

QUESTION ONE

Mr. Chan is an accountant of a Cyprus incorporated company (“the Company”) which is a subsidiary of a large group of companies incorporated in Hong China. He is a professional accountant and an expert in financial instruments. Further to the company working hours, Chan is working until late regularly during which time he processes the major part of the company’s transactions.

More specifically, he is using a few bank accounts, which were opened in the name of the Company, to carry out transfers in foreign currencies. In most of the cases these activities are not linked to the business activities of the Company. In addition, the balance of the accounts is usually nearly zero; however, the total amount of the transfers and volume of transactions is often considerable.

The transactions posted in the general ledger are split in small amounts and in addition, many of the transactions are rounded amounts and less than €1.000. The internal policy of the company is to supervise transactions which are above €1.000. The proceeds from the transactions are deposited at different branches of the same bank. In addition, he makes short-term investments, mainly using electronic means to transfer, in marketable securities and derivatives, which are quickly liquidated so that the proceeds can be reinvested.

The investments are spread in Seychelles and Mauritius and other locations around the world.

Chan behavior has been identified by some other employees of the Company, but without taking any further steps or informing any person of the Company high on the hierarchy. The company recently hired a new accountant supervisor to assist the financial controller of the Company and he suspects that Yianni’s transactions are outside the corporate goals of the Company and its activities and seems not to be legitimate transactions

Required

- (a) Identify and explain any five (5) red flags that suggests the occurrence of money laundering in the above case **(15 Marks)**
- (b) What are the obligations of Mr. Chan in the above case **(10 Marks)**

QUESTION TWO (25 MARKS)

Two managers were discussing about Forensic Accounting and fraud auditing. One of the managers, Mrs. Kijanga argued that, Forensic Accounting deals with the application of accounting facts gathered through forensic investigations methods and also provides legal supports in the courts. She said, Forensic Accounting is much different from traditional auditing.

She added that, the main purpose of an audit is to examine the financial statements of an entity in order to express an opinion on whether the financial statements have been prepared in accordance with the International Standards on Auditing (ISAs). In contrast, she said, Forensic Accounting is the investigation of a fraud allegation or suspicion by a forensic accountant with the idea of presenting the evidence in courts. She stressed that; Forensic Accountants must be experts in all statutory laws. Finally she added that, in order to present undisputable evidence in courts, Forensic Accountants must provide absolute assurance that fraud has occurred.

Presenting her arguments the second manager, Mrs. Mzuzuri, said that, auditors employ extensive testing and sampling techniques but, testing and sampling methods are not employed by forensic accountants as part of evidence gathering procedures. She said, an audit is an investigation and its main objective to uncover fraud and is performed with a view to present the evidence in a judicial forum. Forensic Accounting is a discipline consisting of two areas of specialization, namely, investigation and litigation supports.

She contended that, the expertise of the forensic accountant may be used to support a plaintiff who is trying to establish a claim or to support a defendant in order to minimize the impact of a claim against him or her. However, she said sometimes disputes are settled by negotiation. In her conclusion, Mrs. Mzuzuri said “usually the forensic accountant’s findings are based on facts, not opinions. Facts can be investigated, and the forensic accountant can prepare a definitive report on the facts. However, there are situations where the forensic accountant may present findings using an opinion-type report’

Read the managers arguments above, and answer the following questions

- (a) Identify any five (5) statements that are significantly incorrect

(10 Marks)

- (b) provide a correct statement for each of the identified wrong argument **(15 Marks)**

QUESTION THREE

One of the earliest cases concerned with auditors' duties to detect fraud was Kingston Cotton Mill Co. (No. 2) (1896). This is a classic case which the auditing profession has relied on implicitly almost since the judgment was given by the learned Lord Justice Lopes in 1896. Facts of the case:

For several years the manager of the Kingston Cotton Mill had been exaggerating the quantities and values of the company's inventory so as to fraudulently overstate the company's profits.

This came to light when the company was unable to pay its debts and its true financial position was revealed. The auditor relied on a certificate signed by the manager and ensured that the amount appearing in the accounts was consistent with that certificate. The valuation of inventory was described in the accounts as being as 'per manager's certificate'.

In line with contemporary practice, the auditor did not physically observe inventory or attempt to verify the valuation of individual items. Neither did the auditor reconcile inventory with the opening balance and purchases and sales during the year, all of which would have put the auditor on notice that something was amiss. In this case it was held that it was not the duty of an auditor to take stock and that they were not negligent in accepting a certificate signed by company's officials as long as they had no suspicion of fraud. Lopes L.J gave his famous and much over-quoted dictum that the role of the auditor is that of is "a watchdog, not a bloodhound."

Lopes went on to say

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud when there is nothing to arouse their suspicion, and when those frauds are perpetrated by tried servants of the company and are undetected for years by the directors.

Required

Discuss whether the Kingston Cotton Mill Co. (1896) case is still valid in relation to the International Standard on Auditing (ISA) 240 *The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements*

QUESTION FOUR (25 Marks)

You are a manager in Najma Ally & Co, a firm of Certified Public Accountants in Public Practice. You have just attended a monthly meeting of audit partners and managers at which client-related matters were discussed. Information in relation to a client, which was discussed at the meeting, is given below:

Msumari Co

The audit report on the financial statements of Msumari Co, a long-standing audit client, for the year ended 31 December 2020 was issued in April 2021, and was unmodified. In May 2021, MsumariCo's audit committee contacted the audit engagement partner to discuss a fraud that had been discovered. The company's internal auditors estimate that TZS 900 million has been stolen in a payroll fraud, which has been operating since May 2020.

The audit engagement partner commented that neither tests of controls nor substantive audit procedures were conducted on payroll in the audit of the latest financial statements as in previous years' audits there were no deficiencies found in controls over payroll.

The total assets recognised in MsumariCo's financial statements at 31 December 2020 were TZS 16,000 million. Msumari Co is considering suing Najma Ally & Co for the total amount of cash stolen from the company, claiming that the audit firm was negligent in conducting the audit.

Required:

Explain any ten (10) matters that should be considered in determining whether Najma Ally & Co is liable to Msumari Co in respect of the fraud. (25 marks)

QUESTION FIVE

Because of the competitive bidding process for construction contracts often makes profit margins razor thin, contractors may be tempted to increase their profits through fraud. A developer negotiated a \$550 million guaranteed maximum price contract with a prime contractor and subcontractors to erect a 40-story building.

To the developer's surprise, the allowances and contingency holds for unexpected costs and emergencies were exhausted before even the core and shell had been completed. This left the interior work unfunded. Puzzled and suspicious, the developer hired a forensic accountant who discovered the prime contractor had bribed the architect and they were now colluding to defraud the developer.

The contractor was purchasing goods and services beyond those required for the developer's building, diverting the excess to outside jobs on which he and the architect were working and submitting the invoices to the developer. The excess expenses were approved and explained away by the architect. The contractor and the architect had convinced themselves that the developer's cost controls were shortsighted and would make the job unprofitable for them.

When the architect and contractor were confronted with the evidence of the private investigation, they agreed to pay for the remaining construction from their own funds rather than be prosecuted. The developer did not press charges against either the architect or the contractor, but he did report the architect to the licensing board. At the hearing, the investigators produced the evidence they had discovered for the developer and the architect received a written reprimand.

This effectively put the architect on an industry blacklist, which made it difficult for him to find well-paying jobs. As with other fraudsters, the consequences of the dishonest architect's fraud affected his family. He was no longer able to keep his children in private school, and he had to drop a club membership he had enjoyed with his wife. Life went on, but not at the carefree level the family had enjoyed before.

Required

Read the above case and answer the following questions in relation to the fraud triangle

- (a) Identify the persons who committed fraud and the victim of fraud (**5 marks**)
- (b) Explain in detail the three factors that influenced these persons to commit fraud (**12 Marks**)
- (c) How could the above fraud been avoided by the fraud victim? (**8 Marks**)

SOLUTION ONE

(a) There are numerous red flags in the scenario but the obvious ones that are often over looked are

— The employee working until late regularly and possibly does not take vacation. Chan is working until late regularly, where a large volume of transactions is being processed. The absence of any obvious explanation for the late working hours environment could be a sign that they are being deliberately set up to confuse and obscure.

— The employee does not take vacation. The absence of any obvious explanation for not taking vacation suggests that he does not want another person to see what he was doing

— The use of several bank accounts for transfers which in most cases are not linked to the main activities of the Company maybe another indication of money laundering.

Additionally, the bank accounts closing balance on each day is close to zero even though the total amount and volume of transactions is considerable.

— Moreover, the posted transactions are below the threshold of €1.000 which is the Company's threshold for requiring supervision on transactions executed and entered into the system.

— Finally, complex financial instruments, derivatives in this case, being used by a business with no obvious business rationale is a sign of the layering and integration stages of money laundering.

(b) What are the obligations of an 'in-house accountant'?

— Any direct involvement of the accountants in the money laundering process means that they are themselves breaking the Law.

— Additionally, any person, including an auditor, external accountant, tax advisor or trust and company service provider, in practice or elsewhere, who, in the course of his trade, profession, business or employment, acquires knowledge or reasonable suspicion that another person is engaged in money laundering or terrorist financing, commits an offence if he/she does not report his/her knowledge or suspicion to Financial Intelligence Unit (FIU), as soon as it is reasonably practical after the information came to his/her attention.

— This duty to report arises under the Anti-Money Laundering Act and the Anti-Money Laundering Regulations, 2022

— Adherence to the Code of Ethics for Professional Accountants is fundamental in the obligations of an in-house accountant. This promotes professional integrity, which provides the

means to protect against complicity in economic crime and acts as a barrier against (un) professional enablers and even protects against unintentional participation in an economic crime.

— In this case, the accountant is in clear breach of the Law as well as the Directive and the Code of Ethics for Professional Accountants. He did not demonstrate any professional scepticism and integrity and disrespected the company policies and the principles of the law and the Code

SOLUTION TWO

Two managers were discussing about Forensic Accounting and fraud auditing.

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She said, Forensic Accounting is much different from traditional auditing.

She added that, the main purpose of an audit is to examine the financial statements of an entity in order to express an opinion on whether the financial statements have been prepared in accordance with the International Standards on Auditing (ISAs).

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She stressed that; **Forensic Accountants must be experts in all statutory laws.**

Finally she added that, **in order to present undisputable evidence in courts, Forensic Accountants must provide absolute assurance that fraud has occurred.**

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She contended that, **the expertise of the forensic accountant may be used to support a plaintiff who is trying to establish a claim or to support a defendant in order to minimize the impact of a claim against him or her.**

However, she said sometimes disputes are settled by negotiation.

In her conclusion, Mrs. Mzuzuri said “**usually the forensic accountant’s findings are based on facts, not opinions.**

Facts can be investigated, and the forensic accountant can prepare a definitive report on the facts.

However, there are situations where the forensic accountant may present findings using an opinion-type report’

Read the managers arguments above, and answer the following questions

- (a) Identify any five (5) statements that are significantly incorrect **(10 Marks)**
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SOLUTION THREE

Whether the Kingston Cotton Mill Co. (1896) case is still valid in relation to the International Standard on Auditing (ISA) 240 *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*

The judgment given by Lord Justice Lopes in 1896 was that auditors’ role is that of a watchdog (who barks when they see something suspicious) rather than a bloodhound (who actually searches for something suspicious).

The perception of auditor's duty with regards to detection and prevention of frauds and errors was initially based on the decision given in **Kingston Cotton Mills Co. (1896) case**. The judge summed up auditor's duty by stating, “Auditor is a watchdog, not a bloodhound.”

An auditor is not bound to be a detective, or to approach his work with suspicion, or with a foregone conclusion that there is something wrong.

Auditors must not be made liable for not tracking out ingenious and carefully laid schemes of fraud, when there is nothing to arouse their suspicion ... So to hold would make the position of an auditor intolerable.’

This judgment set the tone for the audit profession to be passive checkers rather than be proactive detectives in searching out errors, misstatements and frauds.

However, this statement may no longer have the force it once did in the light of ISA 240 *‘The auditor’s responsibilities relating to fraud in an audit of financial statements’*.

Auditors have now to recognize at least the possibility that fraud may exist and, consequently, adopt an attitude of professional scepticism in their approach to audit work.

They have to recognize that schemes of fraud may involve complex misrepresentations and carry out their work accordingly.

This ISA may well be interpreted by the courts as placing on auditors a rather greater element of awareness, if not actual investigating, than the previous decisions admitted. Auditors still do not have to actively seek out fraud, but they have to be alert of fraud

This judgment set the tone for the audit profession for over a century – auditors were to be passive checkers rather than be proactive detectives in searching, misstatements and frauds.

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ISA 240, *The auditor's responsibilities relating to fraud in an audit of financial statements*’. may well be interpreted by the courts as placing on auditors a rather greater element of awareness, if not actual investigating for fraud, than the previous decisions admitted.

Auditors are also required by the current International Standard on Auditing (ISA) 500, *Audit Evidence* to observe inventory count. This might have not been required in the Kingston Cotton Mills Co. (1896) case age

One of the issues which confront us is just how far these standards which were applicable in 1895 and 1896 should be accepted today.

In 1896 there was in fact no statutory obligation on the part of a trading company (other than certain banking companies) to file annual accounts at the companies registry

The articles on the other hand may have required the company to supply annual accounts to shareholders.

Furthermore there was no legal obligation on the part of companies to appoint an auditor until in the 1900s

SOLUTION FOUR

Ten matters that should be considered in determining whether Najma Ally & Co is liable to Msumari Co in respect of the fraud are:

— It is not the auditor’s primary responsibility to detect fraud. According to ISA 240, *The Auditor’s Responsibilities Relating to Fraud in an Audit of Financial Statements*, management is

primarily responsible for preventing and detecting fraud. The auditor is required to obtain reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or error.

— The total amount estimated to have been stolen in the payroll fraud represents 5.625% of MsumariCo's assets. If the amount has been stolen consistently over a 12-month period, then TZS 6,000 million ($8/12 \times 9,000$ million) had been stolen prior to 31 December 2020.

— TZS 6,000 million is material, representing 3.75% of total assets at the year end. Therefore the fraud was material and it could be reasonably expected that it should have been discovered.

— However, material misstatements arising due to fraud can be difficult for the auditor to detect. This is because fraud is deliberately hidden by the perpetrators using sophisticated accounting techniques established to conceal the fraudulent activity.

— False statements may be made to the auditors and documents may have been forged. Thus, material frauds could go undetected, even if appropriate procedures have been carried out.

— ISA 240 requires that an audit is performed with an attitude of professional skepticism. This may not have been the case. Msumari Co is a long-standing client, and the audit team may have lost their skeptical attitude. Necessary tests of control on payroll were not carried out because in previous years it had been possible to rely on the client's controls.

— It seems that ISAs may not have been adhered to during the audit of Msumari Co. ISA 330 The Auditor's Responses to Assessed Risks requires that the auditor shall design and perform tests of controls to obtain sufficient appropriate audit evidence as to the operating effectiveness of relevant controls if the auditor's assessment of risks of material misstatement at the assertion level includes an expectation that the controls are operating effectively.

— It can be acceptable for the auditor to use audit evidence from a previous audit about the operating effectiveness of specific controls but only if the auditor confirms that no changes have taken place. The audit partner should explain whether this was the case.

— Substantive procedures have not been performed on payroll either. This effectively means that payroll has not been audited. This leads to a conclusion that the audit firm may have been negligent in conducting the audit. Negligence is a common law concept in which an injured party must prove three things in order to prove that negligence has occurred:

- That the auditor owes a duty of care;
- That the duty of care has been breached;

– That financial loss has been caused by the negligence.

— Looking at these points in turn, Najma Ally & Co owes a duty of care to Msumari Co, because a contract exists between the two parties. The company represents all the shareholders as a body, and there is an automatic duty of care owed to the shareholders as a body by the auditor.

— A breach of duty of care must be proved for a negligence claim against the audit firm to be successful. Duty of care generally means that the audit firm must perform the audit work to a good standard and that relevant legal and professional requirement have been followed.

— For an audit firm, it is important to be able to demonstrate that ISAs have been adhered to. Unfortunately, it seems that ISAs have been breached and so the audit firm is likely to have been negligent in the audit of payroll.

— A financial loss has been suffered by the audit client, being the amount stolen while the fraud was operating. In conclusion, Msumari Co is likely to be able to successfully prove that the audit firm has been negligent in the audit of payroll, and that Najma Ally & Co is liable for some or all of the financial loss suffered.

Credit will be awarded for references to legal cases as examples of situations where audit firms have been found to have been negligent in performing an audit, such as *Re Kingston Cotton Mill*.

SOLUTION FIVE

(a) The following are the persons who committed fraud:

- (i) The prime contractor and
- (ii) The architect

(b) Factors that influenced the contractor and the architect to commit fraud included

- (i) Incentive to get more profits
 - The prime contractor and the architect had a number of other jobs that were similar to the developer's job.
 - These outside jobs needed goods and services similar to the ones needed by the developer. They thus bought extra goods and services by using the developer's money and diverted the excess to the outside jobs
- (ii) Opportunity to commit fraud
 - There were no controls to ensure that goods and services purchased were entered in a goods received book. This record could help the developer compare the goods delivered against the goods ordered.

- There were no controls to ensure that goods and services used were entered in a goods delivered book. This record could help the developer compare the goods delivered to the sight
- The prime contractor and the architect circumvented other controls through collusion
- He developer was not investigating the invoices sent to him

(iii) Rationalization

- The prime contractor and the architect believed that the developers cost control were so tight that the job would not provide much profits to them.

(c) The developer could mitigate the above fraud by doing the following

- tighten the controls over purchasing of goods and services as well as the issue of goods and services by stabling a log book to monitor goods and services received and used in the contract
- make a reconciliation of goods and services purchased versus goods and services needed