the misclassification of inventory as tangible non-current assets is material at 80% of the total assets. The management should be requested to correct the mistake and if they refuse then the auditor should consider modifying the report.

Conclusion:

The appropriate form of modification is an adverse opinion that the financial statements do not show a true and fair view. The audit senior is not right by suggesting that a qualified opinion be issued.

SOLUTION THREE

a) Directional testing:

Amounts in the financial statements are supposed to be tested for both overstatements and understatements. Directional testing is a principle that arises out of the double entry book keeping whereby for every transaction there are two aspects. For this reason when one aspect is tested, inevitably the other aspect on the opposite side is also tested.

For example:

If a test on a debit entry to a receivables account is done inevitably this will be testing the corresponding entry in the revenue account.

Using the principle of directional testing, assets and expenses are primarily tested for **overstatement** indirectly testing the **corresponding credits** for **overstatement.** Liabilities and income are primarily tested for **understatement** therefore indirectly testing the **corresponding debits** for **understatement.** By so doing both assets/expenses and liabilities/income are tested for both over and understatements.

Using directional testing is more efficient than if the same transactions are tested directly for both over and understatement.

b) Quality control and professional negligence:

General guidance:

A number of parties are likely to bring action against companies for professional negligence. For an action to succeed against the company, the following must be proved by the plaintiff:

- The existence of a duty of care on the part of the auditors to the injured party.
- The fact that the duty of care was breached and
- The injured party suffered loss as a result of the breach of the duty of care.

i. Litigation by company:

In the case of a company suing the auditors for professional negligence, the following should be noted:

- The company can sue and this means all shareholders acting as a body. An individual shareholder may not bring an action against the auditors. As regards the factors that must be proved the following is the position:
  - The duty of care is assumed to exist between the auditors and the shareholders acting as a group through the company. This need not be proved in an action.
  - Breach of duty has to be proved by the company that the auditors were negligent.

- The company should also prove that it has suffered loss as a result of the breach of duty by the auditor.

Conclusion:

In the case on hand, the company may sue the firm if it feels it has a strong case. The duty of care is assumed but the company will have to prove breach of duty and suffering loss as a result of breach of duty. The firm should be prepared to defend itself against litigation that may be brought against it.

Litigation by third party:

Generally, third parties cannot bring an action against the auditors for professional negligence. This is because the contract by the auditor is between the auditor and the client and not all and sundry.

To succeed in any action against the company a third party should:

- Prove that there exists a duty of care between the auditors and the third party.
- Prove that there was a breach of the duty of care and
- That the third party suffered loss as a result of that breach.

The leading case in support of the above is Caparo Industries v Dickman where it was held that that auditors of a public company owe no duty of care to members of the public at large who relied in the financial statements.

Conclusion:

In line with the decision in Caparo case the suppliers may not succeed in an action against the company unless they prove all the three factors that:

- There existed a duty a care between the firm and them.
- That there was a breach of that duty of care and
- They suffered loss as a result of the breach.

ii. Quality control at the firm level:

Guidance is contained in ISQC 1 *Quality control for firms that perform audits and reviews of financial statements, and other assurance and related services engagements* which provides thus:

The audit firm should have documented quality control policies and procedures.

The policies and procedures should cover the following areas:

- Firm and leadership responsibilities for quality within the firm.
- Human resources in terms of recruitment and considering capabilities, competence and commitment to ethical principles necessary to perform it engagements in accordance with professional standards and regulatory and legal requirements.

- Engagement performance – to ensure that all engagements are performed correctly in accordance with standards. These polices will cover the conduct and supervision of the individual audits and are also dealt with by ISA 220.
- Monitoring – Policies and procedures that continuously monitor their quality control systems on a continuous basis.

Quality control at the individual audit level:

Guidance is contained in ISA 220 *Quality control for an audit of financial statements* which provides as follows:

The guidelines in this standard are specific to quality issues at an individual audit level. The ISA states that the objective of the auditor is to implement quality control procedures at the engagement level that will give assurance to the auditor that:

- The audit complies with professional standards and applicable and regulatory requirements and that
- The auditor's report issued is appropriate in the circumstances.

The standard requires that the firm should consider the following at the individual audit level:

- Leadership at the individual audit level is in the hands of the engagement partner.
- Ethical requirements should be met by the firm and the audit team members particularly issues of independence.
- Acceptance/continuance of client relationship – ensure policies in place for acceptance and continuation of audits.
- Assignment of engagement teams – engagement partner responsible for assigning a team that is appropriately qualified and experienced.
- Engagement performance – relates to the guidelines on the direction, supervision, review and consultation matters in an audit.

iii. Methods of reducing exposure:

Client acceptance procedures:

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

Performance of audit work:

Firms should make sure that all audits are carried out with professional standards and best practice, adhering to the requirements of ISAs. It is

crucial in particular that proper documentation is kept, as this will be useful in the event of litigation.

Quality control:

Firms should implement quality control procedures in line with guidance contained within ISQC 1 *Quality Controls for Firms that Perform Audits and Reviews of Financial Statements, and Other Assurance and Related Services Engagements* and ISA 220 *Quality Control for an Audit of Financial Statements.*

Issue of appropriate disclaimers:

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

SOLUTION FOUR

a) Other information contained in financial statements:

i. Responsibility of auditors regarding other information:

Other information in the financial statements includes any information that accompanies the financial statements excluding the income statement, the statement of financial position, the statement if changes in equity and the notes to the financial statements. In the scenario in the question, the other information is that which is contained on pages 1 to 14 not referred to in the audit report.

ISA 720 *The auditor's responsibilities relating to other information* gives guidance to the auditor:

- The auditor does not have any obligation to report on the other information in the financial statements.
- The auditor's responsibility is to read the other information to identify material inconsistencies if any with the audited financial statements.
- Material inconsistencies may raise doubt about the audit conclusions drawn from the audit evidence previously obtained and possibly, about the basis for the auditor's opinion on the financial statements.
- If there is a material inconsistence between the other information and the financial statements, the auditor will determine whether the audited financial statements or the other information need to be revised. If financial statements need to be revised and the client refuses, the auditor shall consider modifying the report.

ii. Examples of other information:

- A report by management or the board of directors on the operations of the entity.
- Financial summaries or highlights

- Employment data
- Planned capital expenditure
- Financial ratios
- Names of officers and directors
- Selected quarterly data

Action if management declines to change other information:

- If the other information needs to be changed and management refuses then:
  - The auditor shall discuss the matter with those charged with governance.
  - May include in his report an Other Matter paragraph describing the material inconsistence in accordance with ISA 706 or he may withhold the auditor's report or
  - In the worst case he may withdraw from the engagement.

b) Cut off relating to inventory:

i. The assertion of cut off refers to the fact that inventory received or sold must be recorded in the correct financial year. For example if the year-end is 31 March, then all inventory received on or before this date is recorded in the current year under review. Inventory received after 31 March should be recorded in the following accounting period. Incorrect cut off may result in a misstatement of the financial statements.

Audit procedures relating to cut off:

- During the inventory count at the year end, note the last Goods Delivery Note number (GDN), the Goods Received Note (GRN) number.
- Take note of the first GDN and GRN numbers after the year end.
- Check that the noted documents have been processed in the correct financial year.

ii. Effect of inventory misstatement:

The inventory figure for most manufacturing and trading companies is a material figure. For this reason any misstatement of the figure of inventory is likely to lead to a misstatement of financial statements.

Further, any material misstatement of inventory has a direct effect on the profitability of the entity. If inventory is materially overstated, then profit will be overstated by the same amount and vice versa for any understatement.

iii. Financial statement assertions relating to inventory:

Existence – this is the assertion that the inventory represented by the figure in the financial statements existed at the period end.

Audit procedures:

- Observe physical count at the period end.
- For inventory held by third parties obtain third party confirmation.

Rights and obligations – This means that the inventory at the period end and represented by the figure of inventory in the financial statements belongs to the entity.

Audit procedures:

- Verify that inventory held for third parties not included in the year-end inventory figure by being appropriately segregated during the inventory count.
- Ensure that any inventory held by third parties is included in the year-end inventory figure.

Valuation and allocation – this is the assertion that the inventory valuation has been correctly done in line with the provisions of IAS 2 *Inventories.*

Audit procedures:

- Obtain copy of inventory listing and agree totals with the general ledger.
- Cast the inventory listing to ensure it is mathematically correct.
- Vouch a sample of inventory items to supplier's invoices to ensure it is correctly valued.
- Examine prices at which finished goods have been sold after the year end to ascertain whether any finished goods need to be written down.

Accuracy – is the assertion that the figure of inventory is accurate and there is no material misstatement. All inventory that should have been included has been included.

Audit procedures:

- Obtain a copy of the inventory listing and cast it and test the mathematical extensions of quantity multiplied by price.
- Trace the test counts back to the inventory listing.
- If the entity has adjusted the general ledger to agree with the physical inventory count amounts, agree the two amounts.

SOLUTION FIVE:

a) Reliable Limited:

i. Relevance of social matters to the auditor:

Social matters to the entity relate to how the entity treats the society in which it is operating. The entity obtains its inputs from the society and also sells its outputs to the society. For this reason most organizations recognize the fact that they have a social responsibility to give back to the community within which it operates.

In the example given this is by way supporting the local football league and also the awarding of annual grants to the local health facility. The company commitment to sponsor vulnerable children to institutions of higher learning is also part of its social responsibility.

The impact of social responsibility and the auditor concern:

- If a company meets is social responsibility targets then it will be treated like a good citizen by the community.
- There could be legislation pertaining to social responsibility and meeting these targets is indicative of compliance with relevant legislation. For example the company may be committed not to cause harm to employees or the environment. Breach of legislation might have implications for the going concern of the entity.

Environmental matters:

Environmental issues are highly regulated in many countries with heavy fines for non-compliance. In the worst scenario, the entity may have its licence to operate withdrawn if it does not comply with environmental legislation. The company is subject to the factories act as well as the new law passed requiring companies to restore the environment at the end of its life. Non-compliance with legislation has going concern implications for the auditor.

Environmental matters also have an impact on provisions. In this case, under the new legislation the company has an obligation to restore the environment at the end of its activities. There is a risk that provisions may be misstated.

ii. Social responsibility Key performance indictors:

- How many teams supported per year.
- Amount spent on supporting league per year.
- Amount spent on annual grants to health facility as % of total grants.
- Number of injuries per month or year.
- Number of fatalities per quarter or year
- Number of students sponsored per year.

Environmental performance key indicators:

- Cubic meters of toxic substances emitted per month or per year.

b) Mafuta Group of Companies:

i. Risks inherent in the group accounts of the Mafuta Group:

- The fact that the subsidiaries are situated in five different counties poses a risk in the audited accounts of the subsidiaries as the quality of the audits may be different from one country to the other. The different countries may have different oversight rules and regulations.
- There is a risk that the consolidation process is not properly done by the holding company.
- There is a risk of misstatement arising from the conversion of local currency financial statements into the holding company currency.
- The different year ends pause a risk in adjusting the financial statements of the other financial statements so that all accounts consolidated are prepared to the same accounting period.
- One of the subsidiaries is not subject to the IFRS and so there might be need to adjust some figures in the financial statements before they are consolidated and there is a risk that this may not be done correctly.
- The fact that each of the subsidiaries is audited by different auditors poses a risk on the principal auditors as to the quality of the work that has been carried out.
- The fact that the principal auditor will rely on the work of the component auditors is a risk as it will form an opinion on financial statements it has not audited.

ii. Meaning of significant component:

A significant component is one that is identified by the group engagement team that is of individual significance to the group or that due to its specific nature or circumstances, is likely to include significant risks of material misstatement of the group financial statements.

Extent of work by principal auditor on significant component financial statements:

- The group auditor should be involved in the assessment of risk in relation to significant components.
- If component financially significant to the group financial statements, then the group engagement team may perform a full audit based on the component materiality level.
- Group auditor may carry out an audit of specified account balances related to identified significant risks
- Discussion with the component auditor or component management regarding the component's business activities that are significant to the group.

- Discussing with the component auditor the susceptibility of the component to material misstatements of the financial information due to fraud or error.
- Reviewing the component auditor's documentation of identified significant risks of material misstatements including the conclusions drawn by the component auditors.

END OF SUGGESTED SOLUTIONS