

**Answer 1**

Internal controls can be preventive or detective corrective in nature:

**(a)**

**Preventive controls:** are designed to discourage or pre-empt errors or irregularities from occurring. They are more cost-effective than detective controls. Credit cheques, job descriptions, required authorisation signatures, data entry checks and physical control over assets to prevent their improper use are all examples of preventive controls. This can also be referred to as Accounting Controls to check procedures, records, and reports that have been designed to safeguard assets and to promote the reliability of financial accounting records and reports.

**Detective controls:** are designed to search for and identify errors after they have occurred. They are more expensive than preventive controls, but still essential since they measure the effectiveness of preventive controls and is the only way to effectively control certain types of errors. Account reviews and reconciliations, observations of payroll distribution, periodic physical inventory counts, passwords, transaction edits and internal audits are all examples of detective controls. It can also be referred to as administrative controls it comprises of procedures and records that assist management in achieving the organisation's goals and prevent fraud and misuse of resources. Personnel procedures are an example of administrative controls.

**(10 Marks)**

**(b)**

A potential self-interest threat may arise from gifts and hospitality. Where gifts/hospitality are provided that a reasonable and informed third party, having knowledge of all relevant information, would consider clearly insignificant the member in public practice may conclude that the offer is made in the normal course of business with no intent to influence decision-making or to obtain information. In the case of gifts and hospitality that would be evaluated as significant, safeguards should be applied. You may wish to explain your decision in writing.

**(5 Marks)**

**(c)**

No. The Audit is designed in such a way that the auditor cannot verify the financial statements in their entirety. Auditors will use various tests on a substantive basis and by testing controls to generate sufficient and appropriate audit evidence to satisfy themselves that the internal controls adopted by the entity will (a) prevent, (b) detect and (c) correct any material misstatements within the accounts and that the accounts themselves are either free from 'material misstatement' or not. This helps the company become more efficient and will help shareholders understand how effective the directors are running their company.

**(5 Marks)**

**(d)**

The responsibility of prevention and detection of fraud rests with the audit client. The auditor does not have a duty to look for fraud, but they do have a duty to expect fraud at the planning stage and satisfy themselves that fraud has not taken place by undertaking appropriate audit procedures and gathering sufficient and appropriate audit evidence. The auditor has a legal obligation to report directly to the shareholders and their report is addressed to the shareholders, not the directors (though the two may be the same in smaller entities).

**(5 Marks)**

**Answer 2**

**(a)**

To be eligible for appointment, an auditor must generally be a member of a body approved by the department of trade. In the United Kingdom, 16 of the professional bodies which have been approved by the department of trade include the ACCA, CIPFA, ICA (E&W) and the AIA. In Ghana, the Institute of Chartered Accountants is the only approved body which can license individual auditors. The following are ineligible for appointment as auditors of a company

- An officer or servant of a company
- A partner or employee of (a) and
- Anyone disqualified under (a) or (b) above from being the auditor of another company in the same group either holding company, subsidiary or fellow-subsubsidiary.

**(5 Marks)**

**(b)**

No. the company's code prevents any auditors to prepare the accounts and audit it himself. The reason for this is to enable the auditor do his job by exhibiting high level of integrity, professional conduct and showing independence. If it were so, outside might see the accounts prepared as credible for external consumption because it might be

prone to accounting errors that the auditor will be unable to detect. Again, conducting the audit that the auditor had prepared the accounts himself may be subjected to biasness. Under the company's code, this might be equal to the conflicts of interest.

**(5 Marks)**

**(c)**

Financial audit is conducted to obtain reasonable assurance as to whether the financial statements are free of material misstatement. It is designed to provide reasonable, but not absolute, assurance of all transactions. There is a risk that material errors, fraud, or illegal acts, may exist and not be detected by the auditors. In addition, auditors' engagement cannot, therefore, be relied upon to disclose errors, fraud, or other illegal acts that may exist. However, they will inform directors of any material errors and fraud that come to their attention. Accordingly, auditors have no responsibility to identify and communicate significant deficiencies or material weaknesses in company's internal controls as part of their engagement. As per the company's code, auditors are to express an opinion on whether financial statement prepared shows a true and fair view of the state of affairs of the business.

**(5 Marks)**

**(d)**

The 4 different types of opinions that an auditor may issue on the financial statements are Unqualified, Qualified Adverse Reports and Disclaimer reports.

- **Unqualified opinions** are where the auditor agrees the financial statements are free from material misstatement.
- **Qualified opinions** are where the auditor disagrees with the accounting treatment/disclosure within the financial statements and is usually followed by an 'except for' paragraph stating that 'except for' the disagreement, in all other respects, the financial statements give a true and fair view.
- **Adverse opinions** are where the auditor concludes the financial statements do contain a material misstatement/error which the client refuses to correct. This is where the auditor concludes the financial statements do not give a true and fair view.
- **Disclaimers** are where auditor cannot make a conclusion on whether the financial statements give a true and fair view because of various circumstances (typically due to substantial failings in the internal controls) and therefore does not give an opinion. This is the worst opinion the auditor can give and the Government authorities (for example, Companies House) do have the power to demand the director's correct the financial statements.

**(10 Marks)**

**Answer 3**

- (1) **The “smoking gun”** This is the argument that only in a few documented instances has auditor independence been found to be implicated in audit failures, at least if one accepts the evidence provided by lawsuits and prosecutions of auditors for securities fraud. Most lawsuits and prosecutions of auditors have been based on assertions of incompetence or lack of due diligence in the application of auditing standards, rather than lack of independence. An inability to obtain access to detailed records of lawsuits and other evidence about audit failures, however, makes this incantation difficult to prove.
- (2) **“We are doing pretty good.”** Based on public opinion surveys, the public accounting profession has generally been held in high regard. Public opinion polls assessing the esteem of the profession often address issues like objectivity, reliability, and honesty, rather than independence per se. While objectivity, reliability, honesty, and independence may overlap, what “independence” actually means to the general public is unclear. Often, the public is not well informed about what auditors do.
- (3) **The “public good.”** This incantation suggests that if too many constraints are placed on the public accounting profession’s scope of services, accounting firms will be unable to serve clients properly, thereby imposing significant costs on the public. Some public accounting firms have argued that providing nonauditing services allows them to perform better audits because they can obtain a better understanding of the client’s systems. R. David Plumlee, in “The Standard of Objectivity for Internal Auditors: Memory and Bias Effects” (*Journal of Accounting Research*, vol. 23, No. 2, 1985), has asserted that while this argument seems reasonable, it is difficult to accept that, even with independence of mind, auditors can objectively opine on the proper functioning of systems that they have designed.
- (4) **“Trust us.”** Independence is often said to be a mental state possessed by professional accountants and therefore not subject to empirical observation or quantification. This incantation is based on the idea of auditor economic self-interest; that is, auditors are assumed to maintain independence and objectivity so as not to harm their longer-term economic interests. This assumes that auditors continually evaluate the costs and benefits associated with ethical behavior and always resolve conflicts in favor of behaving ethically because doing so produces the greatest long-term economic benefit. While these assumptions may be argued, it can also be observed that the individual economic calculus of a particular auditor may weigh in favor of retaining an important client rather than being objective and independent, thus undermining the “trust us” argument.

**(12.5 Marks each for every 2 points provided)**

**Answer 4(a)**

Auditing is getting more attention than ever before thanks to Enron, Worldcom, and the outrage that they stirred up. The Sarbanes-Oxley Act includes a requirement for internal controls over financial reporting to be assessed annually with the conclusions of the assessment published and attested to by external auditors. This has increased the pressure dramatically.

At the same time, many internal auditors are changing the way they work, away from routine examination of internal controls and towards a more flexible audit of all types of risk appearing on the corporate risk register. Although auditors feel this is a good direction it is somewhat experimental and does create some difficulties. One trend that may become more important is for organisations to set up a team of internal control specialists whose role is to help managers design, develop, and implement good control systems. They may do reviews, but the objective is very different from internal audit. This allows internal auditors to concentrate on what they do best, which is independent assessment, rather than getting stuck into design. The new rules announced by the SEC on 27 May 2003 may accelerate this trend. The rules say that companies cannot describe their controls as effective if there is even one “material weakness”. Many companies will use the extra time they have been given to try to eliminate as many weaknesses as possible and publish a clean report. While auditors can help with this, ultimately, you cannot audit your way to corporate health. Someone has to have the creative solutions to problems that have often lingered for years.

**(15 Marks)**

**(b)**

- it is not longer possible for auditors to test 100% of the transactions in a company’s accounting records sampling is necessary and sampling carries with it a quantifiable but small risk of error;
- even if it were possible to test 100% of the transactions in a company’s accounting records, there is always an element of detection risk in that mistakes and errors of judgement can be made in interpreting results;
- Large-scale fraud is often deliberately concealed by senior management who collude to prevent it coming to the auditors’ attention and such frauds are very difficult to detect. it is possible to conduct fraud audits but they are expensive and are not necessarily cost-effective because the cost of detection often outweigh the assets recovered as a result of detection.
- Auditors rely on the operation of internal controls to provide them with assurance as to the effective operation of a system; there are inherent limitations in the operation of such systems.
- most audit evidence is persuasive, rather than conclusive in nature;

**(Any 3 points from the above will earn 5 points)**

(c)

Judgements made by auditors in arriving at the audit opinion are as follows:

- in arriving at any audit opinion, the auditor should be satisfied that sufficient appropriate evidence has been obtained on the financial statements as a whole and on individual account areas in order to form an opinion;
- if insufficient evidence has been obtained, there has been a limitation in the scope of the audit and the auditor will either issue a qualified opinion in relation to an area which is material (e.g., an except for opinion in relation to lack of evidence to support the cash sales figure), or, a disclaimer of opinion on the financial statements as a whole (stating that the auditor is unable to form an opinion at all). The sufficiency of evidence is almost wholly a matter of professional judgement;
- If sufficient evidence has been obtained but the auditor disagrees with accounting treatment or presentation, an except for or adverse opinion will be issued, depending on the severity of the matter. Again, disagreement is a matter of judgement and different auditors may have different opinions on the same subject;
- Auditors also exercise judgement when considering whether to issue an emphasis of matter which draws attention to a particular feature of the financial statements (such as financing arrangements).

**(Any 3 points from the above will earn 5 points)**