CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: FRIDAY, 28 APRIL 2023

MODEL ANSWER AND MARKING GUIDE

IcparApril2023

SECTION A

QUESTION ONE: Hams Hotels Group (HHG)

Marking Guide

Marks

Q1 (a): Business risks faced by HHG to be considered in the final audit

Award up to 2 marks for every well explained business risk using information from the scenario "specific to HHG". The 2 marks for each business risk should be awarded as follows:

- Up to 1 mark where the business risk is both identified and explained correctly (otherwise award only ½ mark if the business risk is only identified but not explained)
- 1 mark for the implications of the business risk (e.g., due to the business risk there are potential cash flow shortages, revenue reduction, etc.

Specific business risks include:

- Deficiencies in corporate governance
- Potential non-renewal of the operating licenses
- Famous footballer's accident in HHG's gym
- Over-trading and cash flow shortage
- Potential loss of the diamond 5-star standard
- Foreign exchange fluctuations
- Integrity of management – potential fraud
- New Bank loan – Implications of possible failure to repay the loan and interest
- Risks relating to the implementation of the Expansion plan

Note: **Do Not Award –** Points that are generalised and therefore not aligned/related to the specific information regarding HHG as provided in the scenario (including speculative issues)

Maximum Marks for Q1 (a) – using the guide provided above 14

Q1 (b): Risks of material misstatements (ROMMs) to be considered when planning the final audit for HHG

Award up to 3 marks (except where it is stated otherwise) using the ROMM marking guide provided below for the following ROMMs specific to the audit of HHG (but are not limited to):

- Amortization of the operating licenses
- Potential impairment loss to Goodwill
- Potential fines and penalties (maximum of 4 marks where the answer includes a correct analysis for a contingent liability)
- Uncertainties to going concern
- Advance payment for purchase and maintenance of equipment
- Related party transaction (with an extra 1 mark for a "correct identification of a "related party relationship" and an extra 1 mark for a correct identification of a "related party transaction" from the scenario) (maximum of 5 marks)
- Borrowing costs (maximum of 4 marks where the answer goes on to indicate a possible risk if the interest cost is not correctly time-apportioned
- New subsidiaries in Kenya – Goodwill computation (maximum of 5 marks where the answer correctly includes both the risk relating to the determination of the "purchase consideration" and "fair valuation of the identifiable net assets)
- New subsidiaries in Kenya – unwinding the discount (as a result of the present value of the purchase consideration)
- New subsidiaries – consolidation where the acquisition is made three months to the year-end
- Government Grant – early recognition in the profit or loss (maximum of 4 marks where the answer also identifies a group profit turning into a loss if the grant income is correctly accounted for)

Any other valid ROMMs raised by the student that are relevant to the audit of GDF relating to the information provided in the scenario (where applicable using the ROMM marking below)

Where correctly applied, award 1 mark for each valid point referencing to "materiality" item well developed and 0.5 marks for any other correct calculation (e.g., calculation of the finance cost on the loan)

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The ROMM marking guide for each correctly identified audit risk award is provided as below:

i. Accounting treatment: Award up to 1 mark for a reasonable/correct reference to the accounting treatment relevant in the circumstances otherwise its 0.5 marks where they only attempt but do not well develop the accounting treatment or no mark for a wrong accounting treatment (Note: no penalty for a wrong quotation of the IFRS number and/or title since it's the guidance for the accounting treatment that is of importance here)

ii. Risk of material misstatement (ROMM): Award up to 1 mark for a well-developed risk of material misstatement where they use the specific information provided in the scenario for HHG to "identify" the potential ROMM (taking 0.5 marks of the allocated 1 mark) and go ahead to explain or recognize how this is a ROMM (taking the other 0.5 marks of the allocated 1 mark)

iii. Where the financial statement risks are correctly identified in the audit risk assessment, award 0.5 marks for every correct financial statement risk arising from the ROMM (e.g., assets are "overstated" - goes for 0.5 marks and expenses are "understated" - gets the other 0.5 marks) picking the "double-entry application" or a full 1 mark for a correct "disclosure" impact

Other points (marked outside the ROMM guide)

- Lack of an audit committee (2 marks)
- Management bias (maximum of 3 marks across the entire question)

Note: Do Not Award:

- Generic (speculative) risks developed from rote-learning which are not supported by the information given in the scenario
- The two Kenyan-based subsidiaries acquired in the current year becoming new audit clients for our audit firm and/or opening balances have not been audited by our firm (as these are potential detection risks but detection risks are not part of risks of material misstatements)
- Impairment or amortization of the HHG brand (this is an internally generated brand by HHG over several years)
- Separation of the equipment upgrade and maintenance costs as the equipment from Europe has not yet been delivered and hence the asset cannot be capitalized under PPE by the reporting date.
- Foreign exchange losses arising from individual entity transactions as the payment for the purchase of the equipment from Fountain Suppliers Limited was settled in advance and in full and there is no outstanding balance that needs re-translation.
- Risks relating to operating segments and therefore segmental information as the question instruction clearly indicated this should be ignored

- Stating that the government grant will impact on the profit or loss (e.g., through depreciation of the equipment or marketing costs) as these expenses will be incurred from August 2023 (so this is strictly a deferred income on 30 June 2023 and the MD has wrongly instructed a full recognition of the grant income in the P&L)
- A risk of wrong allocation of the revenue due to an inappropriate allocation of a percentage (%) of completion associated with long-term contracts (as the scenario is specific that majority of the customer contracts last for not more than seven (7) days making these short-term contracts)

Maximum Marks for Q1 (b) - using the guide provided above 26

Q1 (c): Principal audit procedures - audit work to be performed in respect of:

i. The government grant received from the Government of Rwanda *(see marking guide for audit procedures below)* 5

ii. The segmental information relating to the Group's revenue (see marking guide for audit procedures below) 5

Award up to 1 mark for each valid audit procedure based on the model answer and/or any other valid audit procedure(s) provided by the student answers (where the 1 mark includes 0.5 marks for a correct "what - supported a valid source where applicable" and the other 0.5 marks for a valid "why or reason" relating to the financial statement assertion being tested

Total marks **50**

Model Answers

Part (a): Business risks faced by HHG to be considered in the final audit

In planning the final audit of HHG, the following evaluation of business risks specific to HHG will be taken into consideration:

Deficiencies in corporate governance

HHG is listed on the Rwanda stock exchange with strict listing requirements that include ensuring the corporate governance code is compiled to. One compliance requirement will usually include a requirement to separate the roles and person taking on the role of Board Chairperson from the executive director which is not the case with HHG where Mr. Muzungu is holding both roles as the HHG Board Chair-person and he is also the Managing Director.

In addition, HHG does not have an audit committee which is very important in ensuring the existence and continued review of internal controls and compliance to regulations. A lack of an audit committee will expose HHG to potential gaps in the internal controls which can potentially result in fraud and non-compliance to laws and regulations.

Due to the significant gaps in HHG's corporate governance system, there is a high potential that HHG may be penalized by the Rwanda stock exchange regulations which may into result into a reputational risk with the high-profile shareholders disposing of their shares and/or failure to attract new shareholders in the current share issue where HHG is in need of equity capital to finance their expansion plans.

Potential non-renewal of the operating licenses

The companies under the HHG require a 5-year license to operate in Rwanda and Kenya and HHG must comply to strict health and safety regulations which are inspected regularly by the government department before a license renewal is granted. There is a high risk that some or all the licenses that are left with only two remaining years may not be renewed considering that there is potential non-compliances to health and safety standards required e.g., the case where the famous footballer was involved in the accident due to a gym equipment which was not a good working condition in the HHG hotel in Rwanda. If the risk of accidents escalates to all hotels of HHG, there is a high potential for non-renewal of the operating licenses which implies that HHG will not continue with the business operations in both Rwanda and Kenya.

Famous footballer's accident in HHG's gym

The famous footballer's accident involving the use of a gym equipment is a clear indication that the equipment used by HHG may not be in a good working condition exposing the customers and its staff to a risk of their health and safety. In addition, this is a clear indication of non-compliance to health and safety regulations which can attract penalties from the government regulations.

Due to fame of the footballer with a large number of followers on the social media and the media press coverage of the accident, HHG's is highly exposed to significant reputational risk where current and potential customers will switch to other service providers in fear of exposure to similar

accidents in the HHG hotels and gyms and this will lead to reduction in the revenues and adversely impacting on the HHG's going concern.

In addition, the footballer's indication of a possible legal suit against HHG for compensation will result in high amounts of cash needed to fund the legal process and a probable compensation to the football. The amount of cash flow needed to compensate the football of FRW 50,000 million and other legal costs involved is a drain in HHG's cash flow.

Due to the accident, there are major inspections planned by the Government of Rwanda to inspect the quality of equipment and service provided by HHG will require potential high inspection fees to be paid by HHG and this will further drain HHG's cash flows that are already in an overdraft status.

Note: Credit will be awarded where appropriate going concern risks specific to HHG are further given e.g., closure of the hotels due to equipment in poor conditions.

There is a risk that the current and potential shareholders may not easily be assured of the success of HHG's hotel business if HHG's financial performance deteriorates due to the negative publicity arising from the accident to the footballer. This will adversely impact on the planned floatation of the HHG shares from which HHG is planning to raise funds to settle the outstanding acquisition of the two hotel companies in Kenya.

Over-trading and cash flow shortage

HHG's extract of the management accounts indicates a significant increase in Revenue by 35% compared to cash and cash equivalents that have turned from a positive cash balance in the previous year to a significant bank overdraft in the current year which is a clear indicator of over-trading tendencies by HHG.

A significant bank overdraft for HHG implies that HHG may not have available funds needed to settle payments that fall due for example the likely payment for footballer's legal claim, support with HHG's expansion plans, major inspections needed to ensure renewal of the operating licenses, maintenance of hotel gym equipment etc which consequently raises a risk to the going concern if cash flows are not readily available to manage the operations of HHG.

Potential loss of the diamond 5-star standard

HHG currently operates with a "diamond 5-stardard" status which is the highest standard in the hotel industry in Rwanda and Kenya and this standard requires high quality customer service provision. There is a risk that HHG will lose the diamond 5-star standard status if they do not maintain the hotel services to the required highest level due to cash flow difficulties which will impact on the revenues if the corporate customers and other high-profile customers like tourists needing a high standard of services switch to other hotels.

Foreign exchange fluctuations

HHG is involved in a number of transactions with significant amounts denominated in a foreign currency e.g., the significant loan borrowed in the USD currency and will be settled in the USD currency will expose HHG foreign currency fluctuations if they do not apply effective hedging arrangements for example there has been significant FRW: USD fluctuations periodically when making regular loan repayments and interest. In addition, HHG has settled the purchase of the new equipment and the maintenance costs with Fountain Suppliers in the Euro currency which will further expose HHG to foreign currency fluctuations considering that the maintenance costs will continue to be paid annually in future. All these foreign exchange fluctuations if not hedged will result into fluctuations of HHG's cash flows and profitability.

Integrity of management – potential fraud

There is a potential management integrity weakness with HHG through the dominance of Mr Muzungu who is both the Managing Director and the Board chair-person. For example, Mr. Muzungu's instruction to make an emergency purchase of equipment of a high price from his wife's company in Europe without any due process of competitive tender bidding open to the public is potentially a fraudulent transaction which may result in financial losses to HHG if the transaction is not fairly priced or the purchased equipment is not of the required quality.

In addition, the advance payment for the equipment that will take nine months to be delivered and an advance payment for maintenance of the equipment for all the future five (5) years relating to the equipment that is yet to be received is a clear indication of potential fraud which may have drained HHG's cash flows.

Note: Credit will be awarded where additional points relating to the rushed payment in a foreign currency for the equipment (without any competitive bidding) and maintenance costs may be linked to other illegal motives such as "money laundering" schemes.

New Bank loan – Implications of possible failure to repay the loan and interest

HHG has borrowed FRW 150,000 million which is a significant amount and at a floating interest rate of 10%. The loan requires repayments with interest on a six-monthly basis which will require sufficient cash flow available to settle the loan repayments. Given the current cash flow difficulties with HHG operating with a significant bank overdraft, funds may not readily be available on the stipulated dates to ensure the loan repayments are made on time which will be a default of the loan agreement. The bank lending this money may take possession of HHG's assets that are considered as collateral security for the loan which will impact adversely on the HHG's operations without the attached assets.

In addition, the repayment of the loans will have a significant impact on HHG's cash flows. This is especially the case with the interest payments which are based on a floating rate which implies that the interest rate may change in future and such changes in the interest rate will remain unpredictable impacting adversely on HHG's cash flows and profitability. The current interest expense based on the 10% interest rate is FRW 15,000 million which is a significant cash flow drain that must be incurred annually by HHG on the loan.

It is evident that HHG has reached its bank borrowing limit. Any breach of payments of the loan (and the interest) on time will have a huge impact on HHG's credit rating which implies that HHG may not be able to extend the borrowing limits with the bank or getting borrowing facilities from any other banks. Though HHG is resorting to issuing equity shares to raise finance, this may not possible at all times especially where the finance performance and/or reputation of HHG is uncertain to motivate the public to buy shares in HHG.

Implementation of the Expansion plan

HHG's expansion plans involving the acquisition of two hotel companies in Kenya within the year will result in potential disruptions of the existing operations in Rwanda. This is the case where the top senior management team has fully devoted their time to the acquisition and smooth transition of the Kenyan hotels into the Group hotels' HHG model leaving limited or no time for the senior management team to supervise the Rwandan hotel operations. This will adversely affect the hotels operations in Rwanda including quality controls and significant internal controls which may potentially expose HHG Rwanda hotels to fraud or poor service delivery to their customers.

Note: Credit will be granted where the lack of senior management attention to the HHG hotels in Rwanda is linked to the deterioration of quality controls such as the health and safety (e.g., the poor equipment standards that led to the accident to the footballer) and/or the likely negative results from the pending government inspection of the hotel facilities.

In addition, by expanding HHG's operations to Kenya, there is a high chance that the regulatory framework in Kenya that is specific to the hotel industry may be significantly different to the laws and regulations of Rwanda that HHG is familiar with.

Any non-compliance to the laws and regulations of Kenya for the hotels management will adversely impact on the reputation of HHG in both Kenya and Rwanda and this will also affect the strategic plan of attracting the international customers (tourists) to Rwanda who are a big number in Kenya. This may further constrain the government grant condition if a target number of tourists traveling from Kenya to Rwanda was a requirement of the grant from the Government of Rwanda.

The expansion plans in Kenya will need a significant amount of cash availability in the first year to ensure a smooth transition of the operations in Kenya in line with the HHG brand and mode of operations and other strategic interests. This is evident with the fact that the HHG senior management team has fully concentrated on the HHG Kenya segment to ensure its operations are aligned to the HHG operations which may result into high expenses on the travel and sustainability of the senior management personnel regularly traveling in and out of Kenya. This therefore drains HHG's cashflows significantly and may be the reason for the current high overdraft status at the reporting date.

Note: *Credit will be awarded for additional points on business risks faced by HHG where these risks have been correctly based on the information in the scenario.*

Part (b): Risks of material misstatements that should be considered in the planning of the final audit of the individual and consolidated financial statements of HHG.

Lack of an audit committee

HHG is currently operating without an audit committee. As a large company and with the implementation of the expansion plans which involves acquiring other hotel companies in Kenya (a foreign country), there is potential of significant internal control deficiencies which exposes HHG to potential significant fraud. In addition, an audit committee is required to independently review HHG's compliance to laws and regulations through implementation of relevant internal controls that ensure HHG is tracking its compliance to the relevant laws and regulations specific to the hotel industry in both Rwanda and now in Kenya with the new subsidiaries acquired within the year.

It is evident that the audit committee will be needed by HHG to review the integrity of the published financial statements which are a requirement of the new listing requirements on the Rwanda Stock Exchange obtained this year.

Lack of an audit committee will expose HHG to potential weaknesses in the control environment likely extending to fraudulent financial statements where the financial information reported in the financial statements will be manipulated by management or due to human error.

This is a case if these financial statements are not independently reviewed before they are published and hence the financial statements will not reliable for the users especially the shareholders to rely upon.

Note: Credit will be awarded where a student's answer links the absence of an audit committee to potential management fraud (or loss of management integrity) e.g., the procurement of hotel equipment under the instruction of the MD from a related party without any bidding process.

Management bias

HHG has obtained the stock listing on the Rwanda stock exchange for the first time this year. Due to the pressure to present a favorable financial performance to the shareholders in their first set of published financial statements as a listed company, HHG may publish fraudulent financial information to impress the shareholders.

In addition, HHG may practice management earnings in order to provide favorable key performance indicators that are needed for assessment by the stock market regulator in order to portray a favorable first year of operations under a listing status. This is especially the case where HHG's revenue and profit before tax have significantly increased this year by 35% and 98% respectively compared to last year.

Note: *Credit will be awarded accordingly where management bias is indicated in any other relevant point e.g., the possibility of earnings management in bias to provide a favorable financial performance prior to a share issue intended to raise funds to settle the acquisition of the two subsidiaries.*

Amortization of the operating licenses

IAS 38 "Intangible assets" requires an entity to amortize an intangible asset with a finite useful life to reflect the pattern of consumption of the asset over its economic useful life with the amortization charge recognised in the profit or loss. All the companies under the HHG group operate with an operating license whose finite useful life is 5 years. The risk is that HHG may not have amortised the operating licenses appropriately over the 5 years or may not have amortised the licenses at all resulting into overstated assets and understated expenses.

Potential impairment loss to Goodwill

HHG is currently faced with a major reputational damage on the Goodwill of the respective subsidiary hotel where the famous footballer got an accident. The reputational damage may have escalated to the other hotel companies considered as subsidiaries in the HHG group. In accordance with IFRS 3 "Business combination" and IAS 36 "Impairment of assets", where there is evidence of indicators of impairment loss, an impairment loss review should be conducted and an asset or disposal group of assets is written down to its recoverable amount which is the higher of the value in use and the fair value less of costs of disposal.

The risk is that HHG may not have appropriately assessed the recoverable amount of the goodwill acquired on the respective subsidiaries considering that the continued negative media coverage of HHG due the footballer's accident may be a clear indication that the goodwill is impaired. This will result in overstated assets and understated expense.

Note: Credit will be awarded where a valid explanation for a probable impairment loss for HHG's equipment in gyms is made, for example if this emerges from a possibility of a significant reduction in customers using the equipment following the accident of the famous footballer.

Potential fines and penalties

The famous footballer has threatened HHG with a legal claim for the accident suffered when the footballer was using the gym equipment in the HHG hotel in Rwanda. Under IAS 37 "Provisions, contingent liabilities and assets" where there is a present obligation, and the entity is expected to settle the obligations using its own economic resources and a reliable estimate of the obligation can be made then a provision should be recognised. The risk is that HHG may not have recognised the footballer's legal claim of FRW 50,000 million and other relevant costs that will be incurred in the probable legal case which is not in line with the accounting standard's requirements. This will result in understated expenses and liabilities and may be partly explained by the fact the there is a significant increase in the HHG's profits before tax of 98%.

The legal claim of the famous footballer is 202% of profits before tax and 2.96% of the total assets and therefore this is material.

This is further compounded by the fact that management is under pressure to present a good financial performance in the current year where they have achieved a stock listing for the first time and where they have acquired two additional subsidiaries. It is highly probable that management

may not correctly recognise the legal costs and claims in the financial statements due to the "uncertain" amount or timing of the obligation so as to avoid a reduction of the reported profits.

Where it is only possible that HHG shall have to settle the legal claim, then an adequate disclosure of the contingent liability will be required for example the nature of the present obligation, potential amount of the legal claim that will be paid etc. There is a risk that HHG has not made an adequate disclosure or has not made any disclosure of the legal claim resulting in a risk of inadequate or non-disclosures in the HHG individual and consolidated financial statements.

Uncertainties to going concern

IAS 1 "Presentation of financial statements" and the "conceptual framework for financial reporting" requires an entity to adequately disclose significant indicators that create material uncertainties regarding going concern. There is a risk that HHG has not adequately disclosed the material uncertainties to its going concern yet there are clear possibilities of the existence of going concern risks emerging from circumstances such as the massive negative media publicity of the HHG services and poor equipment condition after the accident suffered in the HHG hotel gym. This will result in inadequate or a non-disclosure risk. Disclosure of the material uncertainties to going concern is material by nature.

Note: Credit will be awarded where an explanation using other examples of indicators providing going concern uncertainties are explained e.g., the potential non-renewal of the HHG operating licenses if the government inspection confirms significant defaults in the hotels leading to the non-renewal of the licenses

Presentation of advance payment for purchase and maintenance of equipment

HHG has paid an advance amount of FRW 150,000 million to Fountain Suppliers Limited for the purchase and ongoing maintenance of equipment in the hotels and gyms based in Rwanda. Under IAS 1 "Presentation of financial statements", the advance payment for the purchase of the equipment will be classified as "advance for equipment assets" under current assets since the equipment is expected to be received in not more than 12 months from the reporting date. The advance payment relating to the maintenance will be presented as a "prepayment" under the current asset for the costs expected to be incurred within the12-months period after the reporting date while the maintenance costs after 12 months from the reporting date shall be presented under the" non-current assets". The risk is that HHG may have presented all the advance payment of FRW 150,000 million as a capital expenditure under property, plant and equipment or if a separation is made for the advance payment between the equipment purchase and the maintenance costs, there is a risk that HHG may have recognised the entire maintenance costs for the five-years (FRW 5,000 million * 5 years) FRW 25,000 million as an expense in the profit or loss which is incorrect as this will result in an overstated expense and understated assets.

The advance payment of FRW 150,000 million is 8.9% of the total assets and therefore material. The cumulative five years maintenance cost of FRW 25,000 is 101% of the profit before tax and therefore material.

Related party transaction

In accordance with IAS 24 "Related party disclosures" includes as an example of a related party a key management personnel and also includes a person with a close relationship to a key management person as a related party to the entity. In the case of HHG, Mr. Muzungu as the managing director of HHG is a key management personnel and his wife is a closely related person to Mr. Muzungu implying that both Mr. Muzungu and his wife are related parties to HHG. In addition, Fountain Suppliers Limited, a company owned by Mr. Muzungu's wife is also a related party to HHG. Therefore, HHG's purchase of equipment and maintenance of the equipment is a related party transaction under the financial statements of HHG.

IAS 24 "Related party disclosures" requires the entity to adequately disclose related party transactions in the notes to the financial statements including for example, the nature of the transaction, the price paid in the transaction, the terms agreed in the transaction etc. The risk is that HHG may not have adequately disclosed the transaction with Fountain Suppliers Limited or may not have disclosed the transaction especially considering that this transaction may have been motivated by Mr. Muzungu's lack of integrity. This will result in an inadequate or non-disclosure risk considering that disclosure of the related party transaction is material by nature.

Borrowing costs

In accordance with IAS 23 "Borrowing interests" all borrowing costs incurred on a qualifying asset shall be capitalized as part of the initial cost of the related asset. IAS 23 defines a qualifying asset as that asset that takes substantially a long period of time to construct or to complete the acquisition through purchase and get it ready for its intended use. Though it will take nine (9) months to get the purchased equipment received by HHG in Rwanda, this will be after the end of the reporting date (i.e., after 30 June 2023) which makes this a qualifying asset since a finance cost on the borrowing shall have been recognised in the HHG financial statements.

The borrowing cost to be capitalized shall be restricted to only the cost of the equipment of (FRW 150,000 – FRW 25,000) FRW 125,000 million after adjusting for the maintenance costs whose finance costs should be expensed in the profit or loss. Therefore, the related finance costs to be capitalized on 30 June 2023 is FRW 6,250 million (125,000 * 10% * 6/12 months) which though is 0.4% of the total assets and immaterial it is 25% of profit before tax and therefore material.

The risk is that HHG may has incorrectly expensed all the borrowing costs rather than capitalize FRW 6,250 million of the borrowing costs which will result into overstated expenses and understated assets.

It is also possible that HHG may have wrongly computed the borrowing costs for an entire year of 12 months without correctly time-apportioning the finance costs to six months (January to June 2023) therefore overstating the finance costs recognised in the financial statements.

New subsidiaries in Kenya – Goodwill computation

Under IFRS 3 "Business combinations", goodwill should be computed on the date of acquisition to take into consideration the purchase consideration and the fair value of the identifiable assets and liabilities in the subsidiary on the date of acquisition. IFRS 3 requires, the fair value of the purchase consideration where the settlement is a deferred consideration to be discounted to present value using the parent's incremental borrowing rate as the appropriate discount rate.

Considering that HHG will settle the purchase consideration of FRW 250,000 million on 1 April 2024 (12 months from the date of acquisition of 1 April 2023), there is a risk that the purchase consideration used in the computation of goodwill has not been correctly discounted to its present value or an incorrect discount rate not similar to HHG's incremental borrowing rate has been used in computing the present value of the purchase consideration resulting in over/under stated purchase consideration and deferred consideration liability. Based on the incremental borrowing rate of 10%, the present value of the purchase consideration on the date of acquisition should be FRW 227,273 million (FRW 250,000 / 1.1) which is 13.5% of the total assets and it is material.

In addition, in the computation of the goodwill, the assets and liabilities of the subsidiary should be identified and revalued to their fair values on the date of acquisition. The risk is that HHG may not have correctly identified the assets and liabilities of the acquired subsidiaries e.g., if contingent liabilities that existed in the subsidiaries on the date of acquisition are not considered in the fair values of the net assets on the date of acquisition. Alternatively, there is a risk that HHG did not correctly assess the fair values of the identified assets and liabilities of the subsidiaries on the date of acquisition. This will result in an over/under stated net assets and goodwill regarding the subsidiaries in the consolidated financial statements.

New subsidiaries in Kenya – unwinding the discount (as a result of the present value of the purchase consideration)

The present value of the purchase consideration should be unwound at the reporting date using the incremental borrowing rate and where appropriate time-apportioned on the reporting date with the finance cost recognised in the consolidated profit or loss. The risk is that HHG may not have unwound the discount to remeasure the deferred consideration and recognize a finance cost on the reporting date resulting in understated deferred consideration (liabilities) and finance cost in the profit or loss. The finance cost and increase in the deferred consideration due to unwinding the discount at the reporting date should be FRW 5,682 million (227,273 * 10%) which is 23% of profit before tax and is therefore material.

Note: Credit will be awarded for other risk considerations e.g., deferred tax considerations due to fair value adjustments and/or depreciation adjustments on the reporting date arising from the fair value adjustments for depreciable assets like the hotel equipment

New subsidiaries – consolidation where the acquisition is made three months to the year-end

IFRS 10 "Consolidated financial statements" requires consolidation of a subsidiary to commence from the date control over the subsidiary is obtained to the group's reporting date and where the acquisition was made within the financial year (rather than at the start of the financial year), the profit or loss and other comprehensive income of the subsidiary will be appropriately time-apportioned within the consolidated financial statements.

The risk is that HHG may have consolidated the profit or loss and other comprehensive income for the two newly acquired subsidiaries for a full year and therefore not time-apportioned the line items to three months to the group reporting date (April – June 2023) which is incorrect. This will lead to the group profit being overstated. This is likely the reason why the reported profit before tax has increased by 98% and this may have been done deliberately to overstate the group profits due to the management bias of publishing financial statements with a favorable profit to impress the existing and potential shareholders in the year of acquisition of the subsidiaries in anticipation of the share issue planned for July 2023.

Government Grant – early recognition in the profit or loss

HHG received a grant from the Government of Rwanda of FRW 100,000 million to support HHG's operations in Kenya including marketing costs and refurbishment costs all commencing in August 2023 though the grant is received will have been received in June 2023. IAS 20 "Government grants and disclosure of government assistance" requires a grant received for an expenditure that will impact on the profit or loss in the future period to be recognized as deferred income and the grant should be appropriately classified as a grant related to an asset and/or a grant related to income.

Due to earnings management, there is a risk that Mr. Muzungu's instruction to early recognise the grant income in the profit or loss is probably to report a high profit increase in order to attract a successful floatation of HHG shares in July 2023. A significant increase in the group profits of 98% in the current year could be majorly supported by this wrong accounting treatment as without the full recognition of the grant at FRW 35,000 million the group could have reported a significant loss before tax of FRW 10,250 million (FRW 35,000 million less reported profit before tax of FRW 24,750 million). Turning a profit into a loss implies that the grant income is fundamental and therefore material to the financial statements.

Part (c): Principal audit procedures

(i) **The government grant received from the Government of Rwanda**

- Obtain the minutes of the Board meeting to confirm the authorization of the Board for the application and receipt of the government grant
- Obtain a copy of the government grant agreement and confirm:
  - The date of grant was received,
  - The amount of the grant received
  - The period / length of the grant period
  - The conditions attached to the grant

- Trace the amount received of the grant to the cash book or bank statement
- Review HHG's approved plans to confirm that the grant shall be used in line with the conditions stipulated in the grant agreement
- Obtain a written management representation confirming that HHG will comply to the specific conditions of the grant
- Review any correspondences between HHG and the Government of Rwanda regarding the government grant to confirm whether there are not anticipated penalties to HHG for non-compliance to the grant conditions

(ii) **Segmental information relating to the Group's revenue**

- Confirm through a review of the HHG's organizational structure to confirm that Board of Directors is the chief operating decision maker of the HHG Group
- Review the periodic financial information submitted to the Board of Directors to confirm the basis of segmental information reported internally and compare for consistency the basis of information used in the notes to the published financial statements
- Discuss with management to confirm the means by which the segmental information is reviewed by the chief operating decision maker e.g., such as financial information discussed as an agenda item at the Board meetings.
- Obtain and review minutes of the Board meetings to confirm that the segmental information discussed in the Board meeting is consistent with the auditor's understanding of the basis for monitoring the HHG's financial information in the published financial statements.
- Review the draft financial statements to confirm whether a consistent basis of segmental information is disclosed in the notes to the financial statements similar to what is reported internally such disclosures primarily based on geographical operations in Rwanda and Kenya and secondary basis is based on business lines such as hotel room hire incomes, conference rooms hire, restaurant sales etc. or vice-versa
- Discuss with management to confirm the specific details or income streams falling under the "other incomes" category to confirm whether this can be justified as a separable operating segment.
- Obtain the detailed breakdown of HHG's revenue e.g., by geographical operation or by separate business line, to confirm that revenue has been appropriately allocated between the reportable segments,
- Re-cast the revenue total amounts from the detailed revenue breakdown to confirm the segments qualify as reportable segments by each contributing at least 10% quantitatively of the group revenue
- Conduct analytical procedures to confirm the trends for each reportable segment and discuss any unusual trends with the HHG management.

SECTION B

QUESTION TWO: Byamungu Rwanda Wholesalers (BRW)

Marking Guide	**Marks**
Q2(a): Relevance of "forensic accounting" to the report and recommendation made by the internal auditor of BRW	
Award 1 mark for every valid point raised regarding the "relevance" of applying or conducting forensic accounting service (or forensic investigations) on the inventory loss at BRW. Max is 8 marks (Note: The maximum marks will include 1 mark (as maximum) where the student's answer includes a definition (or the nature or components) of "forensic accounting")	8
Q2(b): Fraud Investigation procedures to conduct on the financial loss relating to the stolen inventory	
Award 1 mark for every valid point raised relevant to performing fraud investigation procedures for the stolen inventory (using the guidelines of mark allocation similar to audit procedures). Max is 5 marks	5
Q2(c): SIX matters to consider in determining the extent of BRW's financial loss resulting from the alleged stolen cash	
For each of the SIX matters, award up to 2 marks (that include 1 mark for a correct "identification of the matter" and another 1 mark for a reason explanation of the matter). Max is 12 marks	12
Total marks	**25**

Model Answers

Part (a): **Relevance of "forensic accounting" as applied to the suspected loss of inventory**

Forensic accounting is the process of gathering, analyzing and reporting on data for the purpose of finding facts and/or evidence in the context of financial/legal disputes and/or irregularities. Forensic accounting is applied where an expert investigates a specific issue, usually with a legal implication, such as a suspected fraud.

In the case of BRW, forensic accounting will be applied where the forensic accountant will investigate the loss of inventory with the objective of confirming whether inventory was stolen and quantify the financial loss suffered by the company.

The forensic accountant will also provide BRW preventative advise based on the evidence gathered during the investigations. The preventative advise will usually be recommendations to the company to improve the internal control systems in order to prevent and detect fraud in future.

The relevance is that our firm, Muhoza and Partners is likely to be requested to provide a forensic accounting service to BRW which will be conducted as forensic investigation and therefore specifically this will be a fraud investigation in the theft of inventory in its largest store based in Kigali.

The objective of the fraud investigation into the inventory loss at BRW will be to first confirm whether fraud has actually taken place in the store based in Kigali and secondly, if fraud has taken place, the amount of the financial loss suffered by BRW as a result of the fraud.

The fraud investigation should help to identify the person(s) who has perpetrated the fraud and support this finding with evidence that will help BRW initiate legal proceedings to prosecute the person(s) involved in the fraud.

In the case of BRW's inventory loss, an investigation into the suspicion that inventory is being stolen should be done since there could be other reasons for the discrepancies found in the inventory records such as:

- The inventory may have been held in another store of BRW at the time of the stock-take and therefore not included in the stock count
- As a perishable good, the cartons of juice may have become obsolete or damaged and were thrown away without updating the stock records by eliminating the disposed items from the inventory records
- It could be a case where the incoming inventory is not recorded correctly e.g., the incoming inventory may have been double-recorded in the inventory system
- They may have been dispatches from the store which were not recorded in the inventory system

If proved that theft of the inventory took place, then the forensic accountant will gather evidence to:

- Prove the identity of the person(s) involved in the fraud including those that have perpetrated the fraud;
- Identify how the fraud took place e.g., confirm the weaknesses in BRW's internal controls that allowed the fraud to take place
- Quantify the financial loss suffered by BRW as a result of the inventory stolen

It is possible that BRW could provide the evidence gathered to the court and help with commence criminal proceedings against the person(s) identified to have been involved in the fraud. Therefore, our firm may be requested by the court to act as an expert witness in the criminal proceedings.

Part (b): Investigation procedures to be conducted on stolen inventory

- Review the internal control system applied by BRW as the inventory management system to assess its reliability in ensuring inventory movement is all tracked
- Obtain the stock take reports for a minimum of two prior stock taking exercises to determine if the extent of inventory losses reported.
- Review the stock records maintained in the main stores at Kigali to confirm any unrecorded inventories and compare with the discrepancies reported in the stock take reports confirming the average loss of 500 cartons of the packed juice per month
- Conduct a physical count of the inventory in the main store in Kigali and roll back to the last inventory count to confirm if they are any discrepancies in the stock quantities
- Compute the potential inventory loss using the estimated cartons of juice multiplied by the cost price per carton.
- Confirm whether an existing insurance cover policy on lost inventory is in place and confirm the potential insurance compensation amount against the inventory loss.

Part (c): Matters to consider in determining the extent of the stolen cash

The matters to consider in determining the extent of the financial loss arising from the stolen cash are:

- The report details made to the police: This is expected to include the finance manager's estimate of the possible extent of the fraud while reporting the disappearance of the accountant to the police.
- The minimum financial loss suffered by BRW: This is likely to be the sales made in the five days to the day the accountant disappeared. Where this amount cannot be easily known due to the accountant disappearing with the cash book (which is the most reliable source record), an estimated calculation can be made based on 5/30 days multiplied by the average sales made in a month.
- Cash records kept by the delivery team: An inquiry of the delivery teams whether they keep any separate records with evidence of the accountant's signature confirming receipt of the cash from the delivery teams to establish the potential total amount of cash that may have been received by the accountant in the five days before his disappearance.

- The pattern of cash bankings extracted from the bank statements: A falling trend in the bankings done during the year will mark the time from which the accountant began to misappropriate cash.
- The accountant's lifestyle: A confirmation of suspicions that may have been reported in the past by BRW's staff members regarding the accountant's behavior and lifestyle e.g., if it is reported that the accountant was making high expensive personal spendings which are probable beyond his income earning capacity.
- Prior year audit findings on cash management: Since the prior year audit opinion was unmodified and if the audit opinion was appropriate, then the accountant's alleged fraud may have started in the current year from January 2023.
- BRW's cash insurance cover: Considering that BRW's transactions are mainly in cash including cash sales made outside Kigali being transported to Kigali, it is important to consider whether BRW has any ongoing insurance cover for thefts of cash held by employees to enable the company make any claim for fraud/loss of cash.
- Likelihood of attaching personal assets of the accountant: Assess whether BRW can recover the lost cash by for example accessing any valuable personal asset of the accountant that can be used to settle BRW's claims against the accountant in the event the accountant is caught or successfully prosecuted

QUESTION THREE: Trinity Limited

Marking Guide	**Marks**
Q3(a) Ethical issues and challenges faced by Jadon Associates in relation to the final audit of Trinity	
Award up to 1 mark for each valid point raised as a relevant ethical and/or challenge arising from our firm the ethical issues and challenges our firm faces in relation to the final audit of Trinity for the year ended 31 March 2023	
Note: Specifically, the 1 mark for a point on ethics is not given for a mere mention of the "type of ethical threat (e.g., stating self-interest threat" but the mark is awarded for "explaining how the ethical threat arises and its consequences of the ethical threat to the firm"	
Award 1 mark for any correct safeguard proposed to manage the ethical threat (to a maximum of 5 marks throughout this part of the question)	
Maximum marks for Q3(a)	15
Q3(b): Audit work to be performed in regard to the balances reported in the financial statements of Trinity including:	
(i) Work-in-progress furniture for NHA	
Award up to 1 mark for each valid point raised as a work to be performed by the auditor for the "Work-in-progress furniture for NHA" (max. of 3 marks)	3
(ii) Trade receivable relating to NHA	
Award up to 1 mark for each valid point raised as a work to be performed by the auditor for the "Trade receivable relating to NHA" (max. of 3 marks)	3
(iii) Any TWO other "actions" Jadon Associates would take if sufficient evidence regarding the work-in-progress and trade receivables from NHA is not obtained	
Award 1 mark for each correct action proposed (maximum of 2 marks)	2
Profession marks:	
Award 2 professional marks for an adequate "letter format (that includes a mark for a valid/reasonable heading used and 1 mark for a reasonable introduction)	2
Total marks for Question Three	**25**

Model Answers

The International Federation for Accountants (IFAC) through the International Ethics Standards Board for Accountants (IESBA) has extensive rules through the "International Code" for professional conduct that are designed to ensure that auditors act ethically paying attention to their integrity, objectivity and independence. It is crucial that auditors should be seen to be independent at all times during their engagement with a client.

15% commission paid to CEO of Marie Insurance

Jadon Associates paid to Valence (the CEO of Marie Insurance) a commission of 15% as a referral fee for the introduction of Trinity as a client to Jadon Associates. This is a breach of the IESBA code for obtaining professional work as "referred clients" should only come from persons or organizations that are aware and accept to abide by the same ethical standards as the audit firm's IESBA code. Jadon Associates may have made the payment without confirming whether the Valence (CEO of Marie Insurance) follows any ethical code similar to the IESBA code and if this is the case then this is ethically wrong for Jadon Associates.

In addition, the payment made to the CEO of Marie Insurance can be perceived as a "bribe" paid by Jadon Associates in regard to the fact that the firm is pushing to increase its firm's revenue without due regard to professional requirements like a "professional clearance" from an outgoing auditor or an assessment of whether Jadon associates has the competence to provide quality audit to the client – for example Trinity may be a large client that Jadon (say) may not have had the human resources to provide quality services This is evident as Trinity is one of the largest clients for Jadon Associates and all the seven years, Jadon Associates uses the same engagement partner (potentially due to inadequate skills or limited number of partners in the firm).

Engagement partner – long association with the audit client

Moses Matabaro has been the engagement partner for Trinity for all the seven consecutive years since Trinity became our clients which indicates that Moses has had a long association with the same client. This causes a familiarity threat as they are high chances that a close relationship has developed between Moses and the client especially with Trinity's top management. Consequently, Moses may not exercise the required professional skepticism during the audit of Trinity's financial statements.

According to the IESBA code, an engagement partner is prohibited from acting as the same engagement partner for the same listed audit client for more than seven years as this creates a severe familiarity threat. Therefore, Jadon Associates should rotate the engagement partner and appoint a new engagement partner for Trinity in the following year's audit. Since this is the seventh consecutive year as the engagement partner for Trinity, Moses should be informed that the seventh year is the last year he acts as the engagement partner and will require a minimum period to "cool-off" of two years before he can be returned as the engagement partner to Trinity.

Confidential information regarding New Heights Academy (NHA) – the largest customer to Trinity

Jadon Associates has confidential information regarding the financial difficulties faced by NHA who is the largest customer to Trinity. The financial difficulties faced by NHA imply that Trinity in future will potentially lose a substantial amount of a financial loss of FRW 4,800 million in regard to the current work-in-progress which will become worthless if the furniture was tailored to NHA's requirements and cannot easily be sold to any other customer. In addition, Trinity will potentially lose FRW 3,200 million for the trade receivable held in regard to NHA which will become a "bad debt".

Considering that FRW 4,800 million held in work-in-progress is 10% of the current annual revenue of Trinity, the size of these financial losses due to NHA's financial difficulties will put Trinity's going concern status in doubt.

This is confidential information held by Jadon Associates which Jadon cannot share with Trinity without NHA's permission. It is highly probable that NHA will not grant Jadon Associates the permission to share the information concerning its financial challenges to Trinity. This creates a significant conflict of interest for Jadon Associates as an auditor since they hold privileged information for both Trinity and NHA.

Jadon Associates is in a position that without NHA's permission to permit the sharing of the information that implies that Trinity will make a potential financial loss on the NHA's order, there is no ground for the auditor to require Trinity to recognize and disclose these financial losses in Trinity's financial statements. If Trinity's financial statements do not provide for the financial loss, then the financial statements are not considered to be "true and fair" and in case the auditor does not modify the audit opinion due to the material misstatement, then Jadon Associates will later be liable to the parties that have relied on their auditor's report on Trinity.

The fact that the potential financial loss to Trinity will cast significant doubt on Trinity's going concern status creates an additional liability to Jadon Associates since the auditor is also required to evaluate the client's going concern and requires the client to adequately disclose any uncertainties to the going concern. This will be complicated to professionally resolve as this is further evidence of Jadon Associates exposed to a conflict of interest.

Under the IESBA code, where there is a conflict of interest between two clients, Jadon Associates is expected to disclose the fact that there is a conflict of interest to Trinity and NHA and possibly resign from one or both clients. However, in this case, such an action by Jadon Associates would not resolve the issue satisfactorily.

Overdue fees from Trinity - audit fees and internal audit consultancy fees

They may be ethical threats to Jadon Associates arising from the overdue fees that remained outstanding from Trinity. The IESBA code does not encourage the auditor to provide further engagement assignments for a client who has not settled the overdue fees as this may be perceived to a "loan" to the client which is professionally unethical.

In the case of the long outstanding unpaid fees from Trinity, the audit firm (Jadon Associates) may be perceived as having too much reliance on Trinity to settle the overdue fees and in practice it will be difficult to receive prompt settlement of the fees from Trinity which is professionally unacceptable.

An intimidation threat arises where there is an actual or perceived threat to the auditor's independence. The unpaid audit fees for the past year's audit and the unpaid internal audit consultancy fees by Trinity creates a perceived intimidation to Jadon Associates that the client may not be able to get this payment made. This creates a significant financial loss to Jadon Associates considering that Trinity is one of its largest clients and also the fact that Trinity will in future likely suffer a large financial loss due to the unpayments from NHA. This intimidation threat may compromise Jadon Associates' objectivity and independence during the audit process.

It is proper for Jadon Associates to demand for the settlement of the outstanding fees before further engagements for trinity can be conducted as this is recommended by the IESBA code. However, due to the conflict of interest with Jadon Associates' access to privileged information, it is professional unethical for Jadon Associates to demand that a "special clearance" by Trinity's bank should be done as this clearly portrays that Jadon Associates wants to take advantage of the information the firm possesses regarding the potential financial loss to Trinity.

Provision of internal audit services to a listed audit client

Jadon Associates is providing internal audit services to Trinity which is a listed company and this is in breach of the IESBA code even if this service is provided using a separate team in Jadon Associates (probably with the required skills and experience as this is done by Jadon Associates' consultancy unit).

The IESBA prohibits the provision of additional services to a listed client that have a significant impact on the financial statements audited by the same audit firm. The internal audit services provided by Jadon Associates will certainly involve technical support to develop internal controls over the accounting systems that support the preparation of Trinity's financial statements.

Jadon Associates' provision of internal audit services to Trinity creates a self-review threat which arises when the internal controls and accounting systems recommended by Jadon Associates during in the internal audit service for Trinity are later reviewed by the same audit firm that recommended the accounting systems implying, we are auditing our own recommended systems and therefore the audit team from Jadon Associates will not exercise the required professional skepticism.

In addition, the provision of internal audit services may result into a management threat which arises where Jadon Associates is supporting Trinity develop internal controls which is a management responsibility. Taking on a management responsibility is prohibited by the IESBA code and therefore Jadon should not accept the provision of internal audit services to Trinity to avoid taking on (or being perceived to take on) management responsibilities.

Self-interest threat: Potential high income earned from Trinity

It is probable that Jadon Associates is earning a high amount of the firm revenue from one client (Trinity) as this is one of Jadon's largest clients for the past seven (7) years. In addition, this year, Jadon Associates commenced providing an internal audit consultancy service to Trinity and as indicated, this income stream has significantly increased Jadon Associates' firm revenue.

This will potentially result into a self-interest threat, if the total firm revenue earned from Trinity is above 15% in the past two consecutive years as our firm will want to protect this financial interest by for example not exercising adequate professional skepticism during the audit.

As mentioned above, our firm should politely decline the provision of the internal audit services since this is already prohibited for a listed client such as Trinity and this may also help in bringing the total amount of firm's revenue from the same client to resolve the self-interest threat.

Part (b): Audit work and actions to take – Trinity's work-in-progress and trade receivable for NHA's furniture

To: The engagement partner

From: Audit manager

Subject: Audit work to be performed and actions to take regarding the work-in-progress and trade receivables balances for NHA as reported in Trinity's financial statements for the year ended 31 March 2023.

Introduction

Our firm (Jadon Associates) provides an audit engagement to both Trinity and NHA and we are aware that NHA is one of the largest customers of Trinity with a current order for furniture which is recognised as work-in-progress and a trade receivable in Trinity's financial statements.

The two balances are material to the financial statements of Trinity with the work-in-progress of FRW 4,800 million and trade receivables of FRW 3,200 million representing 10% and 6.7% of the revenue and therefore both are material to the financial statements of Trinity.

(i) Audit work – Trinity's work-in-progress for NHA's furniture

An inventory write-down representing the work-in progress for NHA should be made in the financial statements of Trinity for the year ended 31 March 2023.

However, due to the requirements for confidentiality regarding the information we possess as auditors of NHA, we cannot share the information regarding NHA's inability to take the finished furniture with Trinity to guide the inventory write-down.

Other alternative audit procedures can therefore be implemented regarding the work-in-progress without breaching the duty of confidentiality our firm has with NHA including:

- Confirm through a review of the detailed breakdown of the cost value for the work-in-progress with the amount of FRW 4,800 million reported by management of Trinity
- Using an auditor's expert, confirm the net realizable value of the work-in-progress and compare this with the cost to confirm whether the cost is the lower amount or vice versa
- Confirm whether Trinity will be able to financially complete the production into finished furniture with the necessary modifications acceptable for sale to any other potential buyer

(ii) Audit work – Trinity's trade receivable from NHA

A trade receivables write-down representing the receivable from NHA should be made in the financial statements of Trinity for the year ended 31 March 2023.

However, due to the requirements for confidentiality regarding the information we possess as auditors of NHA, we cannot share the information regarding NHA's inability to settle the trade receivable with Trinity to guide the trade receivable write-down.

Other alternative audit procedures can therefore be implemented while auditing the financial statements of Trinity to determine its customer "NHA's creditworthiness" including:

- Obtain from Trinity, records of NHA's settlements for bills/invoices to confirm whether the pattern of NHA's payments have changed, for example to confirm whether:
  - The period of settlement has become longer;
  - There is evidence of NHA not settling the full amounts of Trinity's bills
- Discuss with Trinity's credit controller whether there have been any problems encountered in collecting the debts from NHA for example whether NHA has in the past unfairly questioned the quality of work as an excuse to avoid payment of a debt
- As NHA is Trinity's largest customer, make a request for an external confirmation from the credit reference bureau for an opinion on NHA's credit status

(iii) Other "actions" by Jadon Associates - if sufficient evidence is not obtained

If the information obtained from the above audit work provides insufficient evidence to confirm that Trinity will likely suffer a financial loss regarding the work-in-progress and trade receivable for NHA, it will be incorrect to issue an unmodified audit report on the basis that our firm cannot divulge privileged information regarding NHA's financial challenges.

The following "other actions" can be taken by Jadon Associates:

- Seek legal advice regarding the matter
- Delay signing the final audit report for Trinity in the hope that NHA's financial challenges will become public knowledge if a significant event regarding NHA financial status is made public (e.g., NHA is declared bankrupt)

- Considering asking permission from NHA (as our audit client) to disclose information regarding the financial difficulties to Trinity.

In conclusion, it is important to maintain the ethical requirement for confidentiality of information our audit firm possesses from the audit engagement for NHA without using this information for the advantage of a third party such as Trinity. The conflict of interest our firm is exposed to needs to be carefully dealt with by conducting independent audit work for the benefit of the audit of Trinity. The final audit report on Trinity should be justified in line with our understanding of the circumstances impacting on Trinity's financial statements due to the financial challenges faced by their largest client NHA.

QUESTION FOUR: Abacus Global Electronics (Rwanda) Limited (Age-Rwanda)

Marking Guide

	Marks
(a) Consignment of equipment inventory	
(i) Additional information required	
Award up to 1 mark for each correct point made representing the "additional information needed" (where the 1 mark includes 0.5 marks for identifying "what" information is needed and 0.5 marks for explaining "why" this information is needed) - a maximum of 5 marks	5
(ii) Consequences for the consolidated financial statements and on the auditor's report	
Award 1 mark for each valid consequence of the information provided to the "consolidated financial statements" (up to a maximum of 3 marks) and on the auditor's report (at least 1 mark for effect on auditor's report) - a maximum of 4 marks	4
(b) Foreign currency transactions and Going concern uncertainty	
(i) Additional information required	
Award up to 1 mark for each correct point made representing the "additional information needed" (where the 1 mark includes 0.5 marks for identifying "what" information is needed and 0.5 marks for explaining "why" this information is needed) - a maximum of 7 marks	7
(ii) Consequences for the consolidated financial statements and on the auditor's report	
Award 1 mark for each valid consequence of the information provided to the "consolidated financial statements" (up to a maximum of 3 marks) and on the auditor's report (at least 1 mark for effect on auditor's report) - a maximum of 6 marks	6

(c): Consequences of the modification on the auditor's report of the AGE-Sudan subsidiary on the Group auditor's report

Award 1 mark for each valid point made linking the impact of the modification of the auditor's report on the AGE-Sudan's financial statements on the Group auditor's report on the consolidated financial statements (max. of 3 marks)	3
Total marks for Question Four	**25**

Model Answers

Part (a): Consignment of equipment inventory

(i) Additional information required

- The monetary value of the equipment to help the audit team assess its materiality in the context of the consolidated financial statements
- Whether the equipment was intended for a specific customer of AGE-Sudan as the sale and probably the customer may be lost due to the delay in the delivery of the equipment. This may have future consequences to AGE-Sudan as future sales to this customer may be cancelled due to doubts on whether to rely on AGE-Sudan (and perhaps the other customers who get to access this information) which will cause a going concern risk to AGE-Sudan as this customer might be one of the only three (3) major customers the company has.
- The reason(s) for the detention of the equipment by the Sudan Customs. To confirm whether detention of AGE-Sudan's equipment by the Sudan customs has been a regular occurrence as this may have negative implications for the viability of AGE-Sudan's trading activity in Sudan. In addition, this information would assist in assessing the chances of AGE-Sudan recovering the equipment.
- Any insurance arrangements for the equipment to confirm whether recovery for any equipment loss is possible. The insurance may have been paid to the supplier as part of the CIF (Carriage, Insurance and Freight) or may be paid in a separate transaction.
- The verification of the validity of the purchase of the equipment by the auditor of AGE-Sudan for example verifying the following:
  - An authorized purchase order from AGE-Sudan to the supplier of the equipment
  - Support documents from the supplier e.g., supplier's invoice
  - A copy of AGE-Sudan's payment document for the equipment (e.g., a bank funds transfer document)
  - A carriage/freight document from the supplier indicating the equipment was shipped and this may indicate that control over the equipment had been transferred to AGE-Sudan by the supplier and hence any loss of the equipment rests with AGE-Sudan.

(ii) Possible consequences for the consolidated financial statements and the auditor's report

- If the value of the equipment is considered material to the consolidated financial statements, it may be necessary to make an allowance for a write-off of these equipment within the inventory balance in the consolidated financial statements
- If the equipment is adjusted (e.g., by a write-off) in the consolidated financial statements, there will be no implications on the auditor's report.
- Assuming the cost of the equipment (which is inventory for sale) is material and no adjustment is made in the consolidated financial statements then in terms of the implication on the Group auditor's report:
  - There is a limitation in scope for the auditors of AGE-Sudan who were unable to physically inspect the equipment or obtain external confirmation regarding the existence of the equipment. The limitation in scope will be considered material but not pervasive as this is only confined to one area of the financial statements.
  - A qualified "except" for opinion will be issued due to the auditor's inability to confirm a material item in the consolidated financial statements; and
  - A basis for a qualified opinion paragraph will follow immediately after the qualified opinion to provide an explanation for the reasons for the qualification and the quantitative effects to the inventory balance to the consolidated financial statements
- If the value of the equipment is considered immaterial to the consolidated financial statements, it will have no impact on the auditor's report

Part (b): Foreign currency transactions and Going concern uncertainty

(i) Additional information required for:

Foreign exchange fluctuations

- Information regarding the updated status of the Sudan local currency compared to the US dollar currency and a confirmation of whether:
  - The Sudan local currency has stabilized and if the Sudan Government restrictions are likely to be relaxed; or
  - The Sudan local currency is continuing to decline as this may call for additional government intervention by introducing possibly more exchange controls.
- Whether AGE-Sudan has plans to cope with the effects of both the currency fluctuations (like hedging arrangements) and the government restrictions (e.g., AGE-Sudan negotiating with the suppliers to make payment settlements in a local currency or an alternative currency)

Cash flow shortages and going concern implications thereon

- AGE-Sudan's cash flow forecasts and budgets to determine how long the company will be able to continue operating if no further action is taken
- Details of the actions AGE-Sudan has taken to obtain finance to alleviate the cash flow shortages. The parent company AGE-Rwanda may be considering providing financial support to AGE-Sudan to alleviate the cash flow shortages and details of the parent company financial support will be needed to confirm the amount and timing of the financial support.
- Whether AGE-Sudan has approached its local bank in Sudan for financial capital (e.g., a bank loan or a bank overdraft) and whether the local bank has provided or promises to provide the financial assistance. A refusal from the local bank to provide the financial assistance will indicate the bank believes the Sudan Government foreign exchange restrictions are short-termed and not sustainable.
- Whether AGE-Sudan has increased the selling prices for its inventory to recoup the increasing cost of sales (in increased exchange losses, interest for late paid supplies etc) and whether the three major customers have accepted (or will accept) to pay the increased prices

(ii) Possible consequences for the consolidated financial statements and the auditor's report

- The imposition of temporary exchange control restrictions by the Government of Sudan on 15 January 2023 is a non-adjusting event after the reporting date (31 December 2022).

However, due to the fact that this has adversely impacted on AGE-Sudan's going concern, it is an adjusting event in accordance with IAS 10 "Events after the reporting date" if it is material to the consolidated financial statements. This will require an adjustment by writing down the subsidiary's assets to their net realizable value, providing for any additional liabilities and where needed a reclassification of the assets and liabilities.

- Though it is unlikely that the going concern of the entire group of companies is affected, the matter will still need to be disclosed in the notes to the consolidated financial statements.
- Since the going concern uncertainty for AGE-Sudan is unlikely to give rise to doubts about the application of the going concern concept for the consolidated financial statements, our auditor's report on the consolidated financial statements will not be modified.
- However, since AGE-Sudan is one of the five subsidiaries to the AGE-Rwanda group, the uncertainty regarding the going concern and its implication on the values of the assets of AGE-Sudan will be regarded to be material by nature to the consolidated financial statements.

In this case, the material uncertainty to the going concern should adequately be disclosed in the notes to the consolidated financial statements in accordance with IAS 1 "Presentation of Financial Statements".

The following implications on our auditor's report on the consolidated financial statements:

- If the material uncertainties regarding the going concern (related to AGE-Sudan) are adequately disclosed in the notes to the consolidated financial statements, the audit opinion on the consolidated financial statements will be unmodified. However, a separate paragraph after the basis of opinion paragraph will be added in the auditor's report titled "material uncertainties regarding the going concern" referring to the going concern uncertainty.
- If the disclosure of the material uncertainty is inadequate or not provided in the consolidated financial statements of AGE-Rwanda, a modification of the audit opinion will be issued in our auditor's report. The matter will be considered to be material but not pervasive as it is confined to only one of the five subsidiaries rather than the entire AGE-Rwanda group of companies and therefore a qualified "except for" opinion will be issued for the absence of an appropriate disclosure in the consolidated financial statements.
- A basis for a qualified opinion paragraph will follow immediately after the qualified opinion to provide an explanation for the reasons for the qualification in the absence of an appropriate disclosure for the material uncertainty regarding the going concern.

Part (c): Consequences of the AGE-Sudan (subsidiary) audit report modification on the Group auditor's report

The modification of the auditor's report on AGE-Sudan's (the "subsidiary") financial statements does not necessarily imply a modification of the group auditor's report on the AGE-Rwanda consolidated financial statements.

The group auditor's report on the AGE-Rwanda consolidated financial statements may be unmodified if AGE-Sudan is not a significant component of the AGE-Rwanda group or if the reason for the modified auditor's report on AGE-Sudan's financial statements has been resolved at the consolidation stage (e.g., by adding the adequate disclosure regarding the uncertainty of the going concern for AGE-Sudan in the disclosures notes of the consolidated financial statements)

If the Group auditor's report on the AGE-Rwanda consolidated financial statements is modified in respect of AGE-Sudan's uncertainty of the going concern status, then a consistent form to the subsidiary's audit report should be used in the group audit report e.g., having a qualified "except for opinion" in both the subsidiary's and the group auditor's report.

If however, the auditor's report on the AGE-Sudan's subsidiary financial statements was of a pervasive nature (e.g., due to a disagreement in the failure for AGE-Sudan to make the adequate disclosure to the going concern uncertainty), such an extreme audit modification form may unlikely be perceived group audit perceptive. In the AGE-Rwanda group auditor's professional judgment, this may only be considered a qualified "except for" opinion on the consolidated financial statements.

END OF MARKING GUIDE AND MODEL ANSWERS

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