CERTIFIED PUBLIC ACCOUNTANT

INTERMEDIATE LEVEL EXAMINATIONS

I1.4 AUDITING

DATE: FRIDAY 27, APRIL 2023

MARKING GUIDE AND MODEL ANSWERS

SECTION A

QUESTION ONE

Marking guide **Marks**

a. Award marks as below: **3**

(i) 1 mark for each well-explained controls that the company should have in place to reduce the risk associated with food purchases and their preparation in the kitchen. (A maximum of 3 marks)

(ii) 1 mark for each well-explained test of control you should carry out during controls testing to satisfy yourself that control risk is low (A maximum of 3 marks) **3**

Note: Answers to (a)(i) and (b)(ii) can be presented in a combined tabular format or as separated answers

b. Award 1 mark for each well-explained assertion that is generally relevant to the accounts payable obligation and balance in the financial statements at the year-end. (A maximum of 2 marks) **2**

c. Award 1 mark for:

- each correctly identified / stated relevant item of evidence you should obtain (maximum of 3 marks); and
- a well-developed explanation for each of the above identified evidence that might enable you to form a conclusion on the likelihood of the legal claim from the customer being successful (maximum of 3 marks). **6**

d. Award as below:

Accounting treatment for the legal claim in the financial statements (maximum of 2 marks):

- 1 mark for identifying and justifying correctly the legal claim as a contingent liability (only award 0.5 marks if the answer only identifies as a contingent liability with providing a justification)
- 1 mark for the need to have a disclosure note with at least one information item to disclose (only award 0.5 marks if the answer only states a need for a disclosure note without any piece of specific information that should be included in the disclosure note.

Impact on the auditor's report (maximum of 4 marks):

- If an adequate disclosure note is provided in the financial statements:
- 1 mark for unqualified audit opinion
- 1 mark for the need for an emphasis of matter paragraph
- If no disclosure is made or a non-adequate disclosure note is provided in the financial statements:

- 1 mark for a qualified audit opinion (only award the mark if a correct justification for the qualified opinion is given)
- 1 mark for the basis of a qualified opinion paragraph (only award 0.5 marks if the answer does not go ahead to indicate any relevant detail based on the scenario included in this paragraph)
- 1 mark for a justified conclusion that indicates the auditor's role in ensuring that client appropriately accounts for the legal claim **6**

For (d) **Do Not Award**: where the answer indicates:

- A provision for the liability is needed in the financial statements (the case scenario indicates that the legal advice is that the legal claim can "possibly" be successful)
- An adverse opinion (this is not a fundamental / pervasive misstatement)
- A disclaimer of an opinion (the information details regarding the legal claim are available to the auditor)

Note: Other relevant answers not within the model answer will be awarded marks if these are appropriate to the requirement

Total Marks **20**

Model Answers

#	(a) (i) **Controls**	**(a)** (ii) **Tests of controls**
1	Overall authority for food purchasing should be in the hands of a designated person to ensure that the food purchased is of the desired quality.	Review the company's organizational chart and identify the job-position and the person responsible for food purchasing.
2	A prequalified list of suppliers should be in place to ensure that the foods are procured from sources known for their quality.	Obtain the list of prequalified suppliers and check that there are no purchases of food from other Suppliers.
3	A continuous and regular review of the quality controls implemented by the suppliers of the food items to ensure quality standards of the food items is maintained as a requirement for the prequalified suppliers	Obtain and review a sample of the quality control evaluation reports to confirm that these are duly and regularly conducted by the relevant personnel, are approved by an authorized person and these reports support the basis for purchase of food items from the prequalified suppliers
4	On receipt of food, depending on their specification it should be carefully inspected by informed people, including those responsible for food preparation to ensure that it was of the desired quality (as well as	Examine a sample of GRNs to ensure that all bear an approved signature indicating that food has been inspected for quality and the quantity on receipt.

#	(a) (i) **Controls**	**(a)** (ii) **Tests of controls**
	quantity) and a Goods received note (GRN) should be signed to provide evidence of receipt and inspection.	
5	Strict adherence to use-by dates to ensure that no poor-quality food is prepared.	Check that there is no food on the premises which is past its use-by date. Then, discuss with management what happens to food that is past its use-by date and how it is disposed of.

(b) Below are some relevant assertions on Account payables:

- **Rights and obligations:** Accounts payable represent amounts due by the company, thus a confirmation of obligation must be observed.
- **Valuation and allocation:** Valuations of account payable is very critical to ensure the payable balance at the end of the accounting period is correctly valued, taking into account original transaction amounts and other matters such as trade discounts and local sales tax.
- **Existence:** To ensure no ghost suppliers, observation should be made through checking whether original transaction amounts are valid, and the liability exists.
- **Completeness** – Ensure all accounts payable are recorded in the accounting records.

(c) The followings are evidence that should be obtained by the auditor to enable a conclusion to be formed on the likelihood of the claim being successful:

Evidence	**Explanation**
Obtain the written claim by the customer.	By obtaining the customer's written claim you will get to know the reason why the claim was being made and provide other relevant details, such as whether the customer dined in the restaurant or purchased carry-out food, and the date when the alleged food poisoning took place.
Review the controls in force over purchases and food preparation.	This will enable you to ensure whether the company controls appeared to be effective.
Obtain written reports concerning any inspections carried out by company staff or third parties in the food store and food preparation areas.	This would provide information about any problems that may have arisen affecting food quality. Hence extend the audit coverage.
Obtain management representations regarding the likelihood of the claim succeeding.	This is internal evidence and should be approached with professional skepticism, but it would provide the auditor with the views of an informed group.

(d) Accounting treatment of the legal claim and the impact on the auditor's report

Accounting treatment of the legal claim

Since the likelihood of the claim being successful is possible, then this qualifies as a contingent liability under IAs 37 "Provisions, Contingent Liabilities and Contingent Assets".

It would be appropriate for the company to explain the contingent liability by way of note as required by IAS 37 "Provisions, Contingent Liabilities and Contingent Assets" describing the nature of the contingent liability, an estimate of its financial effect, an indication of the uncertainties relating to the amount and timing and the possibility of any reimbursement.

Impact on the auditor's report:

If the company includes an adequate disclosure for the contingent liability as a note in the financial statements in line with the requirements of IAS 37, there would be no need to modify the audit opinion. However, if the legal claim is assessed to be material and the litigation is viewed as exceptional, then an emphasis of matter paragraph might be appropriate in the auditor's report providing the auditor's agreement to and a reference to the adequacy of disclosure note in the financial statements.

However, if the contingent liability is not adequately disclosed or not disclosed at all in the financial statements, the audit opinion must be modified with a qualified "except for" opinion on the grounds that the financial statements are materially misstated (do not contain all the information required). In addition, basis for the qualified opinion will be included as a paragraph immediately after the qualified opinion paragraph explaining the details for the auditor's qualified opinion including a quantification of the possible legal penalty of FRW 90 million

In conclusion, the auditor should persuade management to include the appropriate disclosure regarding the legal claim in the notes to the financial statements to avoid issuing the modified opinion in the auditor's report.

QUESTION TWO

Marking Guide	**Marks**
a. Award marks as below:	
- 1 mark for a correct explanation of a management letter	
- 1 mark for each correct / valid content that makes the information reported in the management letter (maximum of 4 marks)	**5**
b. Award marks as below:	
- 1 mark for a correct explanation of the **'Going Concern" concept**	

- 1 mark for each correct audit procedure on evaluating a company's going concern (maximum of 5 marks) **6**

c. Award 1 mark for each (briefly) explained type of a modified audit opinion including:

- Qualified opinion (1 mark)
- Adverse opinion (1 mark)
- Disclaimer of an opinion (1 mark) **3**

d. Award 1 mark for each of a well-developed circumstance under which an auditor may issue a qualified opinion (maximum of 2 marks). **2**

e. Award marks as below (to a maximum of 4 marks): **4**

- 1 mark for a correct calculation and conclusion of the materiality of the inventory valuation of FRW 12 million related to the "current year profits before tax"
- 1 mark for indicating that with the correction being done before the completion of the audit, then no need to modify the audit opinion
- 1 mark for an explanation of the client's integrity with the immediate correction of the financial statements and its link to the audit-client relationship
- 1 mark for the need to extend the tests of controls to other areas of the financial statements to confirm no other errors are included in the financial statements

Total Marks **20**

Model Answers

a) **Management letter** is a letter prepared by the auditor which discusses findings and recommendations for improvements in internal controls, that were identified during the audit and were not required to be included in the auditor's report on internal control and other management issues. It is a requirement of ISA 265 to communicate deficiencies on internal control to management and must be in written form by way of a letter.

The following are some of the contents of the Management letter:

- The list of weaknesses in the structure of the accounting system and internal controls e.g., there may be no serial numbering of sales invoices so that sales invoices can be lost and not be entered in the records.
- A list of deficiencies in the operation of the records or controls.
- Unsuitable accounting policies and practices.
- Non-compliance with accounting standards or legislation.
- Explanations of the risks arising from each weakness.
- Comments on inefficiencies as well as weaknesses.
- Recommendations for improvement.

b) **Going Concern** is an accounting concept that assumes the entity will continue to operate for the foreseeable future with neither the intention nor the necessity of liquidation, ceasing trading, or seeking protection from creditors pursuant to laws or regulations.

The following are tests and procedures the auditor needs to perform to form an opinion on management's appropriate conclusion that the company is a going concern:

- Check whether management has carried out a going concern assessment and evaluate the assessment done by management.
- Review the cash flow forecast in the subsequent accounting period to confirm future available cash flows to sustain the funding of the company's operations.
- Review management accounts and the financial records in the subsequent accounting period.
- Review correspondence with creditors/suppliers to ensure that there are no incidents creating pressures to settle creditors under stricter terms than usual.
- Review the client profit forecast prepared for the subsequent accounting period to confirm an indication of a profit status in the future period.
- Review minutes of the meeting of directors and management to assess any discussions and decisions impacting on the company's going concern.
- Review management rescue plans to ensure continuity in operations and ensure that they are consistent with facts already known to the auditor.

c) The three types of modified audit opinions that can be issued by the auditor on the company's financial statements are:

- **Qualified opinion**: The auditor issues a qualified opinion when the effect of misstatements in the financial statements or inability to obtain sufficient appropriate audit evidence is only material but not pervasive.
- **Adverse opinion**: This is issued where the effect of misstatements in the financial statements is both material and pervasive.
- **Disclaimer of opinion:** This is issued where the effect of inability to obtain sufficient appropriate audit evidence is both material and pervasive.

d) Circumstances under which an auditor may issue a qualified opinion are:

- Misstatements arising from the inappropriate accounting treatment for transactions and/or account balances in the financial statements where the effect of the misstatement is only material but not pervasive.
- Accounting policies have not been consistently applied in relation to opening balances and if the change has not been properly accounted for and adequately presented and disclosed,
- Inability to obtain sufficient appropriate audit evidence
- Management imposed scope limitations. For example, prohibiting the auditor from carrying out circularization of debtors.

e) **Implication of a corrected error of omission regarding inventory in the auditor's report**

The value of inventory that was initially missed out of the end of year inventory valuation is material to the financial statements as it is (FRW 12m / FRW 24m) 50% of the current year's profit before tax.

Given that the error of omission for the inventory valuation was corrected before the financial statements were issued, it clearly has no impact on the audit report in spite of the fact that the issue is clearly material.

In terms of the auditor's continuing relationship with the client, there will no constraints on the relationship as it is assessed there is no lack of integrity by the client since the error was an oversight that the client has immediately corrected when the error was identified

However, as auditors, it will be important to confirm how the error occurred in the first place and the need to reassess the control risk to confirm that there are no related material errors in other account balances. `

QUESTION THREE

Marking guide		**Marks**
a.	Define analytical procedures and give at least 3 examples of sources of information to conduct analytical procedures. (1 mark for definition and 3 marks for examples	**4**
b.	From your analytical procedures above, clearly show the possible audit risks identified and how they will be addressed in your audit planning documentation:	
i.	Revenue	**4**
ii.	Profit before interest and tax	**4**
iii.	Receivables	**4**
iv.	Inventories.	**4**
Total Marks		**20**

Model Answers

a) Analytical procedures and 3 examples of sources of information to conduct analytical procedures:

Analytical procedures consist of evaluations of financial information made by a study of plausible relationships among both financial and non-financial data. Analytical procedures also encompass the investigation of identified fluctuations and relationships that are inconsistent with other relevant information or deviate significantly from predicted amounts. (ISA 520: para. 4).

Possible sources of information about the client to conduct analytical procedures while planning the audit include:

- Interim financial information
- Budgets
- Management accounts
- Non-financial information
- Bank and cash records
- Sales tax returns
- Board minutes
- Discussions or correspondence with the client at the year end

b) From our analytical procedures, the following are the possible audit risks identified and how they will be addressed in the audit planning documentation.

The recalculation of the ratios.

For the year ended 31 December 2022:

Gross profit margin	$\frac{2,412,797}{6,408,279} \times 100$	= 37.65%
Receivables' days	$\frac{1,491,498}{6,408,279} \times 365$	= 85 days
Inventory turnover ratio	$\frac{6,408,279 - 2,412,797}{1,247,487}$	= 3.2 times
Current ratio	$\frac{1,247,487 + 1,491,498}{998,123 + 107,501}$	= 2.47
Acid test ratio	$\frac{1,491,498}{998,123 + 107,501}$	= 1.35
Return on capital employed	$\frac{527,112}{(308,947 + 1,247,487 + 1,491,498) - (998,123 + 107,501)} \times 100$	= 27.1%

For the year ended 31 December 2021:

Gross profit margin	$\frac{2,891,686}{7,794,301} \times 100$	$= 37.1\%$
Receivables' days	$\frac{1,792,635}{7,794,301} \times 365$	$= 84$ days
Inventory turnover ratio	$\frac{7,794,301 - 2,891,686}{1,199,384}$	$= 4.1$ times
Current ratio	$\frac{1,199,384 + 1,792,635}{1,050,754 + 81,634}$	$= 2.64$
Acid test ratio	$\frac{1,792,635}{1,050,754 + 81,634}$	$= 1.58$
Return on capital employed	$\frac{501,556}{(352,001 + 1,199,384 + 1,792,635) - (1,050,754 + 81,634)} \times 100$	$= 22.7\%$

i) Revenue:

The figures show that there has been a drop in revenue of FRW1,386,022. You should discuss this with the client. It could indicate several things.

- That the company has had a bad year in 2022, with potential impact on going concern
- That the company had a particularly good year in 2021, and 2022 is more representative of what the company expected
- A major customer has been lost
- There have been errors in recording sales
- Lack of completeness in the recording of sales
- Misclassification of sales
- Incorrect application of cut-off
- Inaccuracies (e.g. arithmetical) in the accounting records
- Possible fraud

You should carry out further analysis to assess any explanations given to you by the Rwema Company ltd management. For example, because the gross profit percentage and receivables days are similar to last year, that might indicate that there was not an error in sales recording. As sales appear to require further work, you could plan to carry out a more detailed substantive analytical review on the sales figure, by obtaining detailed analysis of sales by month and by product to see if this reveals any more answers about why the sales figure has dropped in 2022.

ii) Profit before interest and tax

You might expect the profit before interest and tax figure to drop because the revenue figure has dropped by a significant amount compared to last year. However, because the profit before interest and tax figure is approximately the same as it was in 2021, this could indicate several things.

- That the company has implemented cost saving measures and has made substantial savings in administrative expenses
- That there have been errors in recording expenses
- That the amount of interest payable by the company has reduced
- That management has tried to improve profit figures by not recording all relevant expenses for the year

You should discuss this with the client to find out if any cost saving measures have been implemented or if there are any other factors which could have resulted in a reduction in expenses. You could also plan to perform detailed testing of expenses at the year-end to make sure they have been captured in the correct period and not pushed back to the next year.

iii) Receivables

The receivables figure has reduced by FRW 301,137 compared to 2021. This could indicate several things.

- There were less sales in the last few months of this year compared to last year, so there are less outstanding receivables at the year end.
- Customers are paying more quickly than they did in the previous year, so there are less outstanding receivables at the year end.
- There have been errors in recording sales and receivables.

You should discuss this with the client and perform further analysis based on the results of the detailed month by month revenue testing. You could also perform a more detailed analysis on the age of outstanding receivables compared to last year to see if this reveals any more information about why receivables have fallen.

iv) Inventories

The inventories figure has increased slightly compared with 2021, however the inventory turnover ratio has decreased from 4.1 times to 3.2 times. The fall in inventory turnover ratio could be due to:

- A reduction in the total number of products sold
- Incorrect valuation of inventories at the year end
- An error in the cost of sales or inventories figures

As an auditor, you should discuss this with the client and could perform further analysis based on the results of the detailed revenue testing. You could also plan to perform additional procedures around the valuation of inventories, as well as carefully reviewing the results of the inventory count testing her team performed at the year-end to verify that inventory was counted accurately.

SECTION B

QUESTION FOUR

Marking guide	**Marks**
a. Award up to 1 mark for each well-developed matters / considerations specific to developing an audit strategy for an initial audit engagement of Solution Tech Ltd (maximum of 6 marks).	
Note: Only award 0.5 marks where the answer only identifies a valid matter for consideration (without any further explanation)	**6**
b. Award up to 2 marks for each well-developed audit risk specific to the planning of the final audit of Solution Tech Ltd including (maximum of 14 marks)	
Note: Only award:	
- 0.5 marks where the answer only identifies a valid audit risk (without any further explanation); or	
- 1 mark where the answer identifies a valid audit risk with a limited explanation	**14**
Total Marks	**20**

Model Answers

a) In an initial audit engagement, several factors should be considered in addition to the planning procedures which are carried out for every audit. ISA 300 Planning an Audit of Financial Statements provides guidance in this area. The following are examples of Matters specific to developing an audit strategy of Solution Tech Ltd:

- ISA 300 "planning an audit of financial statements" suggests that unless prohibited by laws or regulation, arrangements should be made with the predecessor auditor, for example, to review their working papers. Therefore, communication should be made with the previous auditor to request access to their working papers for the financial year ended 30th June 2022. The review of the previous year's working papers would help in planning the audit, for example, it may highlight matters pertinent to the audit of opening balances or an assessment of the appropriateness of Solution Tech Ltd.'s accounting policies.
- It will also be important to consider whether any previous years' audit reports were modified and if so, the reason for the modification.
- As part of the client acceptance process, a request from previous auditors should be made to check if there are any professional or other reasons why JET Auditors Ltd cannot take up the audit of Solution Tech Ltd.
- Any matters which were brought to the firm's attention by the previous auditor should be considered for their potential impact on the audit strategy.
- With an initial audit engagement, it is particularly important to develop an understanding of the business, including the legal and regulatory framework applicable to the company. This

understanding must be fully documented and will help the audit team to perform effective analytical review procedures and to develop an appropriate audit strategy.

- Obtaining knowledge of the business will also help to identify whether it will be necessary to plan for the use of any experts.
- Given that this is a new audit client, that it is newly listed, when developing the audit strategy, consideration should be given to using an experienced audit team to reduce detection risk.

b) The following are audit risks to be considered in planning the final audit of Solution Tech Ltd:

- **Rapid growth:** The scenario of Solution Tech Ltd indicates that the company has seen rapid growth in the last few years. The growth could indicate a control risk, in that systems and personnel may struggle to keep pace with the volume of transactions that are being processed, leading to accounting errors being made. This is intensified by the lack of an internal audit department to provide assurance on systems and controls.
- **Management bias:** Solution Tech Ltd became a listed entity during the year. This creates an inherent risk at the financial statement level and is caused by the potential for management bias. Management will want to show good results to the new shareholders of the company, in particular the institutional shareholders, and therefore there is an incentive for the overstatement of revenue and profit.

- **Material misstatement due to specific accounting requirements for listed entities:** There is also a risk that management lacks knowledge of the reporting requirements specific to listed entities, for example, in relation to the calculation and disclosure of earnings per share, segmental financial information for (say) the different geographical areas of their operations etc.
- **E-commerce:** With 30% of revenue generated through the company's website, this represents a significant revenue stream, and the income generated through e-commerce is material to the financial statements. E-commerce gives rise to several different audit risks, including but not limited to difficulty in obtaining audit evidence resulting from limited audit trail, hard to maintain robust controls unless they are embedded into the software which records the transaction, and difficulty to perform tests on the controls of the system unless audit software is used.
- **Revenue recognition:** In particular cut-off can be a problem where sales are made online as it can be difficult to determine the exact point at which the revenue recognition criteria of IFRS 15 have been met.
- **Security risk:** Online selling give rise to risks relating to unauthorized access to the system, and there is an increased risk of fraud. All of these risks mean that there is a high audit risk in relation to the revenue generated from the company's website.
- **Franchise income:** The Franchise income which is deferred in the statement is considered material, there is a risk that the accounting treatment may not be appropriate. In addition, due to the high management subjectivity application in measuring the amount and/or determining

the basis for the deferred income at the reporting date, there is high potential for material misstatement again arising from management bias.

- **Foreign exchange transactions:** Solution Tech Ltd products sell in 10 countries and the products are manufactured overseas, so the company is involved with foreign currency transactions which can be complex in nature. There is a risk that the requirements of IAS "21 the Effects of Changes in Foreign Exchange Rates" may not be followed.

QUESTION FIVE

Marking guide	**Marks**
a. Award the marks as below:	**2**
- 1 mark for an appropriate format for the letter/report (e.g., having a title, date, to whom the letter is addressed to, and the background of the case study)	
- Up to 2 marks for each of the well-developed point that includes an implication of control deficiency specific to the case study observations on the control environment (limit to 1 mark for each point that is not well developed); and	
- 1 mark for each valid audit strategy/procedure adopted by the auditor in response to the identified control deficiency (maximum of 4 marks).	**12**
b. Up to 2 marks for a justification whether to report to those charged with governance to each of the 3 control deficiencies (limit to 1 mark where the justification is not well developed)	**6**
Total Marks	**20**

Model Answer

a) Report to Management of Icyerekezo Microfinance Bank

To the Board of Directors

Icyerekezo Microfinance Bank

31st March 2022

Dear Sirs,

R.E: Report on the Implications of Observation during the Audit of Icyerekezo Microfinance Bank.

During the course of our audit, we came across certain weaknesses in your accounting and internal control systems which we consider should be brought to your attention. These are discussed below:

Loans and advances

The absence of appropriate approval and authorization of the selected loans as per the company's delegation of authority matrix represents an exception to the effective operation of the controls, hence we may not rely on such controls or perform additional procedures during the substantive phase.

The genuineness of the loans after extensive reviews does not resolve the exception in the effective operation of the control, hence the control is still deemed ineffective as there exist the chances that other loans may have been disbursed without appropriate authorization.

The impact on the audit is that the team will need to perform additional procedures and may not rely on such controls, thus increasing in sample size, extent the audit focus to other balances with similar controls which will affect audit efficiency.

Tax investigation

There is a lack of regular supervision and review of the work done by the junior staff, as we noted the non-review of the tax computations indicate a deficiency in the management controls around the computation of tax balances. It would lead to additional tax liability and penalties.

Similar to the above, the control is deemed ineffective and as such, we should design appropriate audit procedures to review the management tax estimates. The control lapse should also be reported to those charged with governance.

Receivables' account

There was the non-disclosure of related party transactions, but there exists no risk in the balance since the difference is not material. We may wish to perform additional procedures to establish if the same pattern exists.

We would like to thank the management and staff of Icyerekezo Microfinance Bank. For their assistance and co-operation during the audit.

We would be pleased to provide any further clarification that you may require on the issues raised in this report.

b) The matters should be evaluated and those with significant risk should be submitted to those charged with governance for appropriate remedial action. See below analysis:

Issues	**Description Risk**

Non-adherence to approval limits for loans and advances	**High risk** exists that loans will be disbursed without the right level of risk assessment, thereby leading to higher credit losses for the bank
Non-review of tax computation	There is a risk that the tax computations might be **significantly** misstated leading to a misstatement of the financial statements and possible penalties from the tax authorities.
Variation in receivables account	Variation in receivables was considered **not material.** the level of deficiency is not significant, therefore, this does not to be escalated to those charged with governance.

QUESTION SIX

Marking guide **Marks**

a. Award 1 mark for each matter relevant in the planning and conduct of an audit for a new client (maximum of 5 marks) **5**

b. Award marks as below:

- 1 mark for the definition of materiality
- 1 mark where the answer goes ahead to provide any quantitative thresholds / benchmarks and/or qualitative applications for determining the materiality levels in the conduct of an audit of the financial statements
- 1 mark for a reference that the audit applies professional judgment to determine the materiality level for a transaction and/or account balances
- 1 mark for each valid application of the materiality concept during the process / stages of the audit
- 1 mark for any other correct reference of the auditor's application of materiality concept during the audit process (outside the model answer) e.g., the need for the auditor to continuously review the materiality levels during the audit process **6**

c. i) Award 1 mark for each correct / valid reason or a possible cause that will lead to the auditor reducing the materiality level (maximum of 2 marks). **2**

ii) Award marks as below:

- 1 mark for indicating the inverse relationship between the change in the materiality level to the audit risk
- 1 mark for a valid impact arising from the reduction in the materiality level on audit risk
- 1 mark for each correct audit procedure to be performed as a result of the reduction of the materiality level (maximum of 2 marks) **3**

iii) Award 1 mark for each valid examples of qualitative misstatements to be considered in setting materiality (a maximum of 4 marks) **4**

Total Marks **20**

Model Answers

a) in accordance with ISA 300 "Planning an Audit of Financial Statements" the following matters are necessary to consider in planning and conducting an adequate audit of the financial statements for a new client:

- Acquiring an appropriate understanding of the nature of the client's business, the complexity of its operations, the specific requirements of the engagement such as the purpose, nature, and scope of the work to be performed.
- Acquiring knowledge of relevant industries or subject matters.
- Possessing or obtaining experience with relevant regulatory or reporting requirements.
- Assigning sufficient staff with the necessary competencies.
- Assessing the need to use experts where necessary.
- Agreeing on a realistic time frame for the performance of the engagement.
- Complying with quality control policies and procedures designed to provide reasonable assurance that specific engagements are accepted only when they can be performed competently.

b) Materiality and the auditor's application of the materiality concept in an audit of the financial statements

Materiality concept

An item is considered material if its misstatement or omission (in the perception of the auditor) may affect the economic decision of the users of the financial statements. The presumption is that such users have reasonable knowledge of business, economic activities, and understanding of financial statements including inherent limitations of financial statements.

Though ISA 320 provides quantitative thresholds and quality applications to determine the materiality, the auditor will apply professional judgment in determining the level of materiality to apply in the planning and conduct of the audit of the financial statements.

The auditor reviews the materiality levels throughout the audit process and therefore materiality will be revised during the audit process where the auditor finds it appropriate to revise the materiality in order to address any identified material misstatements.

The auditor's application of the materiality concept:

1. During the planning and performing of the audit, the auditor applies materiality when:

- Determining the nature, timing, and extent of risk assessment procedures.
- Identifying and assessing the risk of material misstatement.
- Determining the nature, timing, and extent of tests of controls and substantive procedures.

2. The auditor applies the materiality concept when expressing an audit opinion, which involves the evaluation of misstatements to determine whether a modified or unmodified opinion is to be issued.

c)

(i) The level of materiality may change during the audit because of any of the following causes:
- Change in circumstances or
- Change in the auditor's knowledge as a result of performing audit procedures.

(ii) There is an inverse relationship between materiality and the level of audit risk. This relationship is considered by an auditor in determining the nature, timing and extent of audit procedures.

The reduction in the materiality level from FRW 10 million to FRW 7.5 million will conversely result in an increase in audit risk. Therefore, in order to compensate the effect of increased audit risk, the auditor will either:

- Reduce the assessed risk of material misstatement, where this is possible by carrying out extended or additional tests of control or
- Reduce the detection risk by modifying the nature, timing, and extent of planned substantive procedures.

(iii) The followings are the examples of qualitative misstatements:
- Inadequate / improper description of an accounting policy when it is likely that a user of the financial statements would be misled by the description.
- Failure to disclose the breach of regulatory requirements when it is likely that the consequent imposition of regulatory restrictions will significantly impair operating capability.
- Non-disclosure of directors' personal expenses, charged to the company even if they are insignificant.
- Non-disclosure of failure to meet debt covenant requirements
- Illegal payments which may not be material but if revealed may have severe repercussions
- Non-disclosure or inadequate disclosure of uncertainties regarding the company's going concern

END OF MARKING GUIDE AND MODEL ANSWERS