

## SOLUTION ADVANCED AUDIT AND PROFESSIONAL ETHICS NOV 2010

### SOLUTION 1

Dawuro Ltd

(a) Principal business risks

Tutorial note: *The requirement to 'identify and describe' suggests that although marks will be awarded for the mere identification of risks from the scenario, those risks must be described (as illustrated below).*

(1) 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.
- Dawuro Ltd cannot predict how emerging and future technologies (eg 'Bluetooth') will affect demand for its services.

(2) Competition

- Although Dawuro Ltd 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 Dawuro Ltd's ability to attract and retain customers
  - reduce Dawuro Ltd's share of new and existing customers
  - force Dawuro Ltd to reduce prices.
- The cost (and revenue-generating capabilities) of new technologies tends to fall significantly and relatively quickly (eg mobile phone technology is available in disposable form).

(3) 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, Dawuro Ltd's operational activities, financial condition and future prospects are likely to be adversely affected.
- Dawuro Ltd may have difficulty in adapting its corporate image to the culture of the Indian network.

(4) Operating losses

- Loss before taxation has in the short-term. Although the groups operations are being combined and more than doubled (increased by 113%). If Boafu Ltd was making significant losses before it was acquired by Dawuro Ltd those losses may have been expected to continue synergies are expected, recurring losses will clearly threaten the new group's operational existence as a going concern.

- (5) Falling ARPC
- ARPC, a key performance indicator, has fallen by more than 20% ( $(437-556/556 = 21.4\%)$ ). This is likely to reflect falling tariffs in a competitive market.
  - Although the number of customers has nearly doubled (increased by 96%), revenue has increased by only 55%. It seems unlikely that such a growth in customer base can be maintained, therefore the reduction in tariffs could result in falling revenues.
  - Some (if not all) of the growth, is due to the acquisition of Boafo Ltd. The fall in ARPC may indicate that Boafo Ltd's ARPC (now absorbed into the enlarged Dawuro Ltd group) is substantially less than that of Dawuro Ltd. If Boafo Ltd's tariffs were lower than Dawuro Ltd's because it was offering a lower level of service it may be difficult for Dawuro Ltd to increase them albeit for an enhanced service.

#### 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 Dawuro Ltd'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.

Tutorial note: *Although there are relatively explicit pointers to the above business risks in the scenario, marks will also be awarded for other risks which are perhaps more implicit (as illustrated below).*

- (6) Countries of operation
- Operations have been expanded from European countries to India. Dawuro Ltd's inexperience of economic and legal developments in India may impair the investment in Ahoma Ltd.
- (7) Foreign exchange rates
- Dawuro Ltd transacts business in several countries and foreign exchange rate fluctuations could have a material adverse affect on operating results.
- (8) 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 Dawuro Ltd's network coverage.
  - Allegations of health risks (eg associated with radio waves from transmitter masts and mobile handsets) could reduce customer demand and increase exposure to potential litigation.

Tutorial note: *Candidates are not expected to have knowledge of industry-related*

*complexities (eg of licensing, subsidies and network recharging) – however, appropriate marks would be awarded for comments on such business risks arising.*

(b) Impact of acquisition on planning

Tutorial note: *Note that the context here is that of the principal auditor's planning of a group audit.*

(1) Group structure

The new group structure must be ascertained to identify the entities that should be consolidated into the group financial statements of Dawuro Ltd for the year ending 30 September 2006.

(2) Materiality assessment

Preliminary materiality will be much higher, in monetary terms, than in the prior year. For example, if a % of revenue is a determinant of preliminary materiality, it will increase by 55% (based on estimate).

Tutorial note: *'Profit' is not a suitable criterion as group is loss-making.*

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 revenue (but not result) is material and less than 5% (say) is not. This will identify, for example:

- those entities requiring an audit visit by the principal auditor; and
- those for which analytical procedures may suffice.

If Ahoma Ltd is particularly material to the group, Eghan may plan (provisionally) to visit Ahoma auditors to discuss any problems shown to arise in their audit work summary (see group instructions below).

(3) Goodwill arising

The audit plan should draw attention to the need to audit the amount of goodwill arising on the acquisitions and management's impairment test at the balance sheet date.

The assets and liabilities of Boafu Ltd and Ahoma Ltd, 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 (Boafu Ltd – February 2009, Ahoma – November 2009).

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 quantity surveyors or other property valuers.

(4) Group (related party) transactions and balances

A list of all the companies in the group (including any associated companies) should be included in group audit instructions to ensure that intra-group transactions and balances (and any unrealised profits and losses on transactions with associated companies) 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 Dawuro Ltd companies and that inter-company balances are regularly reconciled. (Problems are likely to arise if new intercompany balances are not

identified/reconciled. In particular, exchange differences are to be expected.)

(5) On analytical procedures

Having brought in the operations of a group of companies (Boafo Ltd) with similar activities may extend the scope of analytical procedures available. This could have the effect of increasing audit efficiency.

The effective date of the acquisition of Boafo may be so late in the financial year (only four to eight weeks, say, before the year end) that it is possible that its post-acquisition results are not material to the consolidated income statement.

(6) Other auditors

Other auditors will include:

- any affiliates of Eghan in any of the countries in which Dawuro Ltd (as combined with Boafo Ltd) operates; and – unrelated auditors (including those of Ahoma). Eghan will plan to use the work of Ahoma's auditors who are Chartered Accountants. Their competence and independence should be assessed (eg through information obtained from a questionnaire and evidence of their work).

A letter of introduction should be sent to the unrelated auditors, with Dawuro Ltd'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 Eghan's audit team).

(7) Accounting policies (Boafo Ltd & Ahoma Ltd)

Whilst it is likely that Ahoma Ltd has the same accounting policies as Dawuro Ltd (because, as a competitor, it operates in the same jurisdictions) Ahoma Ltd may have material accounting policies which do not comply with the rest of the group. Eghan may request that Ahoma's auditors calculate the effect of any non-compliance with a group accounting policy for adjustment on consolidation.

(8) Timetable

The timetable for the preparation of Dawuro Ltd'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 Eghan;
- 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;
- Eghan’s final clearance of consolidated financial statements.

Tutorial note: *The order of dates is illustrative rather than prescriptive.*

(c) ‘Support letters’

Tutorial note: Although there are different types and uses of such letters (eg for registering a prospectus), the reference to them here is in the context of group audits.

Consolidated financial statements are prepared on a going concern basis when a group, as a single entity, is considered to be a going concern. However, the going concern basis may only be appropriate for certain separate legal entities (eg subsidiaries) because the parent undertaking (or a fellow subsidiary) is able and willing to provide support. Many banks routinely require a letter of reassurance from a parent company stating that the parent would financially or otherwise support a subsidiary with cash flow or other operational problems.

(1) As audit evidence:

- Formal confirmation of the support will be sought in the form of a letter of support or ‘comfort letter’ confirming the parent company’s intention to keep the subsidiary in operational existence (or otherwise meet its obligations as they fall due). Going concern.
  - The letter of support should normally be approved by a board minute of the parent company (or by an individual with authority granted by a board minute).
  - The ability of the parent to support the company should also be confirmed, for example, by examining the group’s cash flow forecast.
  - The period of support may be limited (eg to one year from the date of the letter or until the date of disposal of the subsidiary). Sufficient other evidence concerning the appropriateness of the going concern assumption must therefore be obtained where a later repayment of material debts is foreseen.
  - The fact of support and the period to which it is restricted should be noted in the financial statements of the subsidiary
2. Shows the commitment of directors of the parent company.
  3. Provides documentary evidence to the auditor.

## SOLUTION 2

Atwee & Co

### (a) Need for ethical guidance

- (1) Accountants (firms and individuals) working in a country that criminalises money laundering are required to comply with anti-money laundering legislation and failure to do so can lead to severe penalties. Guidance is needed because:
  - legal requirements are onerous;
  - money laundering is widely defined; and
  - accountants may otherwise be used, unwittingly, to launder criminal funds.
- (2) Accountants need ethical guidance on matters where there is conflict between legal responsibilities and professional responsibilities. In particular, professional accountants are bound by a duty of confidentiality to their clients. Guidance is needed to explain:
  - how statutory provisions give protection against criminal action for members in respect of their confidentiality requirements;
  - when client confidentiality over-ride provisions are available.
- (3) Further guidance is needed to explain the interaction between accountants responsibilities to report money laundering offences and other reporting responsibilities, for example:
  - reporting to regulators;
  - auditor's reports on financial statements (ISA 700);
  - reports to those charged with governance (ISA 260);
  - reporting misconduct by members of the same body.
- (4) Professional accountants are required to communicate with each other when there is a change in professional appointment (ie 'professional etiquette'). Additional ethical guidance is needed on how to respond to a 'clearance' letter where a report of suspicion has been made (or is being contemplated) in respect of the client in question.

Tutorial note: *Although the term 'professional clearance' is widely used, remember that there is no 'clearance' that the incumbent accountant can give or withhold.*

- (5) Ethical guidance is needed to make accountants working in countries that do not criminalise money laundering aware of how anti-money laundering legislation may nevertheless affect them. Such accountants may commit an offence if, for example, they conduct limited assignments or have meetings in a country having anti-money laundering legislation .

### (b) Annual reviews of existing clients

#### (i) Tax investigation

- Edinaman Ltd is a relatively new client. Before accepting the assignment(s), Atwee & Co should have carried out customer due diligence (CDD). Atwee should therefore have a sufficient knowledge and understanding of Edinaman Ltd to be aware of any suspicions that the tax authority might have.
- As the investigation has come as a surprise it is possible that, for example:

- the tax authorities suspicions are unfounded;
- Atweehas failed to recognise suspicious circumstances.

Tutorial note: *In either case, Atwee should now review relevant procedures.*

- Atwee should review any communication from the predecessor auditor obtained in response to its ‘professional inquiry’ (for any professional reasons why the appointment should not be accepted).
- A quality control for new audits is that the audit opinion should be subject to a second partner review before it is issued. It should be considered now whether or not such a review took place. If it did, then it should be sufficiently well documented to evidence that the review was thorough and not a mere formality.
- Criminal property includes the proceeds of tax evasion. If Edinaman Ltd is found to be guilty of under-declaring income that is a money laundering offence.
- Atwee’s reputational risk will be increased if implicated because it knew (or ought to have known) about Edinaman Ltd’s activities. (Atwee may also be liable if found to have been negligent in failing to detect any material misstatement arising in the 31 December 2009 financial statements.)
- Edinaman Ltd’s audit working paper files and tax returns should be reviewed for any suspicion of fraud being committed by Edinaman Ltd or error overlooked by Atwee. Tax advisory work should have been undertaken and/or reviewed by a manager/partner not involved in the audit work.
- As tax advisor, Atwee could soon be making disclosures of misstatements to the tax authorities on behalf of Edinaman Ltd. Atwee should encourage Edinaman Ltd to make necessary disclosure voluntarily.
- If Atwee finds reasonable grounds to know or suspect that potential disclosures to the tax authorities relate to criminal conduct, then a suspicious transaction report (STR) should be made to the financial intelligence unit (FIU) also.

Tutorial note: *Though not the main issue credit will be awarded for other ethical issues such as the potential self-interest/self-review threat arising from the provision of other services.*

(ii) Advice on payments

- As compared with (i) there is no obvious tax issue. Ahafoman is not overstating expenditure for tax purposes.
- Atwee should consider its knowledge of import duties, etc in the destination country before recommending a course of action to Ahafoman.
- The payments being made for security consultancy services may amount to a bribe. Corruption and bribery (and extortion) are designated categories of money laundering offence under The Forty Recommendations of the Financial Action Task Force on Money Laundering (FATF).

If this is a bribe:

- Ahafoman clearly benefits from the payments as it receives income from the contract with the major customer. This is criminal property and possession of it is a money laundering offence • Atwee should consider the seriousness of the disclosure made by the chief executive in the context of domestic law.
- Atwee may be guilty of a money laundering offence if the matter is not reported. If a report

to the FIU is considered necessary Atwee should encourage Ahafoman to make voluntary disclosure. If Ahafoman does not, Atwee will not be in breach of client confidentiality for reporting knowledge of a suspicious transaction. Tutorial note: *Making a report takes precedence over client confidentiality.*

(iii) Financial advisor

- Customer due diligence (CDD) and record-keeping measures apply to designated non-financial businesses and professions (such as Atwee & Co) who prepare for or carry out certain transactions on behalf of their clients.
- Kofi Ahenkan is a ‘politically exposed person’ (‘PEP’ ie an individual who is to be entrusted with prominent public functions in a foreign country).
- Atwee’s business relationships with Oyoko therefore involve reputational risks similar to those with Kofi Ahenkan. In addition, to performing normal due diligence measures Atwee should:
  - have risk management systems to have determined that Kofi Ahenkan is a PEP;
  - obtain senior partner approval for maintaining business relationships with such customers;
  - take reasonable measures to establish the source of wealth and source of funds;
  - conduct enhanced ongoing monitoring of the business relationship.
- Atwee can choose to decline to act for Oyoko and/or Kofi Ahenkan (if asked).
- If the business relationship is to be continued, senior partner approval should be obtained for any transactions carried out on Oyoko’s behalf in future.

Tutorial note: *The Oyoko family is not described as an audit client therefore no familiarity threat arises in relation to an audit (the family may not have any involvement in entities requiring an audit).*

### SOLUTION 3

- (a) (i) **Forensic accounting** utilises accounting, auditing, and investigative skills to conduct an examination into a company’s financial statements. The aim of forensic accounting is to provide an accounting analysis that is potentially suitable for use in court. Forensic accounting is an umbrella term encompassing both forensic investigations and forensic audits. It includes the audit of financial information to prove or disprove a fraud, the interview process used during an investigation, and the act of serving as an expert witness.

Tutorial note: *Forensic accounting can be used in a very wide range of situations, e.g. settling monetary disputes in relation to a business closure, marriage break up, insurance claim, etc. Credit will be awarded for any reasonable examples provided.*

- (ii) **A forensic investigation** is a process whereby a forensic accountant carries out procedures to gather evidence, which could ultimately be used in legal proceedings or to settle disputes. This could include, for example, an investigation into money laundering. A forensic investigation involves many stages (similar to an audit), including planning, evidence gathering, quality control reviews, and finally results in the production of a report.
- (iii) **Forensic auditing** is the specific use of audit procedures within a forensic investigation to find facts and gather evidence, usually focused on the quantification of a financial loss. This



could include, for example, the use of analytical procedures, and substantive procedures to determine the amount of an insurance claim.

## b) **Application of ethical principles to a fraud investigation**

IFAC's *Code of Ethics for Professional Accountants* applies to all ICA members involved in professional assignments, including forensic investigations. There are specific considerations in the application of each of the principles in providing such a service.

### (1) Integrity

The forensic investigator is likely to deal frequently with individuals who lack integrity, are dishonest, and attempt to conceal the true facts from the investigator. It is imperative that the investigator recognises this, and acts with impeccable integrity throughout the whole investigation.

### (2) Objectivity

As in an audit engagement, the investigator's objectivity must be beyond question. The report that is the outcome of the forensic investigation must be perceived as independent, as it forms part of the legal evidence presented at court. The investigator must adhere to the concept that the overriding objective of court proceedings is to deal with cases fairly and justly. Any real or perceived threats to objectivity could undermine the credibility of the evidence provided by the investigator. This issue poses a particular problem where an audit client requests its auditors to conduct a forensic investigation. In this situation, the audit firm would be exposed to threats to objectivity in terms of advocacy, management involvement and self-review.

The advocacy threat arises because the audit firm may feel pressured into promoting the interests and point of view of their client, which would breach the overriding issue of objectivity in court proceedings. Secondly, the investigators could be perceived to be involved in management decisions regarding the implications of the fraud, especially where the investigator acts as an expert witness. It is however the self-review threat that would be the most significant threat to objectivity. The self-review threat arises because the investigation is likely to involve the estimation of an amount (i.e. the loss), which could be material to the financial statements.

For the reasons outlined above, *The Code* states that the firm should evaluate threats and put appropriate safeguards in place, and if safeguards cannot reduce the threats to an acceptable level, then the firm cannot provide both the audit service and the forensic investigation.

Professional competence and due care Forensic investigations will involve very specialist skills, which accountants are unlikely to possess without extensive training. Such skills would include:

- Detailed knowledge of the relevant legal framework surrounding fraud,
- An understanding of how to gather specialist evidence,
- Skills in the safe custody of evidence, including maintaining a clear 'chain' of evidence, and
- Strong personal skills in, for example, interview techniques, presentation of material at court, and tactful dealing with difficult and stressful situations.

It is therefore essential that forensic work is only ever undertaken by highly skilled individuals, under the direction and supervision of an experienced fraud investigator. Any doubt over the competence of the investigation team could severely undermine the credibility of the evidence presented at court.

### (3) Confidentiality

Normally accountants should not disclose information without the explicit consent of their client. However, during legal proceedings arising from a fraud investigation, the court will require the investigator to reveal information discovered during the investigation. There is an overriding requirement for the investigator to disclose all of the information deemed necessary by the court. Outside of the court, the investigator must ensure faultless confidentiality, especially because much of the information they have access to will be highly sensitive.

### (4) Professional behaviour

Fraud investigations can become a matter of public interest, and much media attention is often focused on the work of the forensic investigator. A highly professional attitude must be displayed at all times, in order to avoid damage to the reputation of the firm, and of the profession. Any lapse in professional behaviour could also undermine the integrity of the forensic evidence, and of the credibility of the investigator, especially when acting in the capacity of expert witness.

During legal proceedings, the forensic investigator may be involved in discussions with both sides in the court case, and here it is essential that a courteous and considerate attitude is presented to all parties.

### (5) Independence

#### c) (i) Directors reluctance to disclose

(1) The directors are likely to have several reasons behind their reluctance to disclose the note as recommended by the audit manager. The first is that the disclosure of Alavanyo Ltd 's poor cash flow position and perilous going concern status may reflect badly on the directors themselves. The company's shareholders and other stakeholders will be displeased to see the company in such a poor position, and the directors will be held accountable for the problems. Of course it may not be the case that the directors have exercised poor management of the company – the problems could be caused by external influences outside the control of the directors. However, it is natural that the directors will not want to highlight the situation in order to protect their own position.

(2) Secondly, the note could itself trigger further financial distress for the company. Alavanyo Ltd Co is trying to raise finance, and it is probable that the availability of further finance will be detrimentally affected by the disclosure of the company's financial problems. In particular, if the cash flow difficulties are highlighted, providers of finance will consider the company too risky an investment, and are not likely to make funds available for fear of non-repayment. Existing lenders may seek repayment of their funds in fear that the company may be unable in the future to meet repayments.

(3) In addition, the disclosures could cause operational problems, for example, suppliers may curtail trading relationships as they become concerned that they will not be paid, or customers may be deterred from purchasing from the company if they feel that there is no long-term future for the business. Unfortunately the mere disclosure of financial problems can be self-fulfilling, and cause such further problems for the company that it is pushed into non-going concern status. The directors may also be concerned that if staff were to hear of this they may worry about the future of the company and seek alternative employment, which could lead in turn to the loss of key members of staff. This would be detrimental to the business and trigger further operational problems.

- (4) Finally, the reluctance to disclose may be caused by an entirely different reason. The directors could genuinely feel that the cash flow and operational problems faced by the company do not constitute factors affecting the going concern status. They may be confident that although a final decision has not been made regarding financing, the finance is likely to be forthcoming, and therefore there is no long-term material uncertainty over the future of the company. However audit working papers conclude that there is a significant level of doubt over the going concern status of Alavanyo Ltd , and therefore it seems that the directors may be over optimistic if they feel that there is no significant doubt to be disclosed in the financial statements.
- (c) (ii) Audit report implications
- (1) Audit procedures have shown that there is a significant level of doubt over Alavanyo Ltd's going concern status. IAS 1 requires that disclosure is made in the financial statements regarding material uncertainties which may cast significant doubt on the ability of the entity to continue as a going concern.
- (2) If the directors agree to disclose the note, it should be reviewed by the auditors to ensure that it is sufficiently detailed. In evaluating the adequacy of the disclosure in the note, the auditor should consider whether the disclosure explicitly draws the reader's attention to the possibility that the entity may not be able to continue as a going concern in the foreseeable future.
- (3) The note should include a description of conditions giving rise to significant doubt, and the directors' plans to deal with the conditions. If the note provided contains adequate information then there is no breach of financial reporting standards, and so no disagreement with the directors. If the disclosure is considered adequate, then the opinion should not be qualified. The auditors should consider a modification by adding an emphasis of matter paragraph to highlight the existence of the material uncertainties, and to draw attention to the note to the financial statements.
- (4) The emphasis of matter paragraph should firstly contain a brief description of the uncertainties, and also refer explicitly to the note to the financial statements where the situation has been fully described. The emphasis of matter paragraph should re-iterate that the audit opinion is not qualified. However, it could be the case that a note has been given in the financial statements, but that the details are inadequate and do not fully explain the significant uncertainties affecting the going concern status of the company. In this situation the auditors should express a qualified opinion, disagreeing with the preparation of the financial statements, as the disclosure requirements of IAS 1 have not been followed.

#### **SOLUTION 4**

- a) It has become increasingly common for audit firms to include a disclaimer paragraph within the audit report. However, it is not a requirement of auditing standards and individual audit firms need to assess the advantages and disadvantages of the use of a disclaimer paragraph. The wording is used to state the fact that the auditor's report is intended solely for the use of the company's members as a body, and that no responsibility is accepted or assumed to anyone other than the company and the company's members as a body.
- (2) The main perceived advantage is that the disclaimer should help to reduce the exposure of the audit firm to liability claims from anyone other than the company or the company's body of

shareholders. The disclaimer makes it clear that the audit firm reports only to those who appointed the firm, i.e. the members of the company, and this may make it more difficult for the audit firm to be sued by a third party.

- (3) It is also argued that the use of a disclaimer could help to bridge the 'expectation gap' by providing a clearer indication of the responsibility of the auditor. In this way the audit firm can manage its risk exposure in an increasingly litigious environment. Recent high profile legal cases against audit firms, such as the Bannerman case in Scotland, illustrate that an audit firm's duty of care can extend beyond the company and its shareholders, and that audit firms should consider how to protect themselves against liability claims.

*Tutorial note: It is appropriate here to quote recent cases such as the Bannerman case to illustrate the reason why audit firms face increased potential exposure to claims from third parties. However, knowledge of specific legal cases is not required to gain full marks for this requirement.*

- (4) However, it can be argued that a disclaimer does not necessarily work to protect an audit firm. Each legal case has individual circumstances, and while a disclaimer might protect the audit firm in one situation, equally it may not offer any protection where the facts of the case are different.
- (5) In addition, it is often argued that if an audit firm conducts an audit using full due care and diligence, there is no need for a disclaimer, as a high quality audit would be very unlikely to lead to any claims against the audit firm. Consequently, it could be argued that the use of disclaimers as a means to limit liability could permit low quality audits to be performed, the auditors being confident that legal cases against them are restricted due to the presence of a disclaimer within the audit report.

b)

- (a) Identification of related parties

- (1) Related parties and associated transactions are often difficult to identify, as it can be hard to establish exactly who, or what, are the related parties of an entity. IAS 24 *Related Party Disclosures* contains definitions which in theory serve to provide a framework for identifying related parties, but deciding whether a definition is met can be complex and subjective. For example, related party status can be obtained via significant interest, but in reality it can be difficult to establish the extent of influence that potential related parties can actually exert over a company.
- (2) The directors may be reluctant to disclose to the auditors the existence of related parties or transactions. This is an area of the financial statements where knowledge is largely confined to management, and the auditors often have little choice but to rely on full disclosure by management in order to identify related parties. This is especially the case for a close family member of those in control or having influence over the entity, whose identity can only be revealed by management.

Identification of material related party transactions

- (3) Related party transactions may not be easy to identify from the accounting systems. Where accounting systems are not capable of separately identifying related party transactions, management need to carry out additional analysis, which if not done makes the transactions extremely difficult for auditors to find. For example sales made to a related party will not necessarily be differentiated from 'normal' sales in the accounting systems.

- (4) Related party transactions may be concealed in whole, or in part, from auditors for fraudulent purposes. A transaction may not be motivated by normal business considerations, for example, a transaction may be recognised in order to improve the appearance of the financial statements by ‘window dressing’. Clearly if the management is deliberately concealing the true nature of these items it will be extremely difficult for the auditor to discover the rationale behind the transaction and to consider the impact on the financial statements.
- (5) Finally, materiality is a difficult concept to apply to related party transactions. Once a transaction has been identified, the auditor must consider whether it is material. However, materiality has a particular application in this situation. ISA 550 *Related Parties* states that the auditor should consider the effect of a related party transaction on the financial statements. The problem is that a transaction could occur at an abnormally small, even nil, value. Determining materiality based on monetary value is therefore irrelevant, and the auditor should instead be alert to the unusual nature of the transaction making it material.

(b) (i) **Matters to consider**

(1) **Materiality**

The receivable represents only 0.2% (25,000/12 million x 100) of total assets so is immaterial in monetary terms. However, the details of the transaction could make it material by nature.

The amount is outstanding from a company under the control of Binaba Ltd Co’s chairman. Readers of the financial statements would be interested to know the details of this transaction, which currently is not disclosed. Elements of the transaction could be subject to bias, specifically the repayment terms, which appear to be beyond normal commercial credit terms. Baba Musa may have used his influence over the two companies to ‘engineer’ the transaction. Disclosure is necessary due to the nature of the transaction, the monetary value is irrelevant.

(2) A further matter to consider is whether this is a one-off transaction, or indicative of further transactions between the two companies.

(3) **Relevant accounting standard**

The definitions in IAS 24 must be carefully considered to establish whether this actually constitutes a related party transaction. The standard specifically states that two entities are not necessarily related parties just because they have a director or other member of key management in common. The audit senior states that Kudi Ltd is controlled by Baba Musa, who is also the chairman of Binaba Ltd. It seems that Baba Musa is in a position of control/significant influence over the two companies (though this would have to be clarified through further audit procedures), and thus the two companies are likely to be perceived as related.

IAS 24 requires full disclosure of the following in respect of related party transactions:

- the nature of the related party relationship,
- the amount of the transaction,
- the amount of any balances outstanding including terms and conditions, details of security offered, and the nature of consideration to be provided in settlement,
- any allowances for receivables and associated expense.

There is currently a breach of IAS 24 as no disclosure has been made in the notes to the financial statements. If not amended, the audit opinion on the financial statements should be

qualified with an ‘except for’ disagreement. In addition, if practicable, the auditor’s report should include the information that would have been included in the financial statements had the requirements of IAS 24 been adhered to.

(4) Valuation and classification of the receivable

A receivable should only be recognised if it will give rise to future economic benefit, i.e. a future cash inflow. It appears that the receivable is long outstanding – if the amount is unlikely to be recovered then it should be written off as a bad debt and the associated expense recognised. It is possible that assets and profits are overstated. Although a representation has been received indicating that the amount will be paid to Binaba Ltd Co, the auditor should be sceptical of this claim given that the same representation was given last year, and the amount was not subsequently recovered. The GHC125,000 could be recoverable in the long term, in which case the receivable should be reclassified as a non-current asset. The amount advanced to Kudi Ltd could effectively be an investment rather than a short term receivable. Correct classification on the statement of financial position (balance sheet) is crucial for the financial statements to properly show the liquidity position of the company at the year end.

*Tutorial note: Digressions into management imposing a limitation in scope by withholding evidence are irrelevant in this case, as the scenario states that the only evidence that the auditors have asked for is a management representation. There is no indication in the scenario that the auditors have asked for, and been refused any evidence.*

**Further audit procedures:**

Request from Baba Musa a written representation detailing:

- the exact nature of his control over Kudi Ltd , i.e. if he is a shareholder then state his percentage shareholding, if he is a member of senior management then state his exact position within the entity,
- a comment on whether in his opinion the balance is recoverable,
- a specific date by which the amount should be expected to be repaid, and
- a confirmation that there are no further balances outstanding from Kudi Ltd , or any further transactions between Kudi Ltd and Binaba Ltd .

*Tutorial note: Reference to ISA 550 Related Parties (Revised and Redrafted) requirement for both general and specific management representations will be awarded credit.*

Review the terms of any written confirmation of the amount, such as a signed agreement or invoice, checking whether any interest is due to Binaba Ltd . The terms should be reviewed for details of any security offered, and the nature of the consideration to be provided in settlement.

From discussion with Baba Musa, develop an understanding of the business purpose of the transaction, particularly to understand whether the balance is a trade receivable or an investment. Review the board minutes for evidence of any discussion of the transaction and the recoverability of the balance outstanding.

Obtain the most recent audited financial statements of Kudi Ltd and:

- ascertain whether Baba Musa is disclosed as the ultimate controlling party or disclosed as a member of key management personnel,
- scrutinise the disclosure notes to find any disclosure of the transaction, where it should be

- described as a related party liability, and
- perform a liquidity analysis to establish whether the amount can be repaid from liquid assets.

(ii) **Quality control issues raised from the senior's comments**

There are several issues raised, all of which indicate that quality control procedures have not functioned adequately.

- (1) The planned audit procedures appear to be inadequate, further tests should have been performed to confirm the completeness, existence and valuation of the balance.  
In last year's audit, the management representation was accepted as sufficient evidence in relation to the receivable. Possibly the item was not identified as a related party transaction, or it was not considered to be material enough to warrant further investigation.
- (2) At the planning stage, it is standard procedure to identify key related parties of an entity, and to plan procedures specific to them. Inadequate planning may lead to a lack of prioritisation of this as an area of relatively high audit risk.
- (3) Work on receivables is often carried out by a relatively inexperienced member of the audit team. Audit juniors may not appreciate the potential breach of IAS 24, or the complexities regarding materiality assessment for this type of transaction.
- (4) Insufficient review by the audit manager has been performed on completed working papers, which then failed to spot the weakness of the management representation as a source of evidence. This year the audit senior has highlighted the matter, which can now be resolved through additional audit procedures.

**SOLUTION 5**

- (a) Reasons why a firm of auditors may decide not to seek re-election – any FIVE of the following:

*Disagreement with the client*

The audit firm may have disagreed with the client for a number of reasons, for example, over accounting treatments used in the financial statements. A disagreement over a significant matter is likely to cause a breakdown in the professional relationship between auditor and client, meaning that the audit firm could lose faith in the competence of management. The auditor would be reluctant to seek re-election if the disagreement were not resolved.

*Lack of integrity of client*

The audit firm may feel that management is not acting with integrity, for example, the financial statements may be subject to creative accounting, or dubious business ethics decisions could be made by management, such as the exploitation of child labour. The auditor would be likely not to seek re-election (or to resign) in this case to avoid being associated with the client's poor decisions.

*Fee level*

The audit firm could be unable to demand a high enough audit fee from the client to cover the costs of the audit. In this situation the audit firm may choose not to offer itself for re-election, to avoid

continuing with a loss making audit engagement, and consequently to use resources in a more commercially advantageous way.

#### *Fee payments*

The audit firm could have outstanding fees which may not be fully recovered due to a client's poor cash flow position. Or, the client could be slow paying, causing the audit firm to chase for payment and possibly affecting the relationship between the two businesses. In such cases the audit firm may make the commercial decision not to act for the client any longer.

#### *Resources*

The audit firm may find that it lacks the resources to continue to provide the audit service to a client. This could happen if the client company grows rapidly, financially or operationally, meaning that a larger audit team is necessary. The audit firm may simply lack the necessary skilled staff to expand the audit team.

#### *Competence*

The audit firm could feel that it is no longer competent to perform an audit service. This could happen for example if a client company diversified into a new and specialised business operation of which the audit firm had little or no experience. The audit firm would not be able to provide a high quality audit without building up or buying in the necessary knowledge and skills, and so may decide not to be considered for re-election.

#### *Overseas expansion*

A client could acquire one or several material overseas subsidiaries. If the audit firm does not have an associate office in the overseas location, the firm may feel that the risk and resources involved in relying on the work of other auditors is too great, and so decide not to act for the client any longer.

#### *Independence*

There are many ethical guidelines in relation to independence which must be adhered to by auditors, and in the event of a potential breach of the guidelines, the audit firm may decide not to seek re-election. For example, an audit firm may need to increase the audit fee if a client company grows in size. This could have the effect of increasing the fee received from the client above the allowed thresholds. As there would be no ethical safeguard strong enough to preserve the perception of independence, in this case the audit firm would not be able to continue to provide the audit service.

*Tutorial note: Other examples may be used to explain why the issue of independence could cause an audit firm not to seek re-election, e.g. audit firm takes on a financial interest in the client, close personal relationships develop between the firm and the client.*

#### *Conflicts of interest*

An audit firm may become involved in a situation where a conflict of interest arises between an existing audit client and another client of the firm. For example, an audit firm could take on a new audit client which is a competitor of an existing audit client. Although with the use of appropriate safeguards this situation could be successfully managed, the audit firm may decide that stepping down as auditor of the existing firm is the best course of action

(bi) Audit procedures using audit software

Procedure : Reason for procedure:



Cast the receivables ledger to ensure it agrees with the total on the receivables control account.

- To ensure the completeness and accuracy of recording of items in the receivables ledger and control account.

Compare the balance on each receivable account with its credit limit to ensure this has not been exceeded.

- To check for violation of system rules.

Review the balances in the receivables ledger to ensure no balance exceeds total sales to that customer.

- To check for unreasonable items in the ledger.

Calculate receivables days for each month end to monitor control of receivables over the year.

- To obtaining new/relevant statistical information.

Stratify receivables balances to show all material items and select appropriate sample for testing.

- To select items for audit testing.

Produce an aged receivables analysis to assist with the identification of irrecoverable receivables.

- To assist with receivables valuation testing.

## (bii) **Problems of using audit software**

### i) Cost

There may be substantial setup costs to use the software, especially where the computer systems of the client have not been fully documented, as is the situation in Asetenapa Ltd. A cost benefit analysis from the audit point-of-view should be carried out prior to deciding to use audit software.

### ii) Lack of software documentation

The computer audit department at Asetenapa Ltd cannot confirm that all system documentation is available, especially for the older 'legacy' systems currently in use. This again confirms the view that use of audit software should be deferred until next year to avoid extensive setup costs which cannot be recouped due to system changes.

### iii) Change to clients' systems

Changes to clients' computer systems can result in costly amendments to the audit software. Given that Asetenapa Ltd's systems will change next year, this is almost certain to result in amendments to the software. Starting to use audit software this year is therefore not advisable.

### iv) Outputs obtained

The audit manager needs to be clear exactly what audit assertions are to be tested with the audit software and what outputs are expected. Starting testing just to obtain knowledge of the system is inappropriate as testing may be too detailed and output produced that is not required, increasing the cost for the client.

### v) Use of copy files

The use of copy files means that the auditor will not be certain that these are the actual files being used within Asetenapa Ltd's computer systems, especially as the provenance of those files will not be checked. To ensure that the files are genuine either the auditor should supervise the copying or

the 'live' files on Asetenapa Ltd's computer systems should be used.

(biii) **Auditing around the computer**

This term means that the 'internal' software of the computer is not documented or audited by the auditor, but that the inputs to the computer are agreed to the expected outputs from the computer.

This method of auditing increases audit risk because:

- The actual computer files and programs are not tested; the auditor has no direct evidence that the programs are working as documented.
- Where errors are found in reconciling inputs to outputs, it may be difficult or even impossible to determine why those errors occurred. Constructive amendments to clients' systems cannot be made and there is an increased likelihood of audit qualifications.
- The auditor does not concern himself with how the computer process information.
- Ascertains the controls and validates the inputs.
- Compare inputs with outputs and investigate differences.