NOVEMBER 2016 PROFESSIONAL EXAMINATION
ADVANCED AUDIT & ASSURANCE (PAPER 3.2)
CHIEF EXAMINER'S REPORT, QUESTION & MARKING SCHEME

EXAMINER'S GENERAL COMMENTS

The paper met the required standard in terms of quality and the learning outcomes that have been examined. Majority of the questions involved discussion, evaluation, recommendation, considering and commentary on issues. Only question three required candidates to identify and explain issues as well as state audit procedures. The questions were very clear and within coverage of the syllabus.

The paper examined eight out of the nine sections of the syllabus coverage and weighting. Section F- Audit of the Public Sector was not featured. Section H- Reporting – on the other hand was over loaded with five sub-question which attracted *20marks* instead of *10marks*.

This information is given in the table below:

SYLLABUS COVERAGE

SECTIONS	A	B	C	D	E	F	G	H	I	TOTAL
WEIGHTING %	10	10	10	20	10	10	10	10	10	100%
MARKS ALLOCATED	10	10	10	20	10	10	ML	10	20	100%

GENERAL PERFORMANCE OF CANDIDATES

Performance in the paper was below expectation even through the pass rate of *42%* is better than the *22%* achieved in the last session. Generally candidates did not display the maturity and intellectual depth expected at the level three of the professional examinations. Answers given were shallow and sometimes very amateurish. Only few candidates demonstrated that they prepared well for the paper.

Sadly enough candidates resorted to lengthy and unproductive introduction to the answers as well as defining terms and concepts not called for such behaviour only resulted in wasted effort and unnecessary reading assignment for the examiners.
Some candidates did not organise their answers very well in term of usage of page numbering to identify the questions being answered. Others used the space reserved for markers and moderators. Many candidates glossily abused "Emphasis of matter paragraph" in answering the questions on reporting.

QUESTION ONE

a)

i) Sampson Quaye & Co. has been auditors for Stawac plantations Ltd (a company engaged in rubber production) for the past 10years. Sampson Quaye & Co owns 1% of the shares in Stawac Plantation Ltd., since it is required by the policy of Stawac Plantation Ltd. for their auditors to do so.

ii) United Funds Ltd. are the fund managers of Sampson Quaye & Co.'s Provident Fund Scheme. United Funds Ltd. owns shares in Standard Group, a company listed on the Ghana Stock Exchange with many subsidiaries. Sampson Quaye & Co has been invited by Akroma Ltd. a Subsidiary of Standard Group to tender for its audit.

iii) Nenebi is the audit senior of Sampson Quaye & Co. responsible for the audit of Minimade Ltd. a company listed on the Ghana Stock Exchange. Two weeks into the audit of the accounts of Minimade Ltd for the year ended 31 December 2014, Narteykie the wife of Nenebi inherited 2000 equity shares owned by her late father in Minimade Ltd.

Required:
Comment on the ***ethical and other professional issues*** raised by the above matters.
(10 marks)

b) Wassaman Company is a private company established in the Wassa District in the Western Region to produce plastic bags to supply to sachet water producers. The company has 10 outlets within the district through which distribution is made to water producers. Employees of the company has been complaining about management's reluctantance to provide the health and safety needs of the company. The chief of the area has also shown his dissatisfaction about the extent of compliance of environmental laws and regulations by the company.

Required:
Discuss the responsibilities of management and the auditor to ensure ***adherence to laws and regulations.*** **(10 marks)**

(Total: 20 marks)

QUESTION TWO

a) Nii Adjei & Associates is a firm of Chartered Accountants that provides various services (including Audit, Assurance, Tax and Advisory services) to client undertaking various services. Nii Adjei & Associates has offices in Accra, Tema, Koforidua and Kumasi.

Owusu Mensah was the quality control partner of Nii Adjei & Associates. Owusu Mensah had started the implementation of ethical compliance system for the assurance staff when he was involved in an accident on the Tema motorway on his way home and died. The said system required that staff should confirm in writing their compliance to the code of ethics of The Institute of Chartered Accounts (Ghana). Arrangement to get a replacement for Owusu Mensah had not been completed.

Osei Acquah was the engagement partner in charge of the C. Kokuvi Ltd. (a major client that Nii Adjei and Associates provides audit service, preparation of tax computations and other advisory services). Osei Acquah had an attack on his brain which resulted in stroke. This forced Nii Adjei & Associates to engaged Thomas Essien as the new engagement partner to take charge of the audit of C. Kokuvi Ltd. C. Kokuvi Ltd is not prepared to increase the audit fees from that of the previous year despite the fact that additional work has to be performed as a result of the introduction of a new computer system.

In addition, the starting date of the audit has been delayed as a result of problems with the new system.

Required:
Discuss any ***quality control issues*** identified in the above scenarios and recommend the action which should be taken by Nii Adjei and Associates. **(10 marks)**

b) Ghana Sugar Company Limited a private company has been in operation for many years. Owing to a rising need to raise additional capital the shareholders have passed a resolution to convert the company into a public company and list it on the Ghana Stock Exchange. You have been contracted to help the Directors to carry the resolution through. During your preliminary discussion with the Directors you realised that they were not very conversant with the listing rules of the Ghana Stock Exchange and you drew their attention to the establishment of an Audit Committee as a condition for listing on the Ghana Stock Exchange.

The Directors agreed to discuss the establishment of the Audit committee at the next emergency meeting and invited you to be present.

Required:
Recommend the composition of the ***audit committee*** and describe its ***responsibilities*** to the Directors. **(10 marks)**

(Total: 20 marks)

QUESTION THREE

You are a manager in Amable & Co, a firm of Chartered Accountants, responsible for the audit of Kpandu Sika Limited for the year ended 31 December 2015. Kpandu Sika Limited is a company listed on the Ghana Stock Exchange (GSE) which has been a client of your firm in the past three years. The company manufactures consumer electronic appliances which are then sold to major retail organisations. You are aware that during the last year, Kpandu Sika Limited lost several customer contracts due to cheap imports. However, a new division has been created to sell its products directly to individual customers in Ghana and worldwide via a new website, which was launched on 1 December 2015.

Financial information provided by the Finance Manager is shown below:

STATEMENT OF PROFIT OR LOSS

	Note	Management Accounts Year ended 31/12/2015 GH¢'000	Audited Accounts Year ended 31/12/2014 GH¢'000
Revenue		97,660	111,340
Cost of sales		(58,596)	(60,420)
Gross profit		39,064	50,920
Operating expenses	(i)	(23,560)	(29,450)
Operating profit		15,504	21,470
Finance costs		(5,700)	(5,700)
Profit before tax		9,804	15,770

STATEMENT OF FINANCIAL POSITION AS AT

	Note	31/12/2015	31/12/2014
ASSETS		GH¢'000	GH¢'000
Non-current assets			
Property, plant and equipment	(ii,iii)	342,000	287,850
Intangible assets	(iv)	4,750	-
		346,750	287,850
Current assets			
Inventory		6,840	6,517
Trade receivables		18,726	18,297
Cash and cash equivalents		380	8,930
		25,946	33,744
TOTAL ASSETS		**372,696**	**321,594**

EQUITY AND LIABILITIES			
Equity			
Share capital		76,000	76,000
Revaluation reserve	(iii)	38,000	-
Retained earnings		122,656	132,601
Total equity		236,656	208,601
Non-current liabilities			
Long-term borrowings	(v)	95,000	95,000
Provisions	(vi)	3,800	4,750
Finance lease payable		19,000	-
		117,800	99,750
Current liabilities			
Bank overdraft	(vii)	4,940	-
Trade and other payables		13,300	13,243
		18,240	13,243
Total liabilities		136,040	112,993
Total equity and liabilities		**372,696**	**321,594**

NOTES

i) Kpandu Sika Limited established an equity-settled share-based payment plan for its executives on 1 January 2015. 250 executives and senior managers have received 100 share options each, which vest on 31 December, 2015 if the executive remains in employment at that date, and if Kpandu Sika Limited's share price increases by 10% per annum. No expense has been recognised this year as Kpandu Sika Limited's share price has fallen by 5% in the last six months, and so it is felt that the condition relating to the share price will not be met this year end.

ii) On 1 July 2015, Kpandu Sika Limited entered into a lease which has been accounted for as a finance lease and capitalised at GH¢19 million. The leased property is used as the head office for Kpandu Sika Limited's new website development and sales division. The lease term is for five years and the fair value of the property at the inception of the lease was GH¢76 million.

iii) On 30 June 2015 Kpandu Sika Limited's properties were revalued by an independent expert.

iv) A significant amount has been invested in the new website, which is seen as a major strategic development for the company. The website has generated minimal sales since its launch last month, and advertising campaigns are currently being conducted to promote the site.

v) The long-term borrowings are due to be repaid in two equal instalments on 30 September 2016 and 2017. Kpandu Sika Limited is in the process of renegotiating the loan, to extend the repayment dates, and to increase the amount of the loan.

vi) The provision relates to product warranties offered by the company.

vii) The overdraft limit agreed with Kpandu Sika Limited's bank is GH¢5.7 million.

Required:

a) Using the information provided by the Finance Manager, identify and explain the ***principal audit risks*** to be considered in planning the final audit. **(10 marks)**

b) State the ***principal audit procedures*** which should be performed in respect of the provision for the product warranties offered by the company. **(6 marks)**

c) State the principal audit evidence which you would expect to find in respect of the classification of the new lease in terms of ***IAS 17 Leases*** (Do not consider the application of the new leasing standard ***IFRS 16 Leases***) **(4 marks)**

(Total: 20 marks)

QUESTION FOUR

a) Upon the completion of the audit of Zealow Company Ltd, the Engagement Partner reviewed the audit working papers and came across the following;

- There was material inconsistency between the financial information and other information in documents containing the financial statements and the auditor's report thereon. The material inconsistency has been traced to the financial information but management has refused to effect any change when requested to do so.
- Stocks worth GH¢5 million were valued at cost in the financial statements. The review of the post balance sheet events indicated that not all the stocks could be sold in the normal course of business. Some were damaged and some have become obsolete and slow moving. The total assets of the company is GH¢20 million. If the stocks were valued at net realizable value, the value would have reduced by GH¢2.0 million. The Directors have refused to allow the stocks to be valued at lower of cost and net realizable value and valued all the stocks at cost.
- Management refused to allow auditors to carry out circularization of debtors. The receivables figure was material in the financial statements. In addition, the auditors have not received a reply to the letter of enquiry sent to the company's solicitors in respect of a major litigation affecting the company. The auditors assessed that the effect of the two items is both material and pervasive.
- Subsequent events indicated that a major debtor has become insolvent. The amount involved was material. The directors refused to recognize the provision for a write- off of the amount.

Required:

i) For each of the items, recommend the ***type of audit opinion*** to be issued. **(8 marks)**

ii) Consider what action the auditors should take in view of management refusal to accept the recommendations and/or allowed the auditor to carry out the necessary audit procedures. **(2 marks)**

b) In the audit of financial statements, auditors are required to comply fully with the International Standards on Auditing (ISAs). In general terms the International Auditing and Assurance Standards Board (IAASB) takes the view that "an audit is an audit and should be conducted in line with the same auditing standards". In 2009, (IAASB) issued Q&A publication on matters relevant to audit of SME's-"applying ISAs proportionately with the size and complexity of an entity".

Required:
Discuss the IAASB's Clarity project on ISAs in relation to the audit of SME's.

(10 marks)

(Total: 20 marks)

QUESTION FIVE

a) You are the manager responsible for performing hot reviews on audit files where there is a potential disagreement between your firm and the client regarding a material issue. You are reviewing the going concern section of the audit file of Racific Co, a client with considerable cash flow difficulties, and other, less significant operational indicators of going concern problems. The working papers indicate that Racific Co is currently trying to raise finance to fund operating cash flows, and state that if the finance is not received, there is significant doubt over the going concern status of the company. The working papers concluded that the going concern assumption is appropriate, but it is recommended that the financial statements should contain a note to explain the cash flow problems faced by the company, along with a description of the finance being sought, and an evaluation of the going concern status of the company. The directors do not wish to include the note in the financial statements.

Required:

i) Consider and comment on the possible reasons why the directors of Racific Co. are reluctant to provide the note to the financial statements. **(5 marks)**

ii) Discuss the implications for the auditors if the directors refuse to include the disclosure note. **(5 marks)**

b) J & K Mining Company operates in the Abuakwa Community of the Eastern Region as a Sand Wining Company. The youth of the area had been opposing the activities of the company of late. Sasana the Managing Director of J & K Mining Company approached Kaku & Associates, a Chartered Accounting firm to accept an attest engagement to examine and report on the environmental issues of J & K Mining Company Ltd. for the year ended 31 December, 2013.

Required:

i) Evaluate the ***environmental issues*** that may lead to the risk of misstatements in the Financial Statements. **(3 marks)**

ii) Recommend the actions and the audit procedures that Kaku and Associates should undertake when they realise that J & K Mining Company Ltd. has environmental issues that may affect the Financial Statements.

(7 marks)

(Total: 20 marks)

MARKING SCHEME

QUESTION ONE

Ethical and Other Professional Issues

i) Sampson Quaye & Co. has a direct interest in the audit client, which is technically forbidden by the code of conduct. However, it is a requirement of any firm auditing the company that the shares be owned by the auditors. The interest is not material. The audit firm should safeguard against the risk by not voting on its own re-election as auditor. The firm should also strongly recommend to the company that it removes this requirement from its stature as it is at odds with ethical requirements for auditors. **(3 marks)**

ii) The audit firm has an indirect interest in the parent company of a company it has been invited to tender for by virtue of its provident fund scheme having invested in Standards Group.
This is no barrier to the audit firm tendering for the audit of Akroma Ltd. Should the audit frim win the tender and become the auditors for Akroma ltd. they should consider whether it is necessary to apply safeguards to mitigate against the risk to independence on the audit as a result of the indirect financial interest.
The factors that the partners will need to consider are the materiality of the interest to either party or the degree of control that the firm actually has over the financial interest.
In this case, the audit firm has no control over the financial interest. An independent provident fund scheme administrator is in control of the financial interest. In addition, the interest is unlikely to be substantial and is therefore immaterial to both parties. Only if the threat is significant should the interest be divested.

It is likely that this risk is already sufficiently minimal so as not to require safeguards. However, if the audit firm felt that it was necessary to apply safeguards, they could consider the following;

- Notifying the audit committee of the interest
- Requiring United Fund Ltd to dispose of the shares in Standard Group

(3 marks)

iii) Nenebi is at present a member of the assurance team and a member of his immediate family owns a direct financial interest in the audit client. This is unacceptable.
In order to mitigate the risk to independence that this threat possesses on the audit, the audit firm needs to apply one of two safeguards:

- Ensure that the connected person divests the shares
- Remove Nenebi from the management team

Nenebi should be appraised that these are the options and removed from the team while a decision is taken whether to divest the shares. Nenebi's wife appears to want to keep the shares in which case Nenebi should be removed from the team immediately.

The firm should appraise the audit committee of Minimade Ltd. of what has happened and the actions they have taken. The partners should consider whether it is necessary to bring in an independent partner to review audit work. However, given that Nenebi's involvement is subject to the review of the existing engagement partner and he was not connected with the shares while he was carrying out the work, a partner's review is likely to be unnecessary in this case. **(4 marks)**

b) **Responsibility of management for compliance**

It is the responsibility of management to ensure a client operation is conducted in accordance with laws and regulations. The following policies and procedures, among others may be implemented to assist management in the prevention and detection of non-compliance with laws and regulations.

- Monitor legal requirements and ensure that operating procedures are designed to meet these requirements
- Institute and operate appropriate systems of internal control induding internal audit and an audit committee.
- Develop, publicise and follow a code of conduct
- Ensure employees are properly trained and understand the code of conduct
- Monitor compliance with the code of conduct and act appropriately to discipline employees who fail to comply with it
- Engage legal advisors to assist in monitoring legal requirements
- Maintain a register of significant laws with which the entity has to comply within its particulars industry, and a record of complaints

(1 mark each for any 5 valid point)

Responsibility of the Auditor

ISA 250.10 demands that auditors are to;

- Obtain sufficient appropriate evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements
- Perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements and
- Respond appropriately to non-compliance or suspected non-compliance with laws and regulations identified during the audit.

As part of obtaining an understanding of the entity and its environment in accordance with ISA 315, ISA 250.12 requires the auditor to obtain a general understating of

- The legal and regulatory framework applicable to the entity and the industry or section in which the entity operates
- How the entity is complying with that framework

(1 mark each for any 5 valid point)

(Total: 20 marks)

EXAMINER'S COMMENTS

Question 1a.
This question required knowledge of and application of professional and ethical requirements in the performance of an audit assignment and handling of client relationships. To a very large extent many candidates were able to identify the issues and commented on them as required. However, some candidates were at a loss.

Question 1b.
Candidates were required to discuss the responsibilities of management and auditor to ensure adherence to laws and regulations. Even though there was a preamble to the question, the requirements were general rather than contextual. Performance was mixed. There were those who recognised the general mature pf the question and provided the right answers and those who treated it as contextual question and limited themselves to issues mentioned on the preamble. Performance was good.

QUESTION TWO

The Quality Control issues are;

1) Firm Culture

The International Standard on Quality Control (ISQCI) requires that firms implement policies such that the internal culture of the firm emphasizes the importance of quality control. It is the leader of the firm who are responsible for creating and maintaining this culture through actions and messages. In other words the entire business strategy of the firm should be driven by the need for quality in its operations. The personnel responsible for establishing and maintain the firm's system of quality control must understand ISQCI.

In this case two factors indicate that there is a lack of leadership on quality control;

- The partner responsible for quality control died and has not been replaced. While this may not have a direct impact on the audit of C. Kokuvi Ltd, the fact that there is no one responsible for quality control in the firm increases the risk that quality control deficiencies will go undetected.

- The firm is under pressure to compete the audit and provide other services for the same fee as last year in spite of the fact that additional work will be required. There is a risk that quality will suffer as audit work will not be carried out as thoroughly as it should be in order to complete the work within budget. This problem is exacerbated by the potential lack of proper quality control review due to the death of the quality control partner.

The quality control partner should be replaced as soon as possible. The budget for the audit of C. Kokuvi should be monitored carefully. The audit should be conducted properly and in accordance with ISAs. Any cost overruns should be discussed with the client and additional fees negotiated if necessary.

(4 marks)

2) Ethical requirements

A firm should have procedures in place to ensure that staff is aware of ethical requirement and comply with these. In this case the implementation of the system has not been completed. Whilst members of staff who are members of a professional body should be aware of their responsibilities they may not have all the relevant information to avoid an in advertant breach of the regulations for example details of all companies who are client of the firm. The implementation of the system started by the previous ethics partner should be completed.

(**3 marks)**

3) Monitoring

The fact that the audit partner (Thomas Essien) is new, and the previous partner is no longer with the firm increases the risk regarding audit monitoring. As the current audit partner is new he will not have an extensive knowledge of the audit client initially. The tight deadline for the audit accentuates this problem.To decrease this risk the audit partner must gain an understanding of the business in accordance with ISAs. If possible, it may be appropriate to retain the audit manager and audit senior from the previous year to aid continuity. Adjei & Associates may also consider a second partner review to ensure that quality control standards have been maintained.

(3 marks)

b) Recommendation on composition of an audit committee for Ghana Sugar Company Limited.

An Audit committee is a sub-committee of the board of Directors which is mandated to help the main board to discharge its responsibilities in the area of achieving effective and transparent financial reporting. To play an independent role the audit committee should be composed of at least three and maximum of five members, majority of whom should be non-executive directors. Whiles the members are not required to be accounting and financial professionals they should have sufficient knowledge and experience in financial matters, especially financial reporting requirements.

While these executives of the company cannot be members of the committee, they can be in attendance at meetings.

1) The Chief executive officer
2) The financial director or chief financial or accounting officer
3) Head of internal audit

The external auditor may also be invited when necessary to attend a meeting of the committee.

(5 marks)

Responsibility of an audit committee

The main role and responsibilities of the audit committee are as follows:

1) To monitor the integrity of the financial statements of the company and any formal announcement relating to the company's performance, reviewing significant financial reporting judgements contained in them.
2) To review the company's internal financial controls and, unless expressed addressed by a separate board risk committee composed of independent directors or by the board itself, to review the company's internal control and risk management systems.
3) To monitor and review the effectiveness of the company's internal audit function.
4) To make recommendations to the board, for it to put to shareholders for their approval in general meeting , in relation to the appointment, re-appointment, and removal of the external auditor and to approve the remuneration and terms of engagement of the external auditor.

5) To review and monitor the external auditor's independence and objectivity and the effectiveness of the audit process taking into account relevant professional and regulatory requirements.
6) To develop and implement policy on the engagement of the external auditor to supply non-audit services, taking into account relevant ethical guidance regarding the provision of non-audit services by the external firm and to report to the board identifying any matters in respect of which it considers that action and improvement is needed and making recommendations as to steps to be taken.
7) To report to the board how it has discharge it responsibilities, including
   - How it has addressed significant issues arising in the financial statements
   - How it has addressed the effectiveness of the audit process
   - How auditors objectivity and independence is safeguarded, where the auditor provided non-audit services.

(Any 5 points for 5 marks)

(Total: 20 marks)

EXAMINER'S COMMENTS

Question 2a.
This question was on practice management with particular reference to quality control issues illustrated in the three short cases. Many candidates were able to spot the issues involved and provided the required actions that the audit term should take.

Question 2b.
The question called for recommendations for the composition of an audit committee for a company about to hit on the Ghana Stock Exchange and description of the responsibilities of the committee. The composition of the presented problems to some candidates who rather gave the composition of an Audit Report Implementation Committee (ARIC) in the public sector. However, many candidates were able to describe the responsibilities of an audit committee.

QUESTION THREE

a) Principal Audit risks

i) Profitability

The results of the preliminary analytical review indicate that Kpandu Sika Limited is suffering from declining profitability. Revenue has fallen by 12·3% and the gross margin has fallen from 45·7% to 40%. Operating profit has fallen by 27·8%, and the operating margin has fallen from 19·3% to 15·9%. The declining sales and gross profits may be linked to the company losing several customer contracts.

Return on capital employed (ROCE) as calculated based on the information provided shows a reduction from 7% to 4·4%. However, the capital employed figure is not comparable due to the revaluation that occurred during this year.

When recalculated based on an adjusted capital employed figure, this year's ROCE is 4·9%. Whichever measure is used for capital employed, the trend shows a reduction in efficiency in generating profit.

The falling profitability indicates that going concern should be regarded as an audit risk, especially when the company's liquidity position is considered (see below).

The company's interest cover has fallen from 3·7 to 2·7, indicating that while there is sufficient profit to cover interest payments this year, any further debt raised will place additional strain on the company's ability to meet interest repayments.

In addition, there are several adjustments that may need to be made, which would further reduce the company's profitability. These adjustments are in relation to the share-based payment and lease expenses, which will need to be recognised depending on the outcome of our audit work in these areas.

ii) Management Bias

As Kpandu Sika Limited is renegotiating long-term finance, management could be biased to present as good a profit figure as possible. We should therefore be alert to the risk of accounting practices being used which overstate revenue and understate expenses. The statement of financial position is also at a risk of misstatement, as management may wish to overstate assets and understate liabilities to improve the appearance of the company's liquidity and solvency.

iii) Operating expenses

Operating expenses have fallen by 20%. This is not in proportion with the fall in revenue of 12·3% or the fall in cost of sales of 3%, indicating that operating expenses could be understated. Given the costs involved in setting up a new trading division, operating expenses could be expected to increase this year, due to additional set-up and advertising costs. As the trend is not as expected we must extend our audit procedures on operating expenses.

There could also be a misallocation of expenses between cost of sales and operating expenses.

iv) Share-based payment plan

Equity-settled share-based payment plans are complicated to value and account for, and are inherently risky.

IFRS 2 ***Share-based Payment*** requires that an expense should be recognised over the vesting period, calculated based on the fair value of the share options at the grant date. The condition relating to the 10% increase in share price is a market condition. Market conditions should be taken into account when determining the fair value of the share options at the grant date and are not to be taken into account for the purpose of estimating the number of equity instruments that will vest. This means where the target increase in share price has not been met, an expense should be recognised irrespective of whether that condition is satisfied, and an expense continues to be recognised over the remainder of the vesting period.

The issue here is that no expense has been recognised, and so operating expenses are understated. The corresponding entry to equity has not been made, so equity is also understated.

A further issue relating to the measurement of the expense is that it should be adjusted for the condition relating to executives and senior managers remaining in employment at the end of the vesting period. A risk of inaccurate measurement of the expense arises if no assessment of whether an adjustment being necessary is made, or if the assumptions relating to the continued service of the executives are unrealistic.

The share-based payment plan should also have a deferred tax consequence – a deferred tax asset arises due to the deductible temporary difference arising from the accounting treatment. There is a risk that assets are incomplete if this is not recognised in the statement of financial position.

Marking scheme note: *Credit will be awarded for comments relating to the use of option pricing models and the audit risks associated with them. In determining the expense to be recognised, Kpandu Sika Limited needs to use a valuation method for estimating the fair value of the share options at the grant date. Various models can be used, but all are based on inputs such as share price, exercise price, rate of return and estimated dividend yield. The risk is that inappropriate assumptions have been input to the valuation model, resulting in an unrealistic estimate of the fair value of share options at the grant date. Further, there is a risk that the wrong valuation model has* been *used.*

v) Finance Costs

The financial information shows that finance costs have remained static. This seems unrealistic given that the company has built up a significant overdraft over the year. Finance costs are likely to be understated.

vi) Liquidity

Kpandu Sika Limited has moved from a positive cash position of₵2·35 million to a negative net cash position of₵1·2 million. This increases the going concern risk facing the company, and we must ensure our going concern audit procedures are extended to address this risk.

My preliminary analytical review indicates that the company is still solvent, but liquidity ratios reveal a deteriorating position. The current ratio has reduced from 2·5 to 1·4, and the quick ratio has reduced from 2·1 to 1. Any further deterioration could mean that the company cannot meet its current liabilities as they fall due.

Further indications of problems with operating cash flows are shown by the receivables collection period increasing from 55 to 64 days, and the inventory holding period increasing from 36 to 39 days. Kpandu Sika Limited is also taking longer to settle trade and other payables, with the average payment period increasing from 73 to 76 days.

Kpandu Sika Limited is clearly relying on its overdraft to fund operating cash flows. The fact that it is nearing the overdraft limit is another indication of the going concern risk facing the company this year end.

vii) Revaluation

A material revaluation occurred mid-year. A revaluation surplus of ₵10 million, representing 10·2% of total assets, has been recognised. Despite the valuations being performed by an independent expert, we should be alert to the risk that non-current assets could be overstated in value. This is especially the case given that Kpandu Sika Limited is renegotiating finance, and will want to show a healthy asset position to the provider of finance. We should consider the additional procedures that may need to be conducted to assess the work of this expert. As mentioned above, there is also a risk that depreciation was not re-measured at the point of the revaluation, leading to understated expenses.

The revaluation should also have a deferred tax consequence, as the revaluation gives rise to a taxable temporary difference. If a deferred tax liability is not recognised the statement of financial position is at risk of misstatement through understated liabilities.

Finally, a further audit risk is incorrect or inadequate disclosure in the notes to the financial statements. **IAS 16** ***Property, Plant and Equipment*** requires extensive disclosure of matters such as the methods and significant assumptions used to estimate fair values, the effective date of the revaluation, and whether an independent valuer was used, as well as numerical disclosures.

viii) Current assets

Inventory and receivables have both increased, whereas revenue has fallen. As mentioned above, the receivables collection period has increased from 55 to 64 days, and the inventory holding period increased from 36 to 39 days. This could indicate that both are overstated. The nature of the products being manufactured mean a high risk of obsolescence exists. Cut-off problems may also account for the increase in inventory. Receivables could be overstated if sufficient allowance has not been made for irrecoverable balances.

ix) Long-term borrowings

The long-term borrowings are due for repayment in two equal instalments, one of which is within 12 months of the year end. The borrowings need to be split into two components of GH₵12·5 million and disclosed separately in current liabilities and non-current liabilities. If this is not done the financial statements will be materially misstated, as the borrowings equate to 25·5% of total assets. Thus the disclosure of the loan is a significant audit risk.

Marking Scheme note: *Credit will be awarded where candidates include the effect of reclassification ofGH₵12·5 million as a current liability into their ratio analysis.*

Given the company's lack of cash, if the loans are not successfully renegotiated, it may not be possible for the repayments to be made, creating a going concern risk.

x) Intangible asset

The amount invested in the new website has been capitalised as an intangible asset. The risk is that amounts have been capitalised which do not meet the criteria for recognition as an asset, leading to an overstatement of non-current assets

Only costs in respect of the development of a website should be capitalised, subject to meeting the recognition criteria of **IAS 38 *Intangible Assets*.** Any costs incurred in planning must be expensed, as should expenditure incurred once the website is operational. The risk is that the costs involved in setting up the website have not been categorised correctly, leading to incorrect accounting treatment.

In addition, the website should only be recognised as an asset at all if it can be demonstrated that it will generate probable future economic benefit to Kpandu Sika Limited. There is a risk that this is not the case, in which case all of the expenses should be written off.

Finally, there is a risk that the costs involved with the advertising campaign, and possibly other costs involved in setting up this seemingly significant business division, have been capitalised. Such costs should be expensed as incurred, hence there is a risk of overstated non-current assets and understated operating expenses. **(10 marks)**

b) Provision

The provision for warranties have reduced by 20%, which is not in proportion to the reduction in revenue of 12·3%. Possibly the company has changed its policy on providing warranties, or is selling fewer products with warranties attached. However, we should be alert to the risk of the warranty provision being understated, especially given the incentive for the accounts to be subject to management bias.

It is questionable whether the warranty provisions should be classified as non-current liabilities. It is likely that some, if not all, of the provision will lead to an outflow of economic benefits within the next 12 months and it should be recognised within current liabilities. This potential misclassification affects analysis of liquidity.

Auditors should adopt one or a combination of the following audit procedures in the audit of the Provision

- **Review and test the process used by management to develop the Provision;**
  The steps ordinarily involved in reviewing and testing the process used by management are:
  a) evaluation of the data and consideration of assumptions on which the estimate is based;
  b) testing of the calculations involved in the estimate;
  c) comparison, when possible, of estimates made for the purposes of the preparation of prior period financial statements with subsequent actual outcomes;
  d) consideration of management's approval procedures; and
  e) Obtaining management representations.

- **Use an independent estimate for comparison with that prepared by management;**
  Auditors may make or obtain an independent estimate and compare it with the warranty provision prepared by management. When using an independent estimate auditors would ordinarily evaluate the data and consider the assumptions, and may test the calculation procedures used in its development. It may also be appropriate to compare warranty provisions made for prior periods with actual results of those periods. Or

- **Review subsequent events.**
  Transactions and events which occur after the period end, but prior to completion of the audit, may provide audit evidence regarding a warranty provision made by management. Auditors' reviews of such transactions and events may reduce, or even remove, the need for the auditors to review and test the process used by management to develop the warranty provision or to use an independent estimate in assessing the reasonableness of the warranty provision.

(3 points for 6 marks)

c) Leased Property

The lease taken out in July 2011 has been treated as a finance lease. However, there are indications that it is in fact an operating lease. Firstly, the lease is for only five years, which for a property lease is not likely to be for the major part of the economic life of the asset. According to IAS 17 *Leases*, an indicator of a finance lease is that the lease term is for the major part of the economic life of an asset.

Secondly, the amount capitalised of GH₵5 million represents only 25% of the fair value of the asset. Under IAS 17, for a lease to be classified as a finance lease, the present value of minimum lease payments (the amount capitalised) should amount to at least substantially all of the fair value of the asset. 25% is not substantially all of the fair value, indicating that this is actually an operating lease.

Therefore it appears that the accounting treatment is incorrect. The lease should have been treated as an operating lease. Currently, property, plant and equipment and non-current liabilities are overstated. The finance cost will be overstated if any interest accrued on the lease has been included. Operating expenses are understated as lease payments should have been included in this heading, and so profits are likely to be overstated. However, operating expenses will currently contain depreciation charges for the leased asset, which will need to be reversed. The overall impact on operating expenses could be minimal as the two adjustments will offset each other to an extent. **(4 marks)**

(Total: 20 marks)

EXAMINER'S COMMENTS

Question 3a.
This was a scenario question featuring statement of profit and loss and statement of financial position of a company with notes listing various business risks. Candidates were required to identify the principal risk, that the auditors should consider when carrying out the audit to ensure the financial statement are free from material misstatement. Many candidates were able to identify the risks and explained their possible effect on the financial statements. Even though this question was correctly answered by many candidates, other candidates resorted to the definition of the components of audits risk and did not do well in this question.

Question 3b.
Candidates were required to outline principal audit procedures to be performed in the audit of product warranties given to customers. This question was answered correctly by candidates.

Question 3c.
Principal audit evidence in respect of classification of a lease was demanded.
Performance was good.

QUESTION FOUR

a) The following audit opinions are recommended.

1) Since the inconsistency is traced to the financial statements, it may be considered that the financial statements are materially misstated. The pervasiveness of the effect of the matter will be considered and if it is only material, a qualified opinion "except for" will be issued. On the other hand, if the effect is considered as being both material and pervasive, an **adverse opinion** will be appropriate.
2) GHS2.0 million reduction in the value of stocks amount to 10% of the total assets of the company. This is material. This amounts to material misstatement of the financial statement and non-compliance with applicable financial reporting framework. The recommended audit opinion will be a "**qualified opinion".**
3) Since the auditors consider the effect of the matter to be both material and pervasive, it means that there was a significant inability to obtain sufficient appropriate audit evidence to determine misstatements in the financial statements. The auditors will be unable to express an opinion and therefore a **disclaimer of opinion** will be appropriate.
4) Since management refused to make a provision for the write-off of the debtor, the requirement of IAS 37 have not been complied and thus will be materially misstated. A **qualified opinion** is recommended.

(2 marks for each = 8 marks)

ii) The auditor may consider the reason behind the directors' refusal to effect the changes and determine whether it borders on the directors wanting to commit fraudulent financial reporting which will reflect on their integrity. It could also mean the directors are difficult and just do not want to co-operate with the auditor's. Whatever the case, the auditors may want to bring this to the attention of the shareholders in the annual general meeting.

(2 marks)

b)

1) In the new clarity project on the ISAs, the IAASB reiterated that the next of the ISAs is authoritative and must be followed even in the audit of SMEs.
2) However, the IAASB did state that the work an auditor will need to do in order to comply with the ISA will vary, a small simple entity being likely to require less work than a large and complex one.
3) The auditor needs to use professional judgement in applying the ISAs in order to determine the procedures necessary to comply with their requirements.
4) To take a specific example, the IAASB stated that, the requirement of ISA 315 to obtain an understanding of the entity and its environment is relevant to smaller entities but that because smaller entities are typically simpler, it will be much easier to obtain this understanding.
5) Individual clarity ISAs include guidance on specific points relating to small entity audits.

6) The purpose of this guidance is to assist in the application of the requirement of the ISA to a small entity audit.
7) The clarity project does not limit or reduce the responsibility of the auditor to apply and with requirement of ISAs.

(10 marks)

(Total: 20 marks)

EXAMINER'S COMMENTS

Question 4a (i)

Four scenarios were given for candidates to determine the type of audit opinions to issues. Many candidates did not go through the system process of arriving at the opinions, namely;

1. Identifying the circumstance
2. Assessing the perverseness of the matter
3. Prescribing the appropriate opinion.

Some candidates went through the procedures correctly but ended up issuing wrong opinions. For example adverse opinion was given for inability to obtain sufficient appropriate audit evidence, the effect of which was considered as both material and pervasive.

This question and question 4b. were the worst answered questions.

Question 4a (ii)

Candidates were to consider what actions the auditors should take if management refused to implement audit recommendation to adjust the financial statements and/or allow the auditors to perform certain audit procedures. A mixture for right and wrong answers was given.

Question 4b.

This was a contextual question on the current issues section of the syllabus. It required a discussion of the IAASB's clarity Project in relation to the audit of SMEs.

Many candidates did not have the slightest idea about the requirement. Other candidates make spirited attempt to answer the question but to no avail. Some candidates discussed the financial reporting requirements for SMEs instead of the auditing requirements. As stated previously this question and its counterpart, question 4a were the worst questions attempted by candidates.

QUESTION FIVE

a)

i) The main possible reasons why the directors are reluctant to provide the note to the financial statements are that they fear that:

The note will send a wrong signal to the stakeholders as follows;

- The prospective loan creditor may refuse to provide the needed funds on the basis that the company is not a going concern.
- Trade Creditors may refuse further credit and resort to cash on delivery transactions with the company.
- If the company is a listed entity, its share prices may fall.
- The existing shareholders may think that management is not running the affairs of the company properly.
- Potential investors may be scared away from investing in the company.
- Predators may pick it as signal to make take-over bid for the company.

(1 mark for each point= 5 marks)

ii)

- If the directors refuse to provide the note, the auditors may consider that the financial statements are materially misstated in account of the non-disclosure of the going concern uncertainty.
- In the height of this, the auditors would consider this disagreement on the type of opinion to issue which might be other than unmodified.
- This failure to disclose the going concern problem will result in an adverse opinion. The auditors could also assess the implication of management refusal on their continued association with the client.
- If they consider that it amounted to serious non-co-operation with them by management, they may consider terminating the client relationship.
- However, they have to seek legal counsel and also draw the attention of the shareholders of the problem.

(5 marks for any 5 points)
(5 marks)

b)

i) The environmental issues that may lead to the risk of material misstatements in financial statements are;

- Provisions e.g. for site restoration costs.
- Contingent liabilities, e.g. arising from pending legal action.
- Assets values, e.g. inventory or non-current assets which may be subject to environmental concern.
- Accounting for capital or revenue expenditure on cleaning up the production process or to meet legal or other standards.
- Product redesign costs
- Product viability/going concern considerations

(1 mark each or any 3 valid points)
(3 marks)

(ii). Actions that should be undertaken

- Obtain an appropriate understanding of the company, its operations and in particular, its environmental issues.
- Evaluate whether there is any possible risk of misstatement in the financial statements as a result of environmental issues.
- Enquire of management as to any systems or controls which are in place to identify risk, evaluate control, and account for environmental matters.

(1 mark each or any 3 valid points)
(3 marks)

Audit Procedures

- Obtain an understanding of the control environment operating within the client.
- Obtain written representations from management on any environmental matters
- Obtain evidence from environmental experts where this is necessary.
- Seek corroborative evidence of any statements by management.
- Use professional judgement to consider whether the evidence in relation to environmental matters is sufficiently persuasive.
- Consider minutes of directors, board, committees or environmental officers.
- Review documentation.
- Review all assets for impairment.
- Review liabilities and provisions to ensure all have been included.
- Review contingencies and ensure adequate disclosure.
- Include environmental issues in the review of the appropriateness of going concern.

(1 mark each for any 4 valid points)
(4 marks)

(Total: 20 Marks)

EXAMINER'S COMMENTS
Question 5a (i)
In the preamble to this question the directors of a company were said to have refused to put a note on the financial statements to indicate a significant going concern doubt and candidates were required to give possible reasons for the director's action. The possible reason for the director's refusal were correctly spelt out by many candidates.

Question 5a (ii)
Candidates were to discuss the implication of the director's refusal to provide the note in relation to the work of the auditors. Many candidates restricted themselves to the type of opinion to be issued by the auditors action may amount to non-cooperation with the auditors, or an attempt to indulge in fraudulent financial reporting, calling into question the integrity of the directors. The attempt was not good.

Question 5b (i& ii)
Candidates were required to evaluate environmental issues that may result in misstatements in financial statements of an audit client mentioned in the preamble to the question. The correct answers were given by many candidates.
Recommendation of audit procedures to deal with the audit of a Mining Company Client affected by question was properly answered.

CONCLUSION
Performance in this paper can be grade as better than the performance in the previous session paper, however it still fell below expectation, taking into account the quality of the questions and the level of difficulty involved.
The pass rate for this paper is *42%* as compared to *22%* for the last diet.

Full coverage of the syllabus and marks allocation to questions in line with the syllabus weighting should be the desired objective of the next paper. The push towards examining the highest learning outcomes, namely application, analysis and synthesis and evaluation must continue.