

CPA

Certified Public Accountant Examination

Stage: Intermediate Level

Subject Title: I1.4 Auditing

Revision Guide



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STUDY TECHNIQUE

What is the best way to manage my time?

- Identify all available free time between now and the examinations.
- Prepare a revision timetable with a list of “*must do*” activities.
- Remember to take a break (approx 10 minutes) after periods of intense study.



What areas should I revise?

- Rank your competence from Low to Medium to High for each topic.
- Allocate the least amount of time to topics ranked as high.
- Allocate between 25% - 50% of time for medium competence.
- Allocate up to 50% of time for low competence.

How do I prevent myself veering off-track?

- Introduce variety to your revision schedule.
- Change from one subject to another during the course of the day.
- Stick to your revision timetable to avoid spending too much time on one topic.

Are study groups a good idea?

- Yes, great learning happens in groups.
- Organise a study group with 4 – 6 people.
- Invite classmates of different strengths so that you can learn from one another.
- Share your notes to identify any gaps.

EXAMINATION TECHNIQUES

INTRODUCTION

Solving and dealing with problems is an essential part of learning, thinking and intelligence. A career in accounting will require you to deal with many problems.

In order to prepare you for this important task, professional accounting bodies are placing greater emphasis on problem solving as part of their examination process.

In exams, some problems we face are relatively straightforward, and you will be able to deal with them directly and quickly. However, some issues are more complex and you will need to work around the problem before you can either solve it or deal with it in some other way.

The purpose of this article is to help students to deal with problems in an exam setting. To achieve this, the remaining parts of the article contain the following sections:

- Preliminary issues
- An approach to dealing with and solving problems
- Conclusion.

Preliminaries

The first problem that you must deal with is your reaction to exam questions.

When presented with an exam paper, most students will quickly read through the questions and then many will ... **PANIC!**

Assuming that you have done a reasonable amount of work beforehand, you shouldn't be overly concerned about this reaction. It is both natural and essential. It is natural to panic in stressful situations because that is how the brain is programmed.

Archaeologists have estimated that humans have inhabited earth for over 200,000 years. For most of this time, we have been hunters, gatherers and protectors.

In order to survive on this planet we had to be good at spotting unusual items, because any strange occurrence in our immediate vicinity probably meant the presence of danger. The brain's natural reaction to sensing any extraordinary item is to prepare the body for 'fight or flight'. Unfortunately, neither reaction is appropriate in an exam setting.

The good news is that if you have spotted something unusual in the exam question, you have completed the first step in dealing with the problem: its identification. Students may wish to use various relaxation techniques in order to control the effects of the brain's extreme reaction to the unforeseen items that will occur in all examination questions.

However, you should also be reassured that once you have identified the unusual item, you can now prepare yourself for dealing with this, and other problems, contained in the exam paper.

A Suggested Approach for Solving and Dealing with Problems in Exams.

The main stages in the suggested approach are:

1. Identify the Problem
2. Define the Problem
3. Find and Implement a Solution
4. Review

1. Identify the Problem

As discussed in the previous section, there is a natural tendency to panic when faced with unusual items. We suggest the following approach for the preliminary stage of solving and dealing with problems in exams:

Scan through the exam question

You should expect to find problem areas and that your body will react to these items.

PANIC!!

Remember that this is both natural and essential.

Pause

Take deep breaths or whatever it takes to help your mind and body to calm down.

Try not to exhale too loudly – you will only distract other students!

Do something practical

Look at the question requirements.

Note the items that are essential and are worth the most marks.

Start your solution by neatly putting in the question number and labelling each part of your answer in accordance with the stated requirements.

Actively reread the question

Underline (or highlight) important items that refer to the question requirements. Tick or otherwise indicate the issues that you are familiar with. Put a circle around unusual items that will require further consideration.

2. Define the Problem

Having dealt with the preliminary issues outlined above, you have already made a good start by identifying the problem areas. Before you attempt to solve the problem, you should make sure that the problem is properly defined. This may take only a few seconds, but will be time well spent. In order to make sure that the problem is properly defined you should refer back to the question requirements. This is worth repeating: Every year, Examiner Reports note that students fail to pass exams because they do not answer the question asked. Examiners have a marking scheme and they can only award marks for solutions that deal with the issues as stipulated in the question requirements. Anything else is a waste of time. After you have re-read the question requirements ask yourself these questions in relation to the problem areas that you have identified:

Is this item essential in order to answer the question?

Remember that occasionally, examiners will put ‘red herrings’ (irrelevant issues) into the question in order to test your knowledge of a topic.

What’s it worth?

Figure out approximately how many marks the problem item is worth. This will help you to allocate the appropriate amount of time to this issue.

Can I break it down into smaller parts?

In many cases, significant problems can be broken down into its component parts. Some parts of the problem might be easy to solve.

Can I ignore this item (at least temporarily)?

Obviously, you don’t want to do this very often, but it can be a useful strategy for problems that cannot be solved immediately.

Note that if you leave something out, you should leave space in the solution to put in the answer at a later stage. There are a number of possible advantages to be gained from this approach:

- 1) It will allow you to make progress and complete other parts of the question that you are familiar with. This means that you will gain marks rather than fretting over something that your mind is not ready to deal with yet.
- 2) As you are working on the tasks that you are familiar with, your mind will relax and you may remember how to deal with the problem area.
- 3) When you complete parts of the answer, it may become apparent how to fill in the missing pieces of information. Many accounting questions are like jigsaw puzzles: when

you put in some of the parts that fit together, it is easier to see where the missing pieces should go and what they look like.

3. Find and Implement a Solution

In many cases, after identifying and defining the problem, it will be easy to deal with the issue and to move on to the next part of the question. However, for complex problems that are worth significant marks, you will have to spend more time working on the issue in order to deal with the problem. When this happens, you should follow these steps:

Map out the problem

Depending on your preferred learning style, you can do this in a variety of ways including diagrams, tables, pictures, sentences, bullet points or any combination of methods. It is best to do this in a working on a separate page (not on the exam paper) because some of this work will earn marks. Neat and clearly referenced workings will illustrate to the examiner that you have a systematic approach to answering the question.

Summarise what you know about the problem

Make sure that this is brief and that it relates to the question requirements. Put this information into the working where you have mapped out the problem. Be succinct and relevant. The information can be based on data contained in the question and your own knowledge and experience. Don't spend too long at this stage, but complete your workings as neatly as possible because this will maximise the marks you will be awarded.

Consider alternative solutions

Review your workings and compare this information to the question requirements. Complete as much of the solution as you can. Make sure it is in the format as stipulated in the question requirements. Consider different ways of solving the problem and try to eliminate at least one alternative.

Implement a solution

Go with your instinct and write in your solution. Leave extra space on the page for a change of mind and/or supplementary information. Make sure the solution refers to your workings that have been numbered.

4. Review

After dealing with each problem and question, you should spend a short while reviewing your solution. The temptation is to rush onto the next question, but a few moments spent in

reviewing your solution can help you to gain many marks. There are three questions to ask yourself here:

Have I met the question requirements?

Yes, we have mentioned this already. Examiner Reports over the years advise that failure to follow the instructions provided in the question requirements is a significant factor in causing students to lose marks. For instance, easy marks can be gained by putting your answer in the correct format. This could be in the form of a report or memo or whatever is asked in the question. Likewise, look carefully at the time period requested. The standard accounting period is 12 months, but occasionally examiners will specify a different accounting period.

Is my solution reasonable?

Look at the figures in your solution. How do they compare relative to the size of the figures provided in the question?

For example, if Revenue were 750,000 and your Net Profit figure was more than 1 million, then clearly this is worth checking.

If there were some extraordinary events it is possible for this to be correct, but more than likely, you have misread a figure from your calculator. Likewise, the depreciation expense should be a fraction of the value of the fixed assets.

What have I learned?

Very often in exams, different parts of the solution are interlinked. An answer from one of your workings can frequently be used in another part of the solution. The method used to figure out an answer may also be applicable to other parts of your solution.

Conclusion

In order to pass your exams you will have to solve many problems. The first problem to overcome is your reaction to unusual items. You must expect problems to arise in exams and be prepared to deal with them in a systematic manner. John Foster Dulles, a former US Secretary of State noted that: *The measure of success is not whether you have a tough problem to deal with, but whether it is the same problem you had last year.* We hope that, by applying the principles outlined in this article, you will be successful in your examinations and that you can move on to solve and deal with new problems.

ASSESSMENT STRATEGY

Examination Approach

The skills examined include comprehension, detailed application, synthesis, evaluation, effective communication, the analysis of audit issues and the ability to propose appropriate solutions thereto. All questions are scenario-based. The compulsory questions examine the students' competence over a range of issues and they are asked to show how elements of the syllabus interact and overlap. The remaining questions seek to ascertain the students' knowledge of the practical application of the theoretical concepts studied.

Students are also required to demonstrate, in the context of the scenario presented, the ability to exercise professional judgment (including appropriate professional scepticism and consideration of legal and ethical issues) in drawing conclusions.

Examination Format

The examination is by an unseen closed-book examination of 3 hours' duration. The examination paper consists of 7 questions divided between Section A and Section B.

There are 3 compulsory questions in Section A. Students are required to answer 2 of the 4 questions in Section B.

Marks Allocation

Section A

Question 1 (Compulsory)	20
Question 2 (Compulsory)	20
Question 3 (Compulsory)	20

Section B

Questions 4 to 7 (choice of any 2 out of 4 20 marks each)	40
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Total	100
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LEARNING RESOURCES

Core Texts

Modern Auditing, 3rd Edition 2008 / Cosserrat and Rodda/ Wiley/ ISBN 978 0470319734

Guide to Using International Standards on Auditing in the Audits of Small-and Medium Sized entities /2nd Edition 2010/IFAC/ISBN 978-1-60815-076-2 556. Published in two volumes freely available for download from:

Volume 1:

<http://web.ifac.org/media/publications/5/guide-to-using-international-1/guide-to-using-international-1.pdf>

Volume 2:

<http://web.ifac.org/media/publications/5/guide-to-using-international-1/guide-to-using-international-2.pdf>

Manuals

I1.4 Auditing – Institute of Certified Public Accountants of Rwanda

Technical Material:

1. Auditing and Quality Control

Standards

- International Standards on Auditing

- International Standard on Quality Control

(ISQC 1)

2. Financial Accounting and Reporting Standards

International Financial Reporting Standards (IFRSs)

The International Auditing Standards (IASs) are available from the International Accounting Standards Board website at www.iasb.org

Supplementary Texts and Journals

Principles of External Auditing 3rd ed / Porter, Hatherby, Simon / Wiley 2008 / ISBN 978-0470-01825-5

The Audit Process, Principles, Practice & Cases 5th edition/Gray and Manson / Cengage 2011 / ISBN 9781408030493

Useful Websites (as at date of publication)

www.icparwanda.com

www.iaasb.org – International Auditing & Assurance Standards Board.

www.ifac.org – The International Federation of Accountants.

www.ifrs.org/ - The International Financial Reporting Standards Foundation.

www.frc.org.uk/ - The Financial Reporting Council.

www.frc.org.uk/pob/ - The Professional Oversight Board

I1.4 AUDITING
REVISION QUESTIONS

REVISION QUESTIONS

Question 1

Lifts Ltd. is a leading name within the specialist stair lift industry, based in Kigali. Lifts Ltd. has a strong reputation for customer care and quality of service. Lifts Ltd. is committed to improving accessibility for its elderly and disabled customers by providing custom built solutions. Lifts Ltd. outsources the manufacturing of all parts to a large number of suppliers and then assembles the custom-made lifts from the parts procured in its plant in Kigali. Lifts Ltd. has a fully integrated Computerised Accounting System (CAS). You are Mrs Ayim CPA and it is two weeks before Lifts Ltd.'s financial year end. As part of the interim audit work you have been given responsibility for identifying the relevant internal control issues and testing the procurement, receiving and payable systems.

Procurement, receiving, and payables activity

Lifts Ltd.'s Store Manager has sole responsibility for procurement. The Directors of the company have the utmost confidence in the Store Manager and therefore see no necessity in being involved in the procurement process. The Store Manager selects suppliers based on the suppliers having the necessary certification by Certification Africa (CA) Limited and on price in a competitive tender process.

The inventory control part of the CAS generates a numerically sequenced Purchase Requisition (PR), when the quantity of a particular part falls below re-order level. The PR details the part required and the quantity to order is electronically forwarded to the Procurement Department. Staff in the Procurement Department review the PR, allocate a Purchase Order (PO), identified by a unique sequential order number, to an authorised supplier and send the PO to that supplier using Electronic Data Interchange (EDI). A copy of which is filed in the PO database by the CAS. Large or out of the ordinary purchases require authorisation by the Store Manager.

When parts are received, the Store Clerk confirms that the inventory agrees to the bill of lading and checks the PO database to ensure that the inventory were in fact ordered by Lifts Ltd. Delivery is refused where goods do not have a bill of lading. The CAS is updated to confirm receipt of goods, an electronic numerically sequenced Good Received Note (GRN) is generated and the inventory records are updated to show the receipt of inventory. The physical goods are added to the parts store and the bill of lading is stamped with the PO number and GRN number and is filed in the Goods **Inwards Department**.

When the supplier submits an invoice by EDI, it is matched by the CAS against Lifts Ltd.'s PO and GRN for all relevant data and the CAS is updated to confirm receipt of the invoice. The invoice is added to the purchases database on the CAS.

REQUIREMENT:

(a) Prepare a Management Report, clearly identifying the recipient, listing THREE weaknesses in internal control. For each weakness state the impact and recommend a control to overcome that weakness.

(10 marks)

(b) Identify FIVE audit procedures that an auditor would normally carry out on the procurement, receiving and payables systems at LiftsLtd, describing the reason for each procedure.

(10 marks)

[Total: 20 Marks]

Question 2

Design Jewellery (DJ) is a retailer of jewellery based in Kigali.

With reference to the audit of the bank balance, you, the Audit Manager, are given the following client prepared bank reconciliation by your Audit Junior. Your Audit Junior has already performed some audit work as indicated by the symbols below:

Prepared by: Client/DED – 7 April 2011

Approved by: Client/SW – 8 April 2011

Design Jewellery Bank Reconciliation at 31 March 2011

Balance per bank	17,174	◇
+ Cash deposit in transit (not yet recorded by bank)	<u>450</u>	
	17,624	T
- Outstanding cheques (not yet recorded by bank)	2,000	
= Balance per cash ledger	15,624	T

◇- Traced to Bank Statement at 31 March 2011

T- Total checked for accuracy

REQUIREMENT:

(a) ISA 500 Audit Evidence, “The auditor should use assertions for classes of transactions, account balances and presentation and disclosure in sufficient detail to form a basis for the assessment of risks of material misstatement and the design and performance of further audit procedures”.

(i) Identify and explain FOUR assertions that the auditor would be concerned with in relation to the bank balance.

(4 marks)

(ii) Identify and explain FOUR risk factors relating to bank balance.

(4 marks)

(iii) In addition to the two audit procedures already performed on the bank reconciliation above, list FOUR other audit procedures that an auditor should perform.

(4 marks)

b) Explain, why in verifying bank reconciliations, auditors will be more concerned with the possibility of a non-existent deposit in transit being included in the reconciliation and an outstanding cheque being omitted rather than the omission of a deposit in transit and the inclusion of a non-existent outstanding cheque.

(4 marks)

c) Explain why it is important for the auditor to confirm all bank accounts held and operated by the client during the year.

(4 marks)

[Total: 20 marks]

Question 3

Operating out of Kigali and Gitarama, Transport Ltd. (TL), a freight forwarding company, aims to provide its customers with a reliable and competitively priced freight service, both nationally and internationally. At any one time TL has approximately 100 large trade receivables balances. Each of these balances can fluctuate between RWF50k to RWF200k. At year end, the average large balance is RWF110,000. The remaining accounts have on average a balance of RWF5,000. The trade receivables balances have different due dates for payments and credit limits. The trade receivables are maintained alphabetically in a master file of trade receivables.

Freight Service document data is keyed into a computerised system that simultaneously produces a freight services invoice, income journal and an updated trade receivables master file.

Customers submit cheques and remittance advices to clear their debt. On opening the post, a member of the accounts staff records the list of cheques. Computer services staff carry out a comparison of the remittance advices with this listing. After computer services staff enter the cash receipts information, a cash receipts journal and an updated trade receivables master file are simultaneously prepared.

Summary totals are produced on a monthly basis by the computer services department for updating the general ledger master file accounts i.e. cash, income and trade receivables.

You are Mr Muller, Audit Senior, responsible for the audit of TL's trade receivables balance for 2011. Although previous audits of trade receivables have tended to adopt an 'audit around the computer' approach, you have decided to use audit software to assist with the audit of the trade receivables balance.

REQUIREMENT:

(a) List SIX specific risks posed by information technology to an entity's internal control.

(6 marks)

(b) Explain the concept of 'auditing around the computer' and discuss why this increases audit risk for the auditor.

(4 marks)

(c) Explain the FIVE audit procedures that could be carried out using audit software on the trade receivables balance at TL. For each procedure, explain the reason for that procedure.

(10 marks)

[Total: 20 marks]

Question 4

Kigali Meat Company (KMC) is an Kigali registered company that offers premium meat to its customers at wholesale prices. As part of the planning process the recently appointed auditor is preparing an Overall Audit Strategy, with one of its principal sections being an overview of KMC's business and industry resulting from his acquisition of an understanding of it.

REQUIREMENT:

a) Describe THREE benefits an auditor derives from planning audits.

(3 marks)

(b) Outline the responsibilities of the new and previous auditors when a company is changing auditors.

(3 marks)

(c) Identify the factors the auditor should have considered before accepting appointment as auditor of a company.

(4 marks)

(d) With regard to the auditor obtaining an understanding of a client's business and industry:

i) Explain TWO reasons why an auditor needs an understanding of the client's business and industry.

(2 marks)

ii) identify FOUR major aspects of understanding the client's business, industry, and sources commonly used by auditors to acquire such an understanding for each of the FOUR aspects.

(8 marks)

[Total: 20 marks]

Question 5

Made in Marble (MiM) based in the North of Rwanda, offers design solutions to architectural, construction and engineering customers using marble. MiM create products tailored to customer specifications using computer-controlled machinery and coating materials. MiM's customer base is varied from well-known multinational companies, to individual customers with a design idea. Typical products include dining room tables, landscape seating, spa and pool features and garden planters. MiM's workshop in Kigali contains computer-controlled machines that have the capability to cut blocks of marble into virtually any shape or size.

In previous years, MiM maintained a manual accounts system. This year MiM has purchased a new Computerised Accounts System (CAS) which records purchases and sales transactions and maintains records of trade receivables, trade payables, and inventory.

You, Mr Osei, as MiM's Audit Engagement Supervisor have decided to adopt a risk-based audit strategy in the audit of MiM.

Whilst MiM now maintains records of inventory (in both quantity and value) on its new CAS, you and your audit team will be observing the physical inventory count in MiM at year-end to ensure the proper cut-off of purchases and sales.

REQUIREMENT:

(a)

(i) Explain why observation of the physical inventory count is essential in ensuring the proper cut-off of purchases and sales.

(4 marks)

(ii) What information should the auditor obtain during the physical count to ensure that cut-off for sales is accurate?

(4 marks)

(iii) What information should the auditor obtain during the physical count to ensure that cut-off for purchases is accurate?

(2 marks)

(b) Mrs Keita, Managing Director of MiM, has a number of concerns regarding the audit. She knows that you plan to adopt a risk-based auditing strategy and does not know what this means. She has asked that you send her a letter explaining:

(i) What is meant by a risk-based auditing strategy; and

(4 marks)

(ii) Advising on the steps that you propose to take arising from MiM's implementation of its new computerised accounting system.

(4 marks)

Format and Presentation

(2 marks)

[Total: 20 Marks]

Question 6

The Wine Tavern (TWT) is a bar in Kigali. The premises were built in the 15th Century and still have some of its original features. It serves bar food as well as drinks. TWT's financial year-end is 30 June 2011.

TWT does its banking with the Kigali Remera branch of Commercial Bank of Rwanda (CBR).

On 15 January 2011, TWT took out a 20 year mortgage for RWF5,200,000 to acquire the building adjoining the pub, with the intention of expanding. TWT used the pub and the ground on which the pub stands as collateral. Every month since the loan was obtained a payment of RWF40,000 (principal and interest) has been paid to CBR.

As the responsible audit manager, you are in charge of the current year audit for TWT. TWT is an existing client of your firm but this is the first time TWT has had a mortgage.

REQUIREMENT:

(a)

(i) Explain why it would be necessary to record information on the mortgage for inclusion in the permanent file.

(2 marks)

(ii) Identify what type of information in relation to the mortgage should be included in the permanent file.

(2 marks)

(iii) Identify and explain any THREE key financial statement assertions for the mortgage, interest expense, and interest payable accounts i.e. ONE assertion for each.

(3 marks)

(b)

(i) List the audit procedures you should perform to audit the internal control components of the mortgage.

(5 marks)

(ii) List the substantive audit procedures to verify:

- The issue of the mortgage;

(1 mark)

- the balance of the mortgage at 30 June 2011;

(1 mark)

- interest payable accounts at 30 June 2011;

(1 mark)

- and the balance in the interest expense account for the period ended 30 June 2011.

(1 mark)

(c) Briefly explain why the audit procedures on mortgage payable, interest expense, and interest payable should be conducted together.

(4 marks)

[Total: 20 Marks]

Question 7

Soothing Baby Products (SBP) distributes and sells baby products across Rwanda. Karim, the audit junior, with responsibility for both sales and receivables performed a preliminary evaluation of the company's internal control over sales transactions and concluded that the system of internal controls over sales is in general good and control risk is low. Therefore, Karim decides to test controls to confirm her assessment of control risk. SBP raised approximately 650 sales invoices during the year, whose recorded total is RWF7,500,000. SBP's profit before taxes for the year is RWF1,800,000.

Deciding to use judgemental (non-statistical) sampling Karim randomly selects a sample of 40 copy sales invoices from the recorded sales. She examines each sample invoice by conducting the following tests of control:

- Checks the invoice is correctly coded with customer and nominal codes.
- Checks that the prices on the invoice are consistent with SBP's official price list.
- Checks the invoice for arithmetic, prices and calculations including VAT.
- Traces the invoice details to the customer sales order.
- Traces the invoice amount to SBP's day books, ledgers and inventory records.

After performing the above tests of control, Karim notes a few minor control deviations, for which the SBP's sales staff give her plausible explanations. Karim therefore confirms her assessment of control risk as low. Consequently, Karim decides to confirm receivables at year-end and to limit her sample size to 15 accounts selected haphazardly from the population of 250 receivable accounts.

REQUIREMENT:

- (a) Briefly explain the concept of sampling risk, indicating why such risk exists and what measures Karim should take to minimise such risk.

(5 marks)

(b) Critically evaluate Karim's audit approach with respect to the truth and fairness of sales and receivables.

(6 marks)

(c) Karim decided to determine the sample size judgmentally (non-statistically). Identify FOUR advantages of using statistical sampling instead of using judgemental sampling (non-statistical sampling).

(6 marks)

(d) In the event that customers of SBP do not respond to Karim's request explain THREE alternative procedures that Karim should perform to gain assurance as to the truth and fairness of those balances.

(3 marks)

[Total: 20 Marks]

Question 8

Digital Select (DS) is an indoor and outdoor short run digital print house specialising in small and large format digital signage and display. It has a fully integrated creative studio to take a project from concept right through to completion. You are the Audit Manager for DS and are now at stage in the audit of DS that precedes the audit reporting stage. You ask your Audit Junior, Abi, to draft the audit report and below is a paragraph she has drafted:

“We planned and performed our audit to obtain assurance as to whether the statements are free of misstatement. We examined evidence to support the amounts used by management. An audit also includes assessing the accounting standards as used by the Directors, as it is the Director’s responsibility to prepare the statements.”

REQUIREMENT:

(a) List SIX basic elements of an auditor’s report. Briefly explain why each element is included in the report.

(6 marks)

(b) Identify the errors and deficiencies in the above paragraph drafted by Abi.

(9 marks)

(c) Explain the audit process stage that precedes the audit reporting stage and follows the financial statements testing stage.

(5 marks)

[Total: 20 Marks]

Question 9

Your firm is the auditor of Lost Get IT Returned (LGIR) a Kigali-based company that sells security tags for items such as laptops and mobile phones. Their turnover last year was RWF17m.

You, the Audit Supervisor, are now at the planning stage of the audit and have made some notes for your audit junior in relation to the International Standards on Auditing (ISAs UK and Ireland). Amongst the notes you have given your audit junior are the following:

ISA 300 Planning an audit of financial statements requires that the planning stage of the audit should be used to establish an overall strategy for the audit and to develop an audit plan.

ISA 330 The auditor's procedures in response to assessed risks notes that it is essential that the auditor documents the nature, timing and extent of audit procedures that have been performed.

ISA 315 Obtaining an understanding of the entity and its environment and assessing the risks of material misstatement directs that the auditor must gain an understanding of internal control within an entity that is relevant to the audit.

The audit junior has come back to you and asked you to clarify a number of items for him as outlined in the REQUIREMENT section below.

REQUIREMENT:

- (a) List FOUR key matters that should be contained in an overall strategy for the audit.
(4 marks)
- (b) Should the overall strategy for the audit and other planning documents, like the audit plan, be revised during the course of the audit? Justify your answers.
(6 marks)
- (c) List FIVE items or pieces of information that should be included in the audit documentation to demonstrate that the required audit was conducted according to the International Auditing Standards.
(5 marks)

(d) There are various methods for recording the control systems in the preliminary evaluation of internal control. One method is to use a narrative.

(i) State two other methods.

(2 marks)

(ii) For the narrative method and for each of the other two methods in your answer to part (i), list the advantage of each of the three methods.

(3 marks)

[Total: 20 Marks]

Question 10

One of your responsibilities with your audit firm, XYZ Ltd., member firm of ICPAR, is developing new clients.

XYZ Ltd. is a small audit firm. Motor Ltd. is based in Kigali where they sell new and used cars. Motor Ltd. also service cars. You are currently in discussions with Motor Ltd. in relation to the possibility of ABC Ltd.becoming Motor Ltd.'s new auditors. If your firm consents to be their Auditor, Motor Ltd. has offered to service your car free of charge and the cars of the three audit partners of the audit firm. Normal charge for a service of one of these cars is RWF6000. You plan to communicate with the previous auditor before making your recommendation.

REQUIREMENT:

- (a) State with reasons whether you and the audit partners should accept the offer of free car services from Motor Ltd. in event they are accepted as an audit client.

(6 marks)

- (b) In addition to communicating with the previous auditor, explain FOUR factors that you should consider in determining whether it is feasible for XYZ Ltd. to accept this engagement.

(8 marks)

- (c) Identify THREE items of information you should obtain from Motor Ltd.'s previous auditor.

(6 marks)

[Total: 20 marks]

I1.4 AUDITING
REVISION SOLUTIONS

REVISION SOLUTIONS

Solution 1

(a) Management Letter To the Audit Committee of Lifts Ltd.:

Please find attached the various internal control weaknesses we identified in our assessment of your procurement, receiving and payables internal control systems:

Internal Control Weakness 1

Weakness: The directors do not monitor procurement activity.

Impact: The Stores Manager has sole responsibility for selecting suppliers and could be receiving kickbacks from suppliers.

Recommendation: The directors should identify risks associated with its procurement/receiving/payables activity and should implement a strategy to monitor such risks and for example another member of staff outside the procurement department along with Stores Manager should be involved in selecting suppliers.

Internal Control Weakness 2

Weakness: Lack of proper criteria for selecting suppliers as volume criteria is not specified and nor are any credit references sought.

Impact: Purchases may be made from unacceptable suppliers who may not represent a reliable source of supply because of production inability or financial constraints.

Recommendation: Volume requirements should be considered when selecting a supplier as well as their financial stability (credit reference checks) by the finance department.

Internal Control Weakness 3

Weakness: Stores clerk does not count and inspect goods received.

Impact: Goods may be inaccurately entered into the CAS (quantities and type).

Recommendation: The stores clerk should count the parts and inspect them before entering this information into the CAS.

(b) Audit procedures procurement, receiving and payables systems:

Procedure 1

Obtain a sample of authorised suppliers and check for CA certification

Reason for Procedure 1

To confirm that all authorised suppliers have the requisite certification

Procedure 2

Obtain a sample of POs in the CAS, record details of the PO and trace to the bill of lading filed in the goods inwards department.

Reason for Procedure 2

To confirm that all goods ordered were received.

Procedure 3

For the sample of POs above, agree to the inventory records in the CAS.

Reason for Procedure 3

To confirm that goods received were completely and accurately recorded in the inventory records.

Procedure 4

Obtain a sample of bills of lading and agree to the CAS.

Reason for Procedure 4

To confirm that inventory received has been recorded in Lifts Ltd.'s CAS and that liabilities are therefore not understated.

Procedure 5

For a sample of POs, agree details to trade payables, confirming details against the supplier invoice.

Reason for Procedure 5

To confirm complete and accurate recording of the inventory liability in trade payables.

Procedure 6

For a sample of invoices in the CAS, agree details to the bills of lading for items on that invoice.

Reason for Procedure 6

To confirm that the purchase liability has been recorded only for goods actually received.

Procedure 7

For a sample of supplier invoices, tot and cross tot invoice price and quantities confirming price to the original order.

Reason for Procedure 7

To confirm the arithmetical accuracy of invoices and ensure the company was charged the correct price for goods received.

Solution 2

(a)

i) Assertions:

1. **existence** – does the recorded bank balance exist at the balance sheet date.
2. **rights and obligation** – does DJ have the rights to all bank balances shown at the balance sheet date.
3. **valuation** – is the bank balance recorded in its correct amount.
4. **completeness** – are all bank balances recorded in the correct period and included in the financial statements.
5. **accuracy** – are all bank balances accurately recorded in the financial statements.
6. **cut-off** – have all transactions been accounted for in the correct accounting period.
7. **classification** – are all bank balances properly classified and disclosed in the balance sheet and are all lines of credit, loan guarantees and other restrictions on bank balance appropriately disclosed.

ii) Risk factors relating to bank include:

1. Complexity of the item, as in the case of foreign exchange transactions and hedges.
2. Lack of segregation of incompatible duties facilitating the misappropriation of cash.
3. Reliability of cash recording system.
4. Frequency of bank reconciliation (e.g. how often does the DJ receive bank statements and when are the reconciliations prepared).
5. Physical controls over cash and its susceptibility to theft.
6. Risks due to fraud: False bank accounts, fraudulent or erroneous payments.
7. Rights over Bank accounts (does DJ own the account or does it belong to another company within the group).
8. Does DJ have rights to all cash in the bank accounts or do the directors of DJ have some personal cash in the client bank account.
9. Are all payments and receipts recorded in the correct period.

iii)

1. Agree the total as per the reconciliation to the cash ledger and the bank confirmation letter.
2. Trace outstanding lodgements to post year bank statements.
3. Trace outstanding cheques to post year-end bank statements.
4. For a sample of items included within outstanding cheques and lodgements test to ensure the items have been treated appropriately in year-end trade receivables and trade payables i.e. items included in outstanding lodgements have been removed from the trade receivables ledger, and items included with outstanding cheques have been removed from the accounts payable ledger.
5. Cross-reference totals to lead sheet.
6. Verify bank account reconciliation properly prepared and reviewed on a timely basis.

(b) The risk of material misstatements that are of the greatest concern to auditors in bank reconciliations are intentional ones to cover up a shortage of cash, generally arising from fraud. A fraudulent deposit in transit or an omitted outstanding cheque will both conceal a shortage of cash. Omitted deposits in transit or inclusion of a non-existent outstanding cheque are likely misstatements only in the event that the bank balance, after reconciling items are accounted for, is greater than the ledger balance, which would be highly unusual.

(c) The bank confirmation is a very important part of the audit of bank as it provides the auditor with reliable independent third party audit evidence. In addition, the bank confirmation should identify cash on deposit, loans and details of all accounts in the name of the audit client at the balance sheet date.

Solution 3

(a)

1. Reliance on systems or programs that are inaccurately processing data, processing inaccurate, data or both.
2. Unauthorised access to data that may result in destruction to data or improper changes to data.
3. The possibility of computer services personnel gaining access privileges beyond those necessary to perform their assigned duties thereby breaking down segregation of duties.
4. Unauthorised changes to data in master files.
5. Unauthorised changes to systems or programs.
6. Failure to make necessary changes to systems and programs.
7. Inappropriate manual intervention.
8. Potential loss of or inability to access data as required.

(b) Auditing around the computer

This term means that audit activity is focused primarily on ensuring that the source documentation is processed correctly and the auditor verifies this by checking the source documentation to the output documentation. The 'internal' software of the computer is not documented or audited by the auditor.

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. Useful amendments to clients' systems cannot be made and there is an increased possibility of audit report qualifications.

(c) Audit procedures using audit software

Procedure 1

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

Reason for Procedure 1

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

Procedure 2

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

Reason for Procedure 2

To check for breach of system rules.

Procedure 3

Review the balances in the trade receivables ledger to ensure no balance exceeds total freight services to that customer.

Reason for Procedure 3

To check for unreasonable items in the ledger.

Procedure 4

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

Reason for Procedure 4

To obtain new/relevant statistical information and ensure that there are no cash flow problems.

Procedure 5

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

Reason for Procedure 5

To select items for audit testing and trade receivables confirmation.

Procedure 6

Produce an aged trade receivables analysis to assist with the identification of bad debts.

Reason for Procedure 6

To assist with trade receivables valuation testing.

Solution 4

(a) Benefits from planning audits

There are three main benefits from planning audits: it helps the auditor obtain sufficient appropriate evidence for the circumstances, helps keep audit costs at a reasonable level, and helps avoid misunderstandings with the client.

(b) If the client has been audited previously, under ISA 300 the new auditor should contact the previous auditor, in compliance with relevant ethical requirements, in order to evaluate whether to accept the engagement. Permission must be obtained from the client by both the new auditor and the previous auditor before communication can be made because of the confidentiality requirement in the Auditors Code. The new auditor should be wary of accepting the client if the client does not give permission for this communication to the new auditor and/or the previous auditor. The previous auditor in compliance with relevant ethical requirements is required to respond to the new auditor's request for information if given permission by the client.

(c) Prior to accepting a new client, the auditor should investigate the client before accepting them. The auditor should evaluate the client's standing in the business community, financial stability, and relations with its previous auditor. The main purpose of investigating a new client is to ascertain the integrity of the client and the possibility of fraud. The auditor should be especially concerned with the possibility of fraudulent financial reporting since it is difficult to uncover. The auditor does not want to needlessly expose himself or herself to the possibility of legal liability for failure to detect fraud. The auditor should also assess whether they are competent to perform the audit and have the capabilities, time and resources to do so. In addition, before accepting a new audit client, the auditor should evaluate whether there are any circumstances which could comprise their independence with respect to the client.

(d)

(i) Reasons for obtaining an understanding of the client's business and its industry. ISA 310 requires a reasonable understanding of the client's business and industry. The nature of the client's business and industry affects client business risk and the risk of material misstatement in the financial statements. Auditors use the knowledge of these risks to determine the appropriate amount of audit evidence to gather. Auditors have been exposed to problems resulting from the auditor's failure to fully understand the nature of transactions in the client's industry.

(ii) The major aspects of understanding the client's business and industry, along with potential sources of information that auditors commonly use for each of the areas are as follows:

1. Industry and External Environment – Read industry trade publications, and regulatory requirements.
2. Business Operations and Processes – Tour the plant and offices, identify related parties, and inquire of management.
3. Management and Governance – Read the memorandum and articles of association, read minutes of board of directors and shareholders, and inquire of management.
4. Client Objectives and Strategies – Inquire of management regarding their objectives for the reliability of financial reporting, effectiveness and efficiency of operations, and compliance with laws and regulations; read contracts and other legal documents, such as those for share options, and pension plans.
5. Measurement and Performance – Read financial statements, perform ratio analysis, and inquire of management about key performance indicators that management uses to measure progress toward its objectives.

Solution 5

(a)

i) A proper cut-off of purchases and sales is heavily dependent on the physical inventory observation because a proper cut-off of sales requires that finished goods inventory included in the physical count be excluded from sales and all inventory received be included in purchases.

ii) To make sure the cut-off for sales is accurate, the following information should be obtained during the taking of the physical inventory:

1. The last despatch note number should be recorded in the working papers for subsequent follow- up to sales records.
2. A review should be made of despatches to test for the possibility of inventory set aside for despatch and not counted or other potential cut-off problems.
3. When pre-numbered despatch notes are not used, a careful review of MiM's method of getting a proper sales cut-off is the first step in testing the cut-off.
4. A list of the most recent despatches should be included in the working papers for subsequent follow-up to sales records.

iii) For the purchase cut-off, the following information should be noted:

1. The last goods received note number should be noted in the working papers for subsequent follow-up to purchase records.
2. A review should be made of the goods inwards department to make sure all inventory has been properly included in the physical inventory.

(b) Letter to Mrs Keita

ABC Certified Public Accountants

Avenue du Commerce

Kigali

8 September 2011

Made in Marble

Unit 12

Kigali Industrial Park

Kigali

Dear Mrs Keita,

Queries with reference to the forthcoming audit

You have requested that I clarify a number of issues concerning the forthcoming audit as follows:

Risk-based audit approach

Using a risk-based audit approach; we will carry out a limited amount of testing of transactions and balances and concentrate our efforts on analysing the business risks facing MiM. These then become the focus of our attention. This strategy necessitates that we utilise our most experienced and skilled staff and highlights our considerable confidence in MiM's underlying systems. It is an efficient and cost effective way of auditing companies such as MiM where misstatements have to be fairly material to have an impact on the financial statements. We will therefore not be concerned with individual routine transactions, although we will still be concerned with material non-routine transactions.

Implementation of new computerised accounting system

As MiM has purchased a new system we will as part of our audit carry out the following procedures:

Internal control system review

1. Ascertain the system - determine the flow of documents and extent of controls in existence in MiM's new computerised accounting system

2. Record the system - prepare a comprehensive record (flowcharts, questionnaires) of the system to facilitate evaluation of the systems
3. Corroborate that record with staff at MiM

Assess the systems and internal controls

4. Review the overall system for reliability and formulate a basis for testing their effectiveness in practice

Test the system and internal controls

5. Test the system with some sample checks
6. Evaluate its reliability; and
7. After evaluating the systems and testing controls, we will send you a management letter identifying any weaknesses and recommending improvements.

I hope this answers you queries but please feel free to contact me should you have any further queries.

Yours sincerely,

Mr Osei

On behalf of ABC Certified Public Accountants

Solution 6

(a)

- (i) The permanent file for The Wine Tavern (TWT) will contain documents and matters of continuing importance which will be required for more than one audit. Information on the mortgage should be placed in the permanent audit file so that the appropriate information concerning the mortgage will be conveniently available for future years' audits of TWT.
- (ii) This information should include all the provisions of the mortgage as well as the purchase price, date of purchase, and a list of items pledged as collateral. It may also contain an amortisation schedule of principal and interest (especially if the auditor has access to CAATs for preparation of such a schedule).
- (iii) As companies in general have a natural bias/inclination to understate/hide related liabilities and related expenses, the financial statement assertions that should be focused on most in the performance of substantive procedures are: (1) completeness: are all mortgages disclosed in full – implying the need to test all balances, large or small; (2) classification: are mortgage amounts properly broken down on the financial statements between current and non-current (3) Accuracy and cut-off interest expense: has interest expense been correctly calculated and included in the correct accounting period. (4) Accuracy and cut-off interest payable: has interest payable been correctly calculated and included in the correct accounting period. Although TWT has only one mortgage the above still applies.

(b) Specific Audit Procedures

Internal control

- 1 Obtain an understanding of TWT's mortgage authorisation and repayment system
- 2 Obtain a copy of the mortgage agreement and place on the permanent file, and review terms and conditions (including the face amount, payments, interest rate, restrictions, and collateral.)
- 3 Verify if mortgage was approved by TWT's Board [key control activity performed]
- 4 Review of bank reconciliation [verify that TWT senior management monitor key control activities]
- 5 Verify that TWT's senior management / Board have system in place to identify and monitor (business)risks that adversely impact TWT's cash flows (and its ability to repay mortgage)

Financial Statements balances

- 6 Trace CBR mortgage amount and disclosure to bank agreement terms and conditions and cash inflow to bank statement year-end balances
 - 7 Confirm the mortgage amount, terms, and collateral with the confirmation replies received from CBR
 - 8 Test interest expense for reasonableness through analytical review and knowledge acquired from CBR
 - 9 Recalculate interest payable at the balance sheet date and reconcile interest expense to the decrease in principal and the payments made.
 - 10 Review appropriateness of financial statement presentation and disclosure
- (c) The audit of mortgage payable, interest expense, and interest payable should all be done together since these accounts are related and the results of testing each account have a bearing on the other accounts. The likelihood of misstatement in the client's records (TWT) is determined faster and more effectively by doing them together.

Solution 7

- (a) Sampling risk arises from the possibility that the auditors' conclusion based on the sample may be different from the conclusion reached if the entire population was subject to the same procedure: risk that the sample indicates that a material error exists when in fact one does not and vice-versa.

Sampling risk exists because it is not economically feasible to audit the entire population in order to provide the level of audit assurance sought.

Karim should take the following measures to minimise such risk:

- 1) Ensure population is appropriate and complete
 - 2) Ensure auditor is adequately trained in sampling theory and techniques
 - 3) Adopt statistical sampling methods (like MUS) over judgmental methods, as they are more rigorous.
- (b) Karim first assessed the quality of internal control system design over sales transactions and found it to be good. Karim then performed tests of control, finding few deviations, and then judgmentally selected a sample of customer account balances at year-end for purposes of confirmation. While this overall approach is a valid way for Karim to obtain assurance in the area, there are several weaknesses with his approach:
- Karim only evaluated controls over sales transactions but there is no mention of evaluation of controls over cash receipts. The truth and fairness of year-end receivables will depend upon both systems.
 - Karim accepted explanations from the SBP's sales staff about the deviations she noted in her tests of controls, but she does not appear to have corroborated those explanations with any other audit evidence.

While Karim's sample size of 15 customer confirmation requests at year-end is relatively small, this is a judgment call and appears reasonable. In addition, the fact that she selected the sample haphazardly from the population is acceptable since she is using a judgmental sampling approach. Overall, Karim's conclusions are questionable because of her failure to evaluate and test controls over cash receipts and her failure to corroborate explanations for deviations with other evidence.

- (c) The advantages of using statistical sampling rather than judgemental sampling (non-statistical sampling) include:
- (1) The size of the sample is determined objectively having regard to the degree of risk associated with the area being tested.
 - (2) Bias is eliminated.

- (3) Results of statistical sampling can be more easily justified as being representative of the population as a whole, thus increasing the level of confidence in the results of testing the sample. Because of this, the conclusion drawn from the results of sample testing are more easily justified where an audit client disputes the audit conclusions.
 - (4) The emphasis on risk assessment by the auditor in the determination of the sample size encourages the auditor to concentrate on significant issues (for example a high degree of control risk), which may not otherwise be considered.
 - (5) In instances when there is a large population, the use of statistical sampling techniques may reduce the sample size, and therefore the amount of audit work required, as compared to the sample size that would be selected using judgement-sampling methodology.
 - (6) The auditor may justifiably conclude with a definite level of confidence that the conclusions drawn from the sampling test are within stated precision limits.
- (d)** In the event of SBP's customers not responding to Karim's correspondence seeking confirmation then Karim should undertake the following procedures:
- agree year-end receivables balance to invoice/sales invoices/dispatched note
 - vouch post balance year-end payment of the receivables balance by agreeing payment to SBP's cash receipts book and bank statement and verify that the post balance year end payment is in respect of invoices included on the receivables ledger at the year-end
 - determine whether it is necessary to confirm existence of the customer for example by telephoning the customer or by visiting the premises of the customer

Solution 8

(a) Audit report element

Title of ‘independent auditor’

To identify this as an audit report and distinguish it from other reports on financial statements that might be issued by others, directors, etc. Using the word “independent” distinguishes the independent auditor’s report from reports issued by others.

Addressee

To identify the person(s) who may use or rely on the report. It is usually addressed to the shareholders or those charged with governance of the entity being audited

Introductory paragraph identifying

– the financial statements audited and

To make it clear which pages of an annual report have been audited.

– responsibilities of entity’s directors and the auditors

To make clear that the directors prepare financial statements and the auditors audit them following international standards on auditing (ISAs) (UK and Ireland).

Scope paragraph describing the nature of the audit in terms of ISAs followed and the work performed by the auditor

To explain the scope of the audit so the standard of the auditors work is clear (ISAs UK and Ireland) have been followed and other factors such as limitation of audit testing (for example, not tested all items) is known.

Opinion paragraph referring to the financial reporting framework followed and expressing the auditors opinion

To provide the auditors’ opinion on the financial statements in terms of the true and fair view, to assure the reader that the audit has been carried out in accordance with the requirements of the Companies Act.

Other Matters

To elaborate on matters that provide further explanations of the auditor’s responsibilities in the audit of financial statements or of the auditor’s report thereon. Such matters may be addressed in a separate paragraph following the auditor’s opinion.

Other Reporting Responsibilities

To report on other matters such as performance of additional specified procedures or an opinion on specific matters, such as the adequacy of books and records.

Auditor's signature

This is normally the signature of the audit firm as the firm assumes responsibility for the audit, not the individual engagement partner.

Date of the report

To inform the reader that the auditor has considered effects of transactions that the auditor became aware of on the financial statements up to that date.

Auditor's address

This is normally the city where the auditor responsible for the audit is located so he/she can be contacted, if necessary.

(b)

- There should be two separate paragraphs – basis of opinion and scope
- Does not state “we conducted our audit in accordance with International Standards on Auditing (UK and Ireland)”
- Does not state “an audit includes examination, on a test basis of evidence relevant to the amounts and disclosures”
- “Statements” should be “financial statements” (2 occurrences)
- Should refer to “significant estimates and judgements made by directors”
- “Assessing generally accepted accounting principles as used” should be “whether the accounting policies are appropriate to the company’s circumstances, consistently applied and adequately disclosed”
- Does not state, “reasonable assurance”
- “Misstatement” should be “material misstatement”
- “evidence” should be “Sufficient appropriate evidence”
- Should refer to “evaluated the overall adequacy of the presentation of information in the financial statements”
- Should not refer to “Director’s responsibility to prepare the statements”

- (c) This stage is known as the financial statements review stage, whereby financial statements are examined when forming an overall conclusion as to whether the financial statements as a whole are consistent with the auditor's understanding of the entity: assessment of their overall reliability.

This is achieved essentially through the performance of analytical procedures (critical analysis) on the content and presentation of the financial statements.

Solution 9

- (a)** Factors that should be contained in the overall strategy for the audit of LGIR include:
- i) Relevant characteristics of the audit engagement, such as the reporting framework used in order to set the scope of the engagement.
 - ii) Key dates for reporting and other communications
 - iii) Setting of materiality
 - iv) Preliminary risk assessment and whether internal controls are to be tested
 - v) Consideration of resources available and how they are to be used
- (b)** Yes – the Overall Audit Strategy and Overall Audit Plan for LGIR should be updated and changed as necessary during the course of the audit. We may need to revise the Overall Audit Strategy and Overall Audit Plan (and thereby the planned nature, extent and timing of further audit procedures) when unexpected events, changed conditions or the audit evidence achieved from audit procedures lead to information that is significantly different from information available to us (the auditors) when the audit was first planned.
- (c)** The following items and information should be included in the audit documentation of LGIR:
- Notes pertaining to planning including nature, extent, and timing of audit procedures
 - Description of audit evidence obtained
 - Evidence that the work performed by engagement team staff was supervised and reviewed
 - Evidence that the financial statements or other information on which we (‘the auditor’) are reporting agree with the accounting records underlying such statements or information
 - Evidence of the evaluation and disposition of misstatements
 - Copies of letters (or notes) concerning audit matters reported to the LGIR
- (d)** Other methods for recording the control systems in the preliminary evaluation of internal control systems include:

i)

- Flowcharts
- Questionnaires
- Walk-through tests (test of one control)

ii) The advantage of the narrative method and the each of the other methods in i) above

- Describes the characteristics of the system (Narrative)
- Provides an overview (Flowchart)
- Describes control procedures and weaknesses (Questionnaire)
- Verifies or updates accuracy of documentation of internal controls (Walk-through)

Solution 10

- (a) Auditors must be independent and be seen to be independent at all times. XYZ Ltd. must comply with the CPA Code of Ethics. If the free car service is deemed to have significant value, it may compromise XYZ Ltd.'s, as auditor's, objectivity because it represents a threat to independence due to the self-interest threat. Gifts, hospitality or services should only be accepted if the value of any benefit is modest, and therefore does not present a threat to objectivity. The value of the free services offered to you and the audit partners is RWF6000 each. This is clearly of significant value and, irrespective of the Motor Ltd.'s motivation for making the offer, would represent a threat to the objectivity and independence of XYZ Ltd. as auditor. The offer should be politely refused.
- (b) In determining if it is feasible to accept this engagement the following factors should be considered by XYZ Ltd:
- the identity and business reputation of Motor Ltd.'s principal owners, key management, related parties and those charged with governance
 - identify any indications that Motor Ltd. might be involved in money laundering or other criminal activities
 - assess the level of independence between XYZ Ltd and Motor Ltd. and ensure acceptance does not create an actual or perceived conflict of interest with an existing audit client
 - obtain financial information from prior audited financial statements, interim financial statements, and annual reports
 - ascertain Motor Ltd.'s business environment and who will use the financial statements
 - determine the likelihood that the scope of the audit will be restricted or subjected to an unacceptable time constraint
 - communicate with Motor Ltd.'s bankers, customers, legal representatives, and others who may be able to provide insights into the company's management
 - conduct background searches of relevant databases
 - consider the increased business risk because Motor Ltd.'s industry is one that could have significant implications in terms of financial losses due to current economic issues
 - Motor Ltd. operates in a specialized industry with which XYZ Ltd. does not appear to have any relevant experience; therefore, the audit firm may not have the resources necessary to complete the engagement.

(c) Items of information that XYZ Ltd. should obtain from the previous auditor would include:

- Any scope limitations imposed by Motor Ltd., the client
- Significant differences over applicability of accounting standards
- Difficulties in collecting audit fees from Motor Ltd., the client
- Indications of unethical management practices at / by Motor Ltd.
- Any attempt by Motor Ltd.'s Management's to influence the audit report (such as opinion shopping)