CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: FRIDAY 25, AUGUST 2023

MARKING GUIDE AND MODEL ANSWER

SECTION A

QUESTION ONE
Marking guide

1 (a) Audit risk evaluation
✓ Operating margin and ROCE changes – risk understated expenses/overstated revenue
✓ Trends within operating expenses and related audit risks, e.g. misclassification of expenses
✓ Other operating income – risk of overstatement
✓ Risk of management bias due to listed status (max 2 marks)
✓ Current ratio and gearing and related audit risks, e.g. understated finance costs
✓ Effective tax rate and risk of tax expense being understated (max 2 marks)
✓ Consolidation of Kenyan subsidiaries
✓ Recognition and measurement of foreign exchange gains and losses
✓ Goodwill – audit risk regarding measurement, specifically lack of impairment review
✓ Goodwill on acquisition of Brookside Ltd (max 4 marks for detailed discussion)
✓ Intangible assets – audit risks in relation to unexplained movement in year, whether amounts should have been capitalized and amortization period (max 5 marks)
✓ Increased detection risk regarding Brookside Ltd due to being audited by a component auditor
Award 3 marks for each audit risk identified and explained. Marks may be awarded for other, relevant audit risks not included in the marking guide.
In addition, 1 mark for relevant ratios and ½ mark for relevant trends which form part of analytical review (max 5 marks).

Materiality calculations should be awarded 1 mark each (max 4 marks).

(b)Audit procedures on the goodwill recognized Brookside
✓ Obtain and review the legal documentation, in particular, confirm the targets to be used as the basis for payment of the contingent consideration
✓ Confirm that Kristal has obtained an 80% shareholding and that this conveys control
✓ Agree the FRW 80 million cash paid to the bank statement and cash book of the acquiring company
✓ Review the board minutes for relevant discussions including the minute of board approval
✓ Obtain management's calculation of contingent consideration, and evaluate assumptions used
✓ Discuss the 18% interest rate used in determining the discount factor and evaluate the justification given by management
✓ Confirm that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition by agreeing to stock market records
✓ Obtain a copy of the due diligence report issued by component auditor, review for confirmation of acquired assets and liabilities and their fair values
✓ Evaluation of the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13 *Fair Value Measurement*

✓ Review the calculation of net assets acquired to confirm that Group accounting policies have been applied

Award 1 mark for each well described procedure: max 6

(c) Evaluation of component auditor audit strategy

✓ Controls – evidence needs to be obtained to confirm that controls have not changed

✓ Controls should be tested in a three-year cycle in order to place continued reliance on them

✓ Group audit team may decide to perform additional tests of control of Vulture Associates do not amend their strategy

✓ Evaluate status, competence and quality control approach of the internal audit department

✓ Objectivity should be evaluated where direct assistance is provided

✓ Consider the type of work – work on receivables is not appropriate due to subjective nature

✓ Internal auditors have worked on receivables so not objective

✓ Conclusion on audit quality (1 mark)

Award 2 marks for each issue evaluated: Maximum 10 Marks

(d)Ethical issues relating to request to assist management in preparing an integrated report–Explain the threats to objectivity created – self-review, familiarity and management involvement (1 mark each if fully explained)

✓ Conclusion as to whether service can be provided, following on from justification

✓ Suggest appropriate safeguards if engagement accepted, e.g. independent review (1 mark each)

✓ Explain that audit committee would need to pre-approve the engagement

✓ Bison & Co to consider competence and resource availability

✓ Discuss with audit committee (1 mark)

Award 2 Marks for each relevant point explained, and 1 Mark for relevant safeguard or action: Maximum 4 Mark

Model Answers

(a) Evaluation of audit risk

Selected analytical procedures and associated audit risk evaluation

	2022	2021
Effective tax rate	64/322 = 19·9%	60/240 = 25%
Current ratio	1,450/597 = 2·4	1,420/547 = 2·6
Interest cover	350/28 = 12·5	270/30 = 9
Operating margin	350/5,770 = 6·1%	270/5,990 = 4·5%
Debt/equity	550/2,245 = 24·5%	500/2,093 = 23·9%
Return on capital employed	350/2,245 + 650 = 12·1%	270/2,093 + 620 = 10%

Operating margin and operating expenses

Kristal operating margin has increased from 4·5% to 6·1% despite a fall in revenue of 3·7%. This is due to a reduction in operating expenses of 4·5% and increase in other operating income of 50%. Return on capital employed shows a similar positive trend, despite the fall in revenue. There is an audit risk that expenses are understated, with the reduction in expenses being proportionately more than the reduction in revenue.

Within operating expenses, the trends for each component are different – cost of raw materials consumables and supplies has decreased by 3·1%, which appears reasonable given the decline in revenue of 3·7%. However, staff costs have increased slightly by 1·1% which seems inconsistent with the revenue trend and with the increased automation of operations which has led to staff being made redundant, which presumably means lower payroll costs this year. Expenses could have been misclassified into staff costs in error.

Depreciation, amortization and impairment has increased by 3·6%, which is not a significant change, but will need to be investigated to consider how each element of the category has changed in the year. The most noticeable trend within operating expenses is that the other operating expenses category has reduced very significantly. The amount recognized this financial year is only 7·4% of the amount recognized the previous year; this appears totally inconsistent with the other trends noted. It could be that some costs, for example, accrued expenses, have not yet been accounted for, or that the 2021 figure was unusually high.

Other operating income

There is also an audit risk that other operating income is overstated. According to the information in note 6, during the year a credit of FRW 60 million has been recognized in profit for reversals of provisions, this is 50% greater than the amount recognized in the previous year. In addition, a credit of FRW 30 million has been recognized for reversals of impairment losses. There is a risk that these figures have been manipulated in order to boost profits, as an earnings management technique, in reaction to the fall in revenue in the year.

The risk of management bias is high given the listed status of Kristal, hence expectations from shareholders for a positive growth trend. The profit recognized on asset disposal and the increase in foreign currency gains could also be an indication of attempts to boost operating profit this year.

Current ratio and gearing

Looking at the other ratios, the current ratio and gearing ratio do not indicate audit risks; however, more detail is needed to fully conclude on the liquidity and solvency position of the Group, and whether there are any hidden trends which are obscured by the high-level analysis which has been performed with the information provided.

The interest cover has increased, due to both an increase in operating profit and a reduction in finance charges. This seems contradictory to the increase in borrowings of FRW 50 million; as a result of this an increase in finance charges would be expected. There is an audit risk that finance charges are understated.

Effective tax rate

The effective tax rate has fallen from 25% to 19·9%. An audit risk arises in that the tax expense and associated liability could be understated. This could indicate management bias as the financial statements suggest that accounting profit has increased, but the profit chargeable to tax used to determine the tax expense for the year appears to have decreased. There could be alternative explanations, for instance a fall in the rate of tax levied by the authorities, which will need to be investigated by the audit team.

Consolidation of foreign subsidiaries

Given that Kristal has many foreign subsidiaries, including the recent investment in Brookside Ltd, audit risks relating to their consolidation are potentially significant. Brookside Ltd has net assets with a fair value of FRW 300 million according to the goodwill calculation provided by management, representing 8·6% of Kristal total assets and 13·4% of Kristal net assets. This makes Brookside Ltd material to Kristal and possibly a significant component of Kristal. Audit risks relevant to Brookside Ltd's status as a foreign subsidiary also attach to Kristal other foreign subsidiaries.

According to IAS 21 *The Effects of Changes in Foreign Exchange Rates*, the assets and liabilities of Brookside Ltd and other foreign subsidiaries should be retranslated using the closing exchange rate. Its income and expenses should be retranslated at the exchange rates at the dates of the transactions. The risk is that incorrect exchange rates are used for the retranslations. This could result in over/understatement of the assets, liabilities, income and expenses which are consolidated, including goodwill. It would also mean that the exchange gains and losses arising on retranslation and to be included in Group other comprehensive income are incorrectly determined.

In addition, Brookside Ltd was acquired on 1 March 2022 and its income and expenses should have been consolidated from that date. There is a risk that the full year's income and expenses have been consolidated, leading to a risk of understatement of Kristal profit given that Brookside Ltd is forecast to be loss making this year, according to the audit strategy prepared by component auditor.

Measurement and recognition of exchange gains and losses

The calculation of exchange gains and losses can be complex, and there is a risk that it is not calculated correctly, or that some elements are omitted, for example, the exchange gain or loss on goodwill may be missed out of the calculation.

IAS 21 states that exchange gains and losses arising as a result of the retranslation of the subsidiary's balances are recognized in other comprehensive income. The risk is incorrect classification, for example, the gain or loss could be recognized incorrectly as part of profit for the year, for example, included in the FRW 28 million foreign currency gains which form part of other operating income, which would be incorrect. The amount recognized within other operating income has increased, as only FRW 23 million foreign currency gains were recognized the previous year, indicating a potential risk of overstatement.

Goodwill

The total goodwill recognized in Kristal statement of financial position is FRW1,100 million, making it highly material at 31·5% of total assets.

Analytical review shows that the goodwill figure has increased by FRW 130 million during the year. The goodwill relating to the acquisition of Brookside Ltd is FRW 100 million according to management's calculations. Therefore, there appears to be an unexplained increase in value of goodwill of FRW30 million during the year and there is an audit risk that the goodwill figure is overstated, unless justified by additional acquisitions or possibly by changes in value on the retranslation of goodwill relating to foreign subsidiaries, though this latter point would seem unlikely given the large size of the unexplained increase in value.

According to IFRS 3 *Business Combinations*, goodwill should be subject to an impairment review on an annual basis. Management has asserted that while they will test goodwill for impairment prior to the financial year end, they do not think that any impairment will be recognized. This view is based on what could be optimistic assumptions about further growth in revenue, and it is likely that the assumptions used in management's impairment review are similarly overoptimistic. Therefore, there is a risk that goodwill will be overstated and Kristal operating expenses understated if impairment losses have not been correctly determined and recognized.

Initial measurement of goodwill arising on acquisition of Brookside Ltd

In order for goodwill to be calculated, the assets and liabilities of Brookside Ltd must have been identified and measured at fair value at the date of acquisition. Risks of material misstatement arise because the various components of goodwill each have specific risks attached. The goodwill of FRW100 million is material to Kristal, representing 2·9% of Kristal assets.

A specific risk arises in relation to the fair value of net assets acquired. Not all assets and liabilities may have been identified, for example, contingent liabilities and contingent assets may be omitted.

A further risk relates to measurement at fair value, which is subjective and based on assumptions which may not be valid. The fair value of Brookside Ltd.'s net assets according to the goodwill calculation is FRW300 million, having been subject to a fair value uplift of FRW12 million. This was provided by an independent firm of accountants, which provides some comfort on the validity of the figure.

There is also a risk that the cost of investment is not stated correctly, for example, that the contingent consideration has not been determined on an appropriate basis. First, the interest rate used to determine the discount factor is 18% – this seems high given that Kristal weighted average cost of capital is stated to be 10%. Second, the contingent consideration is only payable if Brookside Ltd reaches certain profit targets. Given that Brookside, according to audit strategy, is projected to be loss making, it could be that the contingent consideration need not be recognized at all, or determined to be a lower figure than that currently recognized, based on a lower probability of it having to be paid. The results of the analytical review have indicated that the other side of the journal entry for the contingent consideration is not described as a component of the non-current liabilities and the accounting for this will need to be clarified as there is a risk that it has been recorded incorrectly, perhaps as a component of equity.

Intangible assets

In relation to expenditure on intangible assets during the year, which totals FRW60 million, there are several audit risks. First, there is a question over whether all of this amount should have been capitalized as an intangible asset. Capitalization is only appropriate where an asset has been created, and specifically in relation to development costs, the criteria from IAS 38 *Intangible Assets* must all be met. There is a risk that if any criteria have not been met, for example, if there is no probable future economic benefit from research into the new technology, then the amount should be expensed. There is a risk that intangible assets are overstated and operating expenses understated.

There is also an unexplained trend, in that intangible assets have only increased by FRW30 million, yet expenditure on intangible assets, according to management information, is FRW60 million. More information is needed to reconcile the expenditure as stated by management to the movement in intangible assets recognized in the Group statement of financial position.

Second, there is a risk that the amortization period is not appropriate. It seems that the same useful life of 15 years has been applied to all of the different categories of intangible assets; this is not likely to be specific enough, for example, the useful life of an accounting system will not be the same as for development of robots. Fifteen years also seems to be a long period usually technology-related assets are written off over a relatively short period to take account of rapid developments in technology. In respect of amortization periods being too long, there is a risk that intangible assets are overstated and operating expenses understated.

Detection risk in relation to Brookside Ltd

Brookside Ltd is the only subsidiary which is not audited by Sonic & Associates. This gives rise to a risk that the quality of the audit of Brookside Ltd may not be to the same standard as Sonic & Associates, as the Kenyan component auditor may not be used to auditing companies which form part of a listed group and results in increased detection risk at the Kristal level. The risk is increased by the problems with the audit strategy prepared by Kenyan component auditor and as has been indicated the audit of Brookside Ltd has not been appropriately planned in accordance with ISA requirements. Since we have not worked with component auditor previously, we are not familiar with their methods and we may have issues with the quality of their work; therefore, the detection risk is high in relation to Brookside Ltd's balances which will form part of the consolidated financial statements.

(b) Principal audit procedures on the goodwill arising on the acquisition of Brookside Ltd

✓ Obtain the legal documentation pertaining to the acquisition, and review to confirm that the figures included in the goodwill calculation relating to consideration paid and payable are accurate and complete. In particular, confirm the targets to be used as the basis for payment of the contingent consideration in four years' time.

✓ Also confirm from the purchase documentation that Kristal has obtained an 80% shareholding and that this conveys control, i.e., the shares carry voting rights and there is no restriction on Kristal exercising their control over Brookside Ltd.

✓ Agree the FRW80 million cash paid to the bank statement and cash book of the acquiring company.

✓ Review the board minutes for discussions relating to the acquisition, and for the relevant minute of board approval.

✓ For the contingent consideration, obtain management's calculation of the present value of FRW271 million, and evaluate assumptions used in the calculation, in particular to consider the probability of payment by obtaining revenue and profit forecasts for Brookside Ltd for the next four years.

✓ Discuss with management the reason for using an 18% interest rate in the calculation, asking them to justify the use of this interest rate when the Kristal weighted average cost of capital is stated at 10%.

✓ Evaluate management's rationale for using the 18% interest rate, concluding as to whether it is appropriate.

✓ Confirm that the fair value of the non-controlling interest has been calculated based on an externally available share price at the date of acquisition. Agree the share price used in management's calculation to stock market records showing the share price of Brookside Ltd at the date of acquisition.

✓ Obtain a copy of the due diligence report issued, review for confirmation of acquired assets and liabilities and their fair values.

✓ Evaluate the methods used to determine the fair value of acquired assets, including the property, and liabilities to confirm compliance with IFRS 3 and IFRS 13 *Fair Value Measurement*.

✓ Review the calculation of net assets acquired to confirm that Kristal accounting policies have been applied.

(c) Evaluation of the extract of the audit strategy prepared by component auditor in respect of their audit of Brookside Ltd

The extract from the audit strategy covers two areas – reliance on internal controls, and the use of internal audit for external audit work. In each area it appears that ISA requirements have not been followed, meaning that the quality of the audit planned by component auditor is in doubt.

Controls effectiveness

In relation to reliance on internal controls, ISA 330 *The Auditor's Responses to Assessed Risks* contains requirements in relation to relying on work performed during previous audits on internal controls. ISA 330 states that if the auditor plans to use audit evidence from a previous audit about the operating effectiveness of specific controls, the auditor shall establish the continuing relevance of that evidence by obtaining audit evidence about whether significant changes in those controls have occurred subsequent to the previous audit. The auditor shall obtain this evidence by performing inquiry combined with observation or inspection, to confirm the understanding of those specific controls, and if there have been changes which affect the continuing relevance of the audit evidence from the previous audit, the auditor shall test the controls in the current audit. If there have not been such changes, the auditor shall test the controls at least once in every third audit, and shall test some controls each audit to avoid the possibility of testing all the controls on which the auditor intends to rely on a single audit period with no testing of controls in the subsequent two audit periods.

Therefore, in order to comply with ISA 330, component auditor needs to do more than simply accept management's assertion that there have been no changes to controls. There needs to be some observation or inspection of controls, to confirm that there have been no changes, and this work and an appropriate conclusion need to be documented in the audit working papers.

In addition, there should be some testing of internal controls each year, so component auditor should plan to perform some tests of controls each year, so that over a three-year cycle, all controls are tested to confirm that controls are still operating effectively and therefore can continue to be relied upon.

Kristal audit team should discuss this issue with component auditor to ensure that adequate controls testing is performed. If, for some reason, component auditor does not amend its audit strategy, then the Kristal audit team may decide to perform additional testing, given that Brookside Ltd is material to Kristal.

Internal audit

According to ISA 610 *Using the Work of Internal Auditors*, it is acceptable, in some circumstances, for the external audit firm to use the internal audit function of an audited entity to provide direct assistance to the external audit team. However, in some jurisdictions, due to local regulations, the external auditor is prohibited from using internal auditors to provide direct assistance, and therefore Kristal auditor team will need to consider whether the prohibition also extends to component auditors and, if so, it would not be appropriate for component auditor to use the internal audit function. Assuming that there is no local restriction, before deciding whether to use the internal audit function, the external auditor must evaluate a number of factors, including:

- ✓ The extent to which the internal audit function's organizational status and relevant policies and procedures support the objectivity of the internal auditors.
- ✓ The level of competence of the internal audit function.
- ✓ Whether the internal audit function applies a systematic and disciplined approach, including quality control.

Component auditor must therefore perform this evaluation before making any decision about whether they should instruct the internal audit team to perform audit procedures. For example, if they find that the internal audit function does not have a good quality control procedure, it would not be appropriate to use them in external audit work.

Using the internal audit function to perform audit procedures is direct assistance to the external auditor. ISA 610 requires that where direct assistance is being provided, the external auditor shall evaluate the existence and significance of threats to objectivity and the level of competence of the internal auditors who will be providing such assistance. The external auditor shall not use an internal auditor to provide direct assistance if there are significant threats to the objectivity of the internal auditor or the internal auditor lacks sufficient competence to perform the proposed work. Component auditor therefore needs to document and conclude upon their assessment of the internal auditors' objectivity and competence.

There is also an issue with regard to the type of work they are given to perform. Component auditor is planning to ask the internal auditors to perform specific audit procedures in relation to trade receivables but this is not likely to be appropriate. ISA 610 states that the external auditor shall make all significant judgements in the audit engagement. Performing a trade receivables circularization and reviewing the allowance against trade receivables both involve judgements, in relation to sample selection and also in relation to measurement of the receivables. The trade receivables are also likely to be a material balance in the financial statements. Therefore, it would not be appropriate for the internal audit team to complete the audit, though they could be used for performing routine procedures not involving the use of judgement.

A further issue is that ISA 610 specifically states that the external auditor shall not use internal auditors to provide direct assistance to perform procedures which relate to work with which the internal auditors have been involved and which has already been, or will be, reported to management or those charged with governance. From the audit strategy, it appears that the internal audit function has worked on trade receivables during the year, so it would not be appropriate for the internal auditors to provide direct assistance to the external audit firm in relation to this area due to the self-review threat which would be created.

It may be possible for the internal auditors to provide direct assistance on non-judgmental areas of the financial statements if they have not performed internal audit work relating to those areas during the year.

In conclusion, from the evaluation of this extract from the audit strategy, it seems that component auditor is planning to carry out the audit of Brookside Ltd in a manner which does not comply with ISA requirements. This is a concern, given the materiality of the subsidiary to Kristal, and our firm should liaise with component auditor as soon as possible to discuss their audit planning.

(d) Ethical and professional implications of the request to provide a non-audit service on Kristal integrated report

There are several issues to consider with regard to providing this service. A significant issue relates to auditor objectivity. The IESBA *Code of Ethics for Professional Accountants* (the *Code*) provides guidance on situations where the auditor is asked by the client to provide non-assurance services. Sonic & Associates needs to evaluate the significance of the threat and consider whether any safeguards can reduce the threat to an acceptable level.

While the integrated report is not part of the audited financial statements, the report will contain financial key performance indicators (KPIs), and Kristal has asked for input specifically relating to the reconciliations between these KPIs and financial information contained in the financial statements. There is therefore a potential self-review threat to objectivity in that the audit firm has been asked to provide assurance on these KPIs which are related to figures which have been subject to external audit by the firm. The team performing the work will be reluctant to raise queries or highlight errors which have been made during the external audit when assessing the reconciliations of KPIs to audited financial information.

It could also be perceived that Sonic & Associates is taking on management responsibility by helping to determine content to be included in the integrated report, which is a threat to objectivity. The *Code* states that the audit firm shall not assume management responsibility for an audit client and that the threats created are so significant that safeguards cannot reduce them to an acceptable level. While the *Code* does not specifically state that helping the client to determine the content of its integrated report is taking on management responsibility, certainly there could be that perception as the auditor will be involved in setting measurements which the company will benchmark itself against. Additionally, working with management on the integrated report could create a familiarity threat to objectivity whereby close working relationships are formed, and the auditor becomes closely aligned with the views of management and is unable to approach the work with an appropriate degree of professional skepticism.

There is a potential problem in terms of compliance with ISA 720 *The Auditor's Responsibilities Relating to Other Information*, should Sonic & Associates accept the engagement. ISA 720 requires that auditors read other information in order to identify any material inconsistencies between the financial statements and information in the other information. ISA 720 applies only to other information in the annual report, and it is not stated whether the Group's integrated report will be included in the annual report, or as a standalone document.

Based on the above, it would seem unlikely that Sonic & Associates can provide this service to the Group, due to the threats to objectivity created. However, should the firm decide to take on the engagement, safeguards should be used to minimize the threats. For example, a partner who is independent should be involved in reviewing the audit work performed.

Aside from ethical issues, Sonic & Associates must also consider whether they have the competence to perform the work. Advising on the production of an integrated report is quite a specialist area, and it could be that the audit firm does not have the appropriate levels of expertise and experience to provide a quality service to Kristal. The fact that Kristal wants to highlight its technological achievements, and presumably will select a range of non-financial KPIs and technological issues to discuss in the integrated report, makes the issue of competence more significant, as the audit firm may not have the necessary technical knowledge to provide advice in this area. Aside from competence, the firm should also consider whether it has resources in terms of staff availability to complete the work to the desired deadline and to perform appropriate reviews of the work which has been completed.

Finally, given that Kristal is a listed entity, it should comply with relevant corporate governance requirements. This means that the audit firm may be prohibited from providing services in addition to providing the external audit to Kristal. The audit committee should apply Kristal policy on the engagement of the external auditor to supply non-audit services, the objective of which should be to ensure that the provision of such services does not impair the external auditor's independence or objectivity. Kristal audit committee will need to pre-approve the provision of the service, and in making this decision they should consider a number of matters, for instance, the audit committee should consider whether the skills and experience of the audit firm make it the most suitable supplier of the non-audit service, whether there are safeguards in place to eliminate or reduce to an acceptable level any threat to objectivity and the level of fees to be incurred relative to the audit fee.

SECTION B

QUESTION TWO

Marking Scheme

(a)(i)

S/N	Implication on Audit Report	
1	1.Net assets of 21,000,000 are overstated by FRW 12,500,000 hence the financials do not portray true and fair view. This is material (12.5/21*100%=59% hence a qualified opinion should be issued. 2. The financials must be adjusted to reflect this accordingly.	2 Marks
2	1.The Profit before tax of 29,000,000 is overstated. This is material 3/29*100%=10% hence a qualified opinion should be issued. 2.The tax computed thereof is also overstated. 3. Nets assets of 21,000,000 need also to be adjusted to reflect this disposal.	2 Marks
3	This has no effect on the audit report unless it becomes recurrent to which those charged with governance should be informed. The effects of the controls need to be identified on how it affects the financials otherwise formal management letter.	2 Marks
4	This remains a current liability until the management representation letter is received. Once representation is made then then it can be classified as non-current liability.	2 Marks
5	Since the case has been concluded then the provision is no longer tenable but rather this is an actual liability of 14,500,000. This meets the definition of liability and the financials must be adjusted to reflect this fact. The net current liabilities should be increased by this amount. The related notes to the financials need to be amended to reflect this fact.	2 Marks

(a)(ii) Overall audit opinion

Nature of matter giving rise to modification	**Auditors' judgement about the pervasiveness or possible effects on the financial statements.**	
	Material and not pervasive	**Material and pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
In ability to obtain sufficient and appropriate audit evidence	Qualified opinion	Disclaimer opinion

(5 Marks)

b) Analyze audit procedures which you might carry out in order to identify any material post balance sheet events. **(10 Marks)**

- Enquiring into management's procedures/systems for the identification of subsequent events;
- Inspection of minutes of members' and directors' meetings;
- Reviewing accounting records including budgets, forecasts and interim information.
- Enquiring of directors if they are aware of any subsequent events that require reflection in the year-end account;

- Obtaining, from management, a letter of representation that all subsequent events have been considered in the preparation of the financial statements;
- Inspection of correspondence with legal advisors;
- Enquiring of the progress with regards to reported provisions and contingencies; and
- 'Normal' post reporting period work performed in order to verify year-end balances:

Mark up to 2 marks for each relevant point explained maximum 10 marks

Model Answers

(a) (i)For each of the issues noted from your review, summaries the potential implications on the audit report (Treat each issue independently)

S/N	Issue	Implication on Audit Report
1	Investment decline by FRW 12,500,000 in market value.	1.Net assets of FRW 21,000,000 are overstated by FRW 12,500,000 hence the financials do not portray true and fair view. This is material (12.5/21*100%=59% hence a qualified opinion should be issued. 2. The financials must be adjusted to reflect this accordingly.
2	Tangible asset with a netbook value of FRW 8,000,000 sold on 29 June 2022.	1.The Profit before tax of FRW 29,000,000 is overstated. This is material 3/29*100%=10% hence a qualified opinion should be issued. 2.The tax computed thereof is also overstated. 3. Nets assets of FRW 21,000,000 need also to be adjusted to reflect this disposal.
3	Minor control points were noted and reported to management	This has no effect on the audit report unless it becomes recurrent to which those charged with governance should be informed. The effects of the controls need to be identified on how it affects the financials otherwise formal management letter.
4	Trade payables FRW 7,000,000 from parent company	This remains a current liability until the management representation letter is received. Once representation is made then then it can be classified as non-current liability.
5	A legal case which was ongoing at the year-end has just been concluded	Since the case has been concluded then the provision is no longer tenable but rather this is an actual liability of FRW 14,500,000. This meets the definition of liability and the financials must be adjusted to reflect this fact. The net current liabilities

		should be increased by this amount. The related notes to the financials need to be amended to reflect this fact.

(b) (ii) **Explain the overall audit opinion that you would express taking into consideration that no further adjustments or disclosures were made for the issues noted.**

If no further adjustments were made the audit opinion, I would express would express is qualified opinion. This modified opinion is due to the fact based on the nature of matter giving rise to modification of opinion, the financial statements were materially misstated, however based on auditors' judgement about the pervasiveness or possible effects on the financial statements, they were material but not pervasiveness.

Nature of matter giving rise to modification	**Auditors' judgement about the pervasiveness or possible effects on the financial statements.**	
	Material and not pervasive	**Material and pervasive**
Financial statements are materially misstated	Qualified opinion	Adverse opinion
In ability to obtain sufficient and appropriate audit evidence	Qualified opinion	Disclaimer opinion

b) Analyze audit procedures which you might carry out in order to identify any material post balance sheet events.

The nature of procedures performed in a subsequent events review depends on many variables, such as the nature of transactions and events and the availability of data and reports.

- Study minutes of the meetings of the Members, Board of the directors and other important executive committees (if any) held after the balance sheet date and enquire about the matters which may be relevant in this regard.
- Discuss with key officials on matters such as company's policy on marketing of new products, price structure, major sales order booked or cancellation of sales orders and loss of major customers, if any, new borrowings, capital commitments, fresh guarantees, outcome of pending law suits and any change in accounting policies etc.
- Ascertain the status of litigations, claims etc. against the company from its legal advisors.
- Inquire, or extend previous oral or written inquiries, of the entity's legal counsel concerning litigation and claims
- Read the entity's latest available budgets, cash flow forecasts and other related management reports for periods after the date of the financial statements.
- Obtain written representation from the management that all relevant events have been appropriately accounted for/dealt with.
- Obtain an assurance from management about:
  i. Current status of items that were accounted for on the basis of estimates or inconclusive data.
  ii. Any events occurred or likely to occur which will require change in the existing accounting policies.

iii. Any events which may cast doubts about the validity of entities 'going concern' assumption. For this purpose, the auditor should remain alert for the circumstances which may cast significant doubt on the company's ability to continue as a going concern.

- Enquiring into management's procedures/systems for the identification of subsequent events;
- Inspection of minutes of members' and directors' meetings;
- Reviewing accounting records including budgets, forecasts and interim information.
- Enquiring of directors if they are aware of any subsequent events that require reflection in the year-end account;
- Obtaining, from management, a letter of representation that all subsequent events have been considered in the preparation of the financial statements;
- Inspection of correspondence with legal advisors;
- Enquiring of the progress with regards to reported provisions and contingencies; and
- 'Normal' post reporting period work performed in order to verify year-end balances:
  - Checking after date receipts from receivables;
  - Inspecting the cash book for payments/receipts that were not accrued for at the year-end; and
  - Checking the sales price of inventories.

QUESTION THREE

Marking Scheme

(a) Verification of revaluation of Land and buildings.

✓ Source data used
✓ Assumptions used
✓ Testing data used by the valuer
✓ Values of current market prices for similar and other property
✓ Basis used to value the property
✓ Check local or national statistics available for indices of properties
✓ Ascertain rental value of similar property
✓ Competence of the valuer
✓ Objectivity and independence of the valuer

Award 1 Mark each for every correct point up to Maximum of 5 Marks

(b) Verification of existence assertion of investments.

✓ Physical inspection
✓ Bank confirmation for investments held as mortgage or safe custody
✓ Receipt of dividend
✓ Representation of directorship in other entities

Award 1 Mark each Maximum of 4 Marks

(c)**Identify three risks and three evidential matters in verifying development costs**

Risks:

✓ Inherent risk due to nature of account and judgments involved.
✓ Commercial viability if future revenues will not cover costs.
✓ Bank may withdraw funding if uncertain

Evidential matter:

✓ License to develop the product is granted by appropriate authorities.
✓ Compare actual cost to date with budgeted cost.

✓ Adequacy of actual sales after commercial production with budgeted sales.

Award 2 Mark for 2 risks and 2 marks for evidential matter Maximum of 4 Marks

(d) Verification of Adequacy of Accumulated Depreciation?

✓ Assess reasonableness of useful lives of high value assets

✓ Assess reasonableness of depreciation method used in relation to pattern in which the asset's future economic benefits are expected to be consumed by the client.

✓ Review estimate of residual value.

✓ Ensure that depreciation is recognized even if the fair value of asset exceeds carrying amount.

✓ In case of revaluation, depreciation should be charged on revalued amount.

✓ Leased assets should be depreciated over lease term, unless there is a reasonable expectation that the assets will be transferred to lessee, in which case, the leased assets may be depreciated over their useful lives.

✓ Excessive losses on disposal may indicate that depreciation was inadequate.

✓ Re-computation

Award 1 Mark each Maximum of 4 Marks

(e) Comment on each of the above costs charged to inventories in (5) above

✓ Selling expenses are not considered to be directly related to acquisition or production of goods.

✓ General and administrative expenses are usually excluded from cost of inventories

✓ Interest costs associated with getting inventories ready for sale are charged to expenses as incurred.

✓ Under recovery of overheads is not allocated to products

Award 1 Mark each Maximum of 4 Marks

(f) Alternative procedures applied if some receivables cannot be directly confirmed.

✓ Review of subsequent collections.

✓ Inspection of invoices and delivery notes

✓ Analytical procedures on the aging schedule of receivables

Award 1 Mark each Maximum of 2 Marks

(g) Procedures to verify accrued expenses

✓ Obtain or prepare a schedule of accruals

✓ Check subsequent payments

✓ Compare with last year and investigate unusual items or accruals

✓ Carry out analytical procedures where relationship is expected to exist.

Award 1 Mark each Maximum of 2 Marks

Model Answers

(a) Advice the procedures to be performed to verify the revaluation of Land and buildings.

Assess professional competence of the valuer. This will involve (a)considering the professional certification or licensing by, or membership in, an approved professional body and (b) experience and reputation in the field of valuers

Assess objectivity and independence of the valuers.

Assess appropriateness of the valuer's work as audit evidence for revaluation of the land building. This will involve consideration of:

a) Source data used

b) Assumptions used

c) Testing data used by the valuer

d) Experienced in valuing properties like those which have been restated at revaluation by the client and the same geographical area.

e) basis used to value the property.

f) Review of documents in possession of the valuers for source and reliability.

g) Inquire the values of current market prices for similar and other property.

h) Ascertain rental value of similar property to estimate current value of client's property.

i)Check local or national statistics available for indices of properties.

(b) How would your trainee verify existence assertion of investments.

Evidence that may be inspected for existence assertion of investments include:

1. Physical inspection
2. Bank confirmation for investments held as mortgage or safe custody
3. Receipt of dividend
4. Representation of directorship in other entities

(c) Identify three risks and three evidential matters in verifying development costs

Risks:

1. Development cost has significant inherent risk due to nature of account and judgments involved.

2. Consider commercial viability. Be alert that the product may not generate future economic benefit if future revenues will not cover costs.

3. Bank may withdraw funding if certain

Evidential matter:

1. Verify that the license to develop the product is granted by appropriate authorities.

2. Compare actual cost to date with budgeted cost.

3. Review adequacy of amortization by comparing actual sales after commercial production with budgeted sales.

(d) How would you verify adequacy of accumulated depreciation?

1. Assess reasonableness of lives of high value assets
2. Assess reasonableness of depreciation method used in relation to pattern in which the asset's future economic benefits are expected to be consumed by the client

3. Review estimate of residual value
4. Ensure that depreciation is recognized even if the fair value of asset exceeds its carrying amount.
5. In case of revaluation, depreciation should be charged on revalued amount.
6. Leased assets should be depreciated over lease term, unless there is a reasonable expectation that the assets will be transferred to lessee, in which case, the leased assets may be depreciated over their useful lives.
7. Excessive losses on disposal may indicate that depreciation was inadequate.
8. Re-computation

(e) Comment on each of the above costs charged to inventories in (5) above

Selling expenses

Selling expenses are not considered to be directly related to acquisition or production of goods. These are more directly related cost of goods sold rather than unsold goods. Selling expenses are, therefore not considered as part of inventory costs.

General and administrative expenses

General and administrative expenses are usually excluded from cost of inventories because such expenses are so unrelated or indirectly related to the immediate production process that any allocation is purely arbitrary. However, where some administrative costs can be allocated as production overheads on a systematic basis, for example, rent of building or wages of the accounting staff dealing with affairs of production may be included in cost of inventories.

Interest costs

Interest costs associated with getting inventories ready for sale are charged to expenses as incurred. IAS 23, Borrowing Costs, only allows capitalization of those borrowing costs which are directly attributable to the acquisition, construction or production of a qualifying asset. Inventories that are routinely manufactured or otherwise produced in large quantities on a repetitive basis over a short period of time are not considered as qualifying assets

Under recovery of overheads

Under recovery of overheads is not allocated to products. This is recorded as expense of the current accounting period.

(f) What alternative procedures are applied if some receivables cannot be directly confirmed.

a) Review of subsequent collections.
b) Inspection of invoices and delivery notes
c) Analytical procedures on the aging schedule of receivables

(g) List four significant procedures to verify accrued expenses

1. Obtain or prepare a schedule of accruals
2. Check subsequent payments
3. Compare with last year and investigate unusual items or accruals which were make last year

but are not reflected in current year's schedule.

4. Carry out analytical procedures where relationship is expected to exist.

QUESTION FOUR

Marking Scheme

(a) (i)Explain the assertion "Existence of performance information is a precondition for an audit of performance information" **(4 Marks)**

- ✓ Possibility of entity not having performance information needed.
- ✓ Auditor to consider whether sufficient information will be available to audit.
- ✓ Whether the preconditions exist for an audit of performance information.
- ✓ Data may exist in a raw form, which must then be analyzed

Award 1 Mark each Maximum of 4 Marks

(ii) Discuss the steps in Planning and conducting the audit of performance information **(6 Marks)**

✓ Identification of objectives against which the performance of the organization is to be evaluated.

- Auditor seeks to answer question of whether organization achieving its objectives?
- Objectives will usually already have been determined by the organization itself
- The organization have determined its own specific numerical measures (KPIs).
- Determination of whether a targeted level of performance has been achieved on the basis of these measures.
- Alternatively, objectives can take the form of general verbal statements,
- The procedures used may include audit-type procedures,
- ISAE 3000 Assurance engagements other than audits
- Tests of controls on the systems used to generate performance information
- Performing analytical review to evaluate trends and gauge the consistency
- Analysis of service-user activity data
- Review of service-user experience surveys
- Surveys of key management and staff
- Interviews with key management and staff
- Review of minutes of meetings where performance information has been discussed
- Confirmation of performance information to source documentation; this may be performed on a sample basis
- Conducting case studies
- Review of existing literature
- Review of results of internal and external challenges

Award 2 Marks for each 3 correct point maximum 6 Marks

(iii) **Analyze the performance of the two universities and identify the best performing.**

(6 Marks)

Gikondo University	230/7,630 *100%	3%
University of Huye	190/5,490 *100%	3.5%

On this basis, Gikondo University appears to be the better performing University. On further investigation, however, the picture becomes more complex. Award 3 marks

After adjusting for dropout due to other reasons, it would appear that University of Huye has the lower (better) dropout rate. This appears to indicate that University of Huye is performing better for ordinary drop out due to failure in final examination.

It should be noted, however, that University of Huye has a higher dropout rate due to other reasons:

Gikondo University	(230 – 120) / (7630 – 6100) = 110/1530	7%
University of Huye	(190 – 70) / (5490 – 4940) = 120/550	22%

Award 3 marks

(iv) Explain some of the difficulties in use of performance information **(4 Marks)**

✓ Manipulation of the reported figures

✓ doctoring the report figures,

✓ change of behavior in order to improve the reported figures, without actually improving performance.

✓ Perverse incentives. Some examples include:

i) A law enforcement officer arresting minors just to show higher number of arrests, or arresting offenders on flimsy grounds which may not necessarily reduce the crime level.

ii) Teachers awarding high marks to students just to show high pass rates but not necessary the improved literacy level or increased knowledge acquisition.

iii)Speed in answering letters, which is not balanced by a measure of the quality of responses. This might encourage people to answer letters quickly, but badly.

iv)A publishing company might set deadlines for books going to print or for drafts being completed, irrespective of their quality.

Award 1 Mark each Maximum of 4 Marks

b) Comment on JiK JiK Club transactions **(5 Marks)**

- increasing focus on whistleblowing as a mechanism to detect fraudulent misconduct.
- Auditing standards require auditors to compile information from all relevant sources, including whistleblowing tips, in their risk assessments.
- Given that whistleblowing can expose financial misdeeds, auditors may consider such reports as a signal of heightened risk for companies whose financial statements they audit.
- There are two areas where legislation may require the auditor to break their duty of confidentiality:
- Where required to disclose by anti-money laundering legislation
- Where required to disclose by any whistleblowing responsibilities,

✓ The transaction described in the scenario raises suspicion of money laundering for several reasons.

✓ It has been alleged by Mr Wahome that the purpose of the transaction has nothing to do with the JiK JiK Club business.

✓ This could be a sign that Mr Wahome is attempting to legitimize the proceeds of a crime through JiK JiK Club by concealing the illegal source of the cash

✓ The amount of the transaction is substantial for JiK JiK Club. An unusually large transaction should alert the auditor to the possibility of money laundering, especially as it does not seem to relate to the business of JiK JiK Club.

✓ The cash amount paid into JiK JiK Club bank account is the same as the amount paid to Lavindo Eateries Ltd. This could be an attempt by Mr Wahome to make the cash appear legitimate by moving it through several companies and jurisdictions.

✓ Mr Wahome was instructed not to record the transaction in the accounting records of JiK JiK Club.

✓ Increased secrecy over transactions is another indicator of money laundering. JiK JiK Club bank statement should be checked to confirm employess assertion.

✓ The suspicious transaction should be reported to the firm's MLRO or as soon as possible and any 'tipping off' must be avoided. It is a criminal offence to not report suspicions of money laundering.

Award 1 Mark each Maximum of 5 Marks

Model Answers

(a) (i) Explain the assertion "Existence of performance information is a precondition for an audit of performance information"

- It is possible that the entity being reported on may not generate all (or any) of the performance information needed.
- In this case, it will be necessary for the auditor to consider whether sufficient information will be available for them to conduct an audit.
- Whether the preconditions exist for an audit of performance information.
- A common situation is one where a lot of data exists in a raw form, which must then be analyzed by the auditor in order to measure performance against the specified objectives.

(ii) Discuss the steps in Planning and conducting the audit of performance information.

1. The first step is to identify the objectives against which the performance of the organization is to be evaluated.

- The question the auditor seeks to answer is simply: is the organization achieving its objectives?
- Objectives will usually already have been determined by the organization itself (or by a higher level of government).
- The organization itself may already have determined its own specific numerical measures (KPIs).
- It may then be determined whether a targeted (aimed for) or standard (minimum acceptable) level of performance has been achieved on the basis of these measures.
- Alternatively, objectives can take the form of general verbal statements, such as 'to improve performance against quality indicators', from which numerical measures may then be derived by the auditor.

2. Having identified the objectives, the auditor plans procedures to test whether they have been achieved.

- The procedures used may include audit-type procedures, but may also involve an element of social scientific research in the form of both quantitative and qualitative research methods.
- ISAE 3000 Assurance engagements other than audits or review of historical financial information is a potential source of guidance here.

Procedures may include:

- Tests of controls on the systems used to generate performance information
- Performing analytical review to evaluate trends and gauge the consistency of quantitative data
- Analysis of service-user activity data
- Review of service-user experience surveys
- Surveys of key management and staff
- Interviews with key management and staff
- Review of minutes of meetings where performance information has been discussed
- Confirmation of performance information to source documentation; this may be performed on a sample basis
- Conducting case studies
- Review of existing literature
- Review of results of internal and external challenges

(iii) Analyse the performance of the two universities and identify the best performing.

At first glance, Gikondo University appear to have the worst dropout rate, with 230 dropouts compared with 190 at University of Huye. These absolute figures may be misleading, however, so it is necessary to calculate the relative dropout rates for each University:

Gikondo University	23/763 *100%	3%
University of Huye	19/549 *100%	3.5%

On this basis, Gikondo University appears to be the better performing University. On further investigation, however, the picture becomes more complex.

Adjusting for dropout due to other reasons

It is likely that dropout due to other reasons carry a higher risk of dropout than drop out due to failure in final examination. An uneven distribution of dropout due to other reasons between the two universities would indicate different risk profiles in each university underlying student's population for the period, which would be expected to affect the dropout rate for each university.
At Gikondo University, 120 students dropped out due to failure in final examination, which gives a dropout rate of 2.0% (120/6100) for drop out due to failure in final examination.
At University of Huye, 70 students dropped out due to failure in final examination, which gives a dropout rate of 1.4% (70/4940) for drop out due to failure in final examination. After adjusting for dropout due to other reasons, it would appear that University of Huye has the lower (better) dropout rate. This appears to indicate that University of Huye is performing better for ordinary drop out due to failure in final examination.

It should be noted, however, that University of Huye has a higher dropout rate due to other reasons:

Gikondo University	(230 – 120) / (7630 – 6100) = 110/1530	7%
University of Huye	(190 – 70) / (5490 – 4940) = 120/550	22%

This could be indicative of problems at University of Huye in relation to dropout rate due to other reasons. It may also be a sign of differences in the underlying the students' populations. Further information on the background of students attending each University would be needed in order to determine which performed better in dropout rate due to other reasons.

(iv) Explain some of the difficulties in use of performance information

✓ An important difficulty in the use of performance information is that of manipulation of the reported figures (indeed, this is part of the reason for this information being subject to audit in the first place).

✓ This could take the form of straightforwardly doctoring the report figures, but perhaps more damaging is the risk that those being measured change their behavior in order to improve the reported figures, without actually improving performance.

✓ This is the problem of perverse incentives. Some examples include:

i) A law enforcement officer arresting minors just to show higher number of arrests, or arresting offenders on flimsy grounds which may not necessarily reduce the crime level.

ii) Teachers awarding high marks to students just to show high pass rates but not necessary the improved literacy level or increased knowledge acquisition.

iii)Employees being punctual at work but not necessarily increased output

iv)Speed in answering letters, which is not balanced by a measure of the quality of responses. This might encourage people to answer letters quickly, but badly.

v) A publishing company might set deadlines for books going to print or for drafts being completed, irrespective of their quality.

b) Comment on JiK JiK Club transactions

- There has been an increasing focus on whistleblowing as a mechanism to detect fraudulent misconduct.
- Auditing standards require auditors to compile information from all relevant sources, including whistleblowing tips, in their risk assessments.
- Given that whistleblowing can expose financial misdeeds, auditors may consider such reports as a signal of heightened risk for companies whose financial statements they audit.
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- The transaction described in the scenario raises suspicion of money laundering for several reasons. (i) It has been alleged by Mr Wahome that the purpose of the transaction has nothing to do with the JiK JiK Club business. This could be a sign that Mr Wahome is attempting to legitimize the proceeds of a crime through JiK JiK Club by concealing the illegal source of the cash.
- The amount of the transaction is substantial for JiK JiK Club. An unusually large transaction should alert the auditor to the possibility of money laundering, especially as it does not seem to relate to the business of JiK JiK Club.
- The cash amount paid into JiK JiK Club bank account is the same as the amount paid to Lavindo Eateries Ltd. This could be an attempt by Mr Wahome to make the cash appear legitimate by moving it through several companies and jurisdictions.

- Mr Wahome was instructed not to record the transaction in the accounting records of JiK JiK Club. Increased secrecy over transactions is another indicator of money laundering. JiK JiK Club bank statement should be checked to confirm employess assertion. The suspicious transaction should be reported to Financial Intelligence Center (FIC) as soon as possible and any 'tipping off' must be avoided. It is a criminal offence to not report suspicions of money laundering.

END OF MARKING GUIDE AND MODEL ANSWERS