



ICPAR
Unlimited possibilities

CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: TUESDAY, 02 DECEMBER 2022

MARKING GUIDE AND MODEL ANSWERS

SECTION A

QUESTION ONE: LITE CO.

Marking guide

Marks

(a): Matters specific to the planning of an initial audit engagement for Lite Co.

Award up to 1 mark for every well explained matter "specific to the initial audit engagement for Lite Co". Only 0.5 marks where a matter is only identified (or a generic issue) but not well developed/explained with reference to the information given regarding Lite Co (**maximum of 8 marks**)

8

(b): Principal audit risks to be considered when planning the final audit for Lite Co

Audit risks specific to Lite Co include (but are not limited to) the following:

Revenue Recognition – timing (see Risk Of Material Misstatement (ROMM) marking guide below excluding materiality - **max 2 marks**)

2

Lion Masters Co - Disputed receivable (see Risk of Material Misstatement (ROMM) marking guide below excluding materiality - **max 2 marks**)

2

Huye Estates Co - Legal claim: recognition and/or disclosure (see ROMM marking guide below excluding materiality add 1 mark for potential "management bias" - **max 2 marks**)

2

Huye Estates Co – potential refund (see ROMM marking guide below excluding materiality - **max 1 marks**)

1

Huye Estates Co - Legal claim: Integrity (Award up to **1 mark** where they link this to either "lack of management integrity" or "management bias")

1

Going concern implications (Award 1 mark for every well-developed point/example linked to a going risk up to a **maximum of 2 marks**. Each 1 mark is only granted where they specifically refer to going concern indicators picked from the information in the scenario)

2

Closing building materials (see ROMM marking guide below excluding materiality - **max 2 marks**)

2

Overseas supplier (see ROMM marking guide below excluding materiality - **max 2 marks**)

2

Warranty provision (see ROMM marking guide below excluding materiality - **max 2 marks**)

2

Majority shareholder - Award up to a **maximum of 2 marks** where they link the impact of the majority shareholder (Jean Katwaza) to either a potential "management bias" and/or "lack of management integrity" in the preparation of the financial statements with specific information in the scenario such as his planned sale of his own shares

2

Related party transactions (see ROMM marking guide below excluding materiality - **max 2 marks**)

2

Any other valid audit risks raised by the student that are relevant to Lite Co. relating to the information provided in the scenario (where applicable using the ROMM marking

below)

Where correctly used, award 1 mark for each materiality item well developed (Following the materiality marking guide below) - to a maximum of 3 marks (across the entire question)

Guide to Materiality marking: Award 1 mark for each materiality where this is BOTH "a correct calculation and conclusion" (**Maximum of 3 marks**). Otherwise award zero is either the calculation is wrong and/or the conclusion is wrong

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

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

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

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

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

20

(c): Principal audit procedures - estimated warranty provision recognized by Lite Co

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

Two Examples below (as a guide to marking audit procedures):

(i) Review contracts or orders for the terms of the warranty (*0.5 marks here for What/Action supported by a valid source like "terms of the warranty"*) to gain an understanding of the obligation of Lite Co. (*another 0.5 marks here for a valid reason for the audit procedure*)

(ii) Review correspondence with customers during the year *(0.5 marks here for What/Action supported by a valid source like "correspondence with customers")* to gain an understanding of claims already in progress at the year-end *(another 0.5 marks here for a valid reason for the audit procedure)*

Maximum Marks for Q1 (c) - using the guide provided above **8**

(d)(i) Quality control procedures that are applicable to the individual audit engagement

Award up to 2 marks for each well-developed quality control procedure applicable to individual audit engagements - where 1 mark is granted for an explanation of relevant quality control and up to 1 mark for any valid relevant quality control procedures or approach within the quality control. The relevant quality controls where a student answer picks up to a Maximum of Any Five controls include:

1. Client acceptance procedures
2. Engagement team
3. Direction
4. Supervision
5. Review
6. Consultation

Maximum Marks for Q1 (d)(i) - using the guide provided above **10**

(d)(ii) Problems faced in implementing quality control procedures in a small accountancy firm and recommended solutions to overcome the problems

Award 1 mark for each valid problem identified and discussed (up to a maximum of TWO problems) and 1 mark for each relevant solution to the identified problem (up to a maximum of TWO solutions)

4

Total marks for Question One **50**

Model answers

Part (a): Matters specific in planning an initial audit engagement for Lite Co.

- Although professional clearance should already have been obtained, we should consider the effect on our strategy of any matters that the predecessor auditor may have brought to our attention. The reason for the predecessor auditor's resignation should be established, as this may have a bearing on our assessment of risk and planning of resources for the audit.
- ISA 300 "Planning an audit of financial statements" suggests contacting the predecessor auditor in order to review their working papers. This would help Ingabire & Associates CPA to plan its audit if there are any matters which would still be relevant to the current year, such as accounting policies. It is possible, however, that the predecessor auditor may refuse access to their working papers especially if the client (Lite Co.) has any outstanding audit fees unpaid.
- Although last year's auditor's opinion was unmodified, if any previous years' auditors' reports were modified then the reason for the modification(s) should be sought, as the matter(s) may continue to be relevant in the current year.
- It is possible that, during the appointment process, matters were discussed which might have a bearing on the audit, e.g., there might have been a discussion of accounting policies. This may affect the audit strategy.
- Ingabire & Associates CPA must obtain evidence on opening balances. Procedures should be performed on whether they have been brought forward correctly, and whether accounting policies are consistent with the prior years.
- Understanding the entity is crucial with an initial audit engagement, and this understanding would clearly have an impact on the audit strategy. It would help Ingabire & Associates to decide on the areas of audit risk, would facilitate analytical review, and would help to plan practical matters such as the use of auditor's experts.
- Jean Katwaza wants the audit to be completed within three weeks from today (1 April 2022) and therefore as soon as possible, which brings forward the deadline for completion of the audit. The audit team may not have time to complete all necessary procedures, or there may not be time for adequate reviews to be carried out on the work performed. Detection risk, and thus audit risk is increased, and the overall quality of the audit could be jeopardized.
- This is especially important given that this is the first-year audit and therefore the audit team will be working with a steep learning curve. Audit procedures may take longer than originally planned, yet there is little time to extend procedures where necessary.
- Jean Katwaza may also exert considerable influence on the members of the audit team to ensure that the financial statements show the best possible position of Lite Co. in view of the sale of his shares. It is important that the audit team members comply strictly to ethical guidelines and that independence is beyond question.
- Due to the seriousness of the matters noted above, a final matter to be considered at the planning stage is that a second partner review (Engagement Quality Control Review) should be considered for the audit this year end. A suitable independent reviewer should be identified, and time planned and budgeted for at the end of the assignment.

Part (b): Principal Audit Risks – Lite Co.

Revenue Recognition – timing

Lite Co. raises sales invoices in three stages. There is potential for breach of IFRS 15 “Revenue from contracts with customers”, which states that revenue should only be recognized once the seller has the right to receive it, in other words the seller has performed its contractual performance obligations. This right does not necessarily correspond to amounts falling due for payment in accordance with an invoice schedule agreed with a customer as part of a contract.

There is a risk that revenue may be recognized too early, in advance of any performance of contractual obligations as Lite Co. appears to receive payment from its customers in advance of performing any obligation, as the stage one invoice is raised when an order is confirmed i.e. before any work has actually taken place. When a payment is received in advance of performance, a liability should be recognized equal to the amount received, representing the obligation under the contract. Therefore, a significant risk is that revenue is overstated and liabilities understated.

Lion Masters Co. - Disputed receivable

The amount owed from Lion Masters Co. is highly material as it represents 51% of profit before tax, 2.3% of revenue, and 3% of total assets. IFRS 9 “Financial Instruments” requires an entity to assess the potential impairment loss of a financial asset (including a trade receivable) if there is expected loss in the recovery of a financial asset due to available indicators for impairment loss.

The risk is that the receivable may not be recoverable in full or in part considering that the client has disputed the quality assurance of the building materials used in the construction and hence there is a need for the recognition of an impairment loss for the receivable. If the impairment loss is not recognised, this will result into an overstated asset and profits.

Huye Estates Co - Legal claim: recognition and/or disclosure

The claim should be investigated seriously by Lite Co. The Managing Director’s (MD) opinion that the claim will not result in any financial consequence for Lite Co. is optimistic. Legal penalties could be awarded against Lite Co. if it is found building lifts are faulty as a result of Lite Co.’s defaults during the construction. The recurring high level of warranty provision implies that faults on the constructed buildings are fairly common and therefore the accident of the lifts operator could be the result of a defective construction work on the building handed to Huye Estates Co. The risk is that no provision is created for the potential damages under IAS 37 “Provisions, Contingent Liabilities and Contingent Assets”, if the likelihood of paying damages is considered probable.

Alternatively, if the likelihood of damages being paid to Huye Estates Co is considered a possibility then a disclosure note should be made in the financial statements describing the nature and possible financial effect of the contingent liability. As discussed below, the MD, Jean Katwaza, has an incentive not to make a provision or disclose a contingent liability due to the planned share sale post year end.

A further risk is that any legal fees associated with the claim have not been accrued within the financial statements. As the claim has arisen during the year, the expense must be included in this year's profit or loss, even if the claim is still ongoing at the year end.

Huye Estates Co – potential refund

On the other hand, If the stage one payments have already been received, then Huye Estates Co. may claim a refund, in which case a provision should be made to repay the amount, or a contingent liability disclosed in a note to the financial statements. If the provision for the refund is not made, then liabilities are understated and profits are overstated. If the contingent liability is not disclosed, then there is a risk of inadequate disclosures in the financial statements.

Huye Estates Co - Legal claim: Integrity

The fact that the legal claim is effectively being ignored may cast doubts on the overall integrity of senior management, and on the integrity of the financial statements. Management representations should be approached with a degree of professional skepticism during the audit.

Going concern implications

Huye Estates Co. has cancelled two orders. If the amounts are still outstanding at the year-end, then it is highly likely that Huye Estates Co. will not pay the invoiced amounts, and thus receivables and profits are overstated.

Huye Estates Co. is one of only five major customers, and losing this customer could have future going concern implications for Lite Co. if a new source of revenue cannot be found to replace the lost income stream from Huye Estates Co. If the legal claim becomes public knowledge, and if Lite Co. is found to have handed over a faulty building, then it will be difficult to attract new customers due to a poor publicity.

A case of this nature could bring bad publicity to Lite Co., a potential going concern issue if it results in any of the five key customers terminating orders with Lite Co. The auditors should plan to extend the going concern work programme to incorporate the issues noted above.

Closing building materials

Work in progress is material to the financial statements, representing 9% of total assets and 6.9% of revenue. The inventory count was held one week prior to the year end. There is an inherent risk that the valuation has not been correctly rolled forward to a year end (31 December 2021) position.

The key risk is the estimation of the stage of completion of work in progress. This is subjective, and knowledge appears to be confined to the chief engineer. Inventory could be overvalued if the machines are assessed to be more complete than they actually are at the year end. Absorption of labor costs and overheads into each building construction is a complex calculation and must be done consistently with previous years.

It will also be important that consumable inventories not yet utilized in the construction process, e.g. cement, nails, timber etc, are correctly valued and included as inventories of raw materials within current assets.

Overseas supplier

As the supplier is new, controls may not yet have been established over the recording of foreign currency transactions. Inherent risk is high as the trade payable should be retranslated using the year end exchange rate per IAS 21 “The Effects of Changes in Foreign Exchange Rates”. If the retranslation is not performed at the year end, the trade payable could be significantly over or under valued, depending on the movement of the FRW to CNY exchange rate between the purchase date and the year end. The components should remain at historic cost within inventory valuation and should not be retranslated at the year end.

Warranty provision

The warranty provision is material at 2.6% of total assets (December 2020 – 2.7%). The provision has increased by only \$100,000, an increase of 4.2%, compared to a revenue increase of 21.4%. This could indicate an under-provision as the percentage change in revenue would be expected to be in line with the percentage change in the warranty provision, unless significant improvements had been made to the quality of constructed buildings handed over to the customers during the year. This appears unlikely given the legal claim by Huye Estates Co. and the disputed final payment for the building used by Lion Masters Co. which is not operating efficiently. The basis of the estimate could be understated to avoid charging the increase in the provision as an expense through the profit or loss. This is of special concern given that it is the MD and majority shareholder Jean Katwaza who estimates the warranty provision who might be influenced by management bias as Jean Katwaza will be interested in selling his shares at a profit. This will result into understated liabilities and expenses.

Majority shareholder

Jean Katwaza exerts control over Lite Co. via a majority shareholding, and by holding the position of MD. This greatly increases the inherent risk that the financial statements could be deliberately misstated, i.e. overvaluation of assets, undervaluation of liabilities, and thus overstatement of profits. The risk is severe at this year-end as Jean Katwaza is hoping to sell some Lite Co. shares post year end. As the price that he receives for these shares will be to a large extent influenced by the financial position of the company at 31 December 2021, he has a definite interest in manipulating the financial statements for his own personal benefit. For example:

- Not recognising a provision or contingent liability for the legal claim from Huye Estates Co
- Not providing for the potentially irrecoverable receivable from Lion Masters Co.
- Not increasing the warranty provision
- Recognising the first stage revenue earlier than permitted by IFRS 15 “Revenue from contracts with customers”.

Related party transactions

Jean Katwaza controls Lite Co. and also controls Jet Co. Transactions between the two companies should be disclosed per IAS 24 “Related Party Disclosures”. There is risk that not all transactions have been disclosed, or that a transaction has been disclosed at an inappropriate value. Details of the lease contract between the two companies should be disclosed within a note to the financial statements, in particular, any amounts owed from Lite Co. to Jet Co. at 31 December 2021 should be disclosed.

Part (c): Principal audit procedures for the estimated warranty provision

ISA 540 “Audit of Accounting Estimates” requires that auditors should obtain sufficient audit evidence as to whether an accounting estimate, such as a warranty provision, is reasonable given the entity’s circumstances, and that disclosure is appropriate. One, or a combination of the following approaches should be used:

Review and test the process used by management to develop the estimate by:

- Review contracts or orders for the terms of the warranty to gain an understanding of the obligation of Lite Co.
- Review correspondence with customers during the year to gain an understanding of claims already in progress at the year end
- Perform analytical procedures to compare the level of warranty provision year on year, and compare actual to budgeted provisions. If possible, disaggregate the data, for example, compare provision for specific types of buildings (commercial or residential) or customer by customer
- Re-calculate the warranty provision to confirm arithmetic accuracy
- Agree the percentage applied in the calculation to the stated accounting policy of Lite Co.
- Review board minutes for discussion of on-going warranty claims, and for approval of the amount provided
- Use management accounts to ascertain normal level of warranty rectification costs during the year
- Discuss with Jean Katwaza the assumptions he used to determine the percentage used in his calculations
- Consider whether assumptions used are consistent with the auditors’ understanding of the business
- Compare prior year provision with actual expenditure on warranty claims in the accounting period
- Compare the current year provision with prior year and discuss any fluctuation with Jean Katwaza.

Review subsequent events which confirm the estimate made as follows:

- Review any work carried out post year end on specific faults that have been provided for.
- Agree that all costs are included in the year end provision.

- Agree cash expended on rectification work in the post balance sheet period to the cash book
- Agree cash expended on rectification work post year end to suppliers' invoices, or to internal cost ledgers if work carried out by employees of Lite Co
- Read customer correspondence received post year end for any claims received since the year end.

Part (d) (i): Quality Controls

ISQC 1 “Quality Control for Firms That Perform Audits and Reviews of Historical Financial Information and Other Assurance and Related Services Engagements” provides guidance on the overall quality control systems that should be implemented by an audit firm. “ISA 220 Quality Control for Audits of Historical Financial Information” specifies the quality control procedures that should be applied by the engagement team in individual audit assignments.

Quality Control Procedures at an individual audit engagement include the following:

1. Client acceptance procedures

There should be full documentation, and conclusion on, ethical and client acceptance issues in each audit assignment. The engagement partner should consider whether members of the audit team have complied with ethical requirements, for example, whether all members of the team are independent of the client.

Additionally, the engagement partner should conclude whether all acceptance procedures have been followed, for example, that the audit firm has considered the integrity of the principal owners and key management of the client.

Other procedures on client acceptance should include:

- Obtaining professional clearance from previous auditors
- Consideration of any conflict of interest
- Money laundering (client identification) procedures.

2. Engagement team

Procedures should be followed to ensure that the engagement team collectively has the skills, competence and time to perform the audit engagement. The engagement partner should assess that the audit team, for example:

- Has the appropriate level of technical knowledge for the tasks assigned
- Has experience of audit engagements of a similar nature and complexity
- Has the ability to apply professional judgement
- Understands professional standards, and regulatory and legal requirements.

3. Direction

The engagement team should be directed by the engagement partner. Procedures such as an engagement planning meeting should be undertaken to ensure that the team understands:

- Their responsibilities

- The objectives of the work they are to perform
- The nature of the client’s business
- Risk related issues
- How to deal with any problems that may arise; and
- The detailed approach to the performance of the audit.

The planning meeting should be led by the partner and should include all people involved with the audit. There should be a discussion of the key issues identified at the planning stage.

4. Supervision

Supervision should be continuous during the engagement. Any problems that arise during the audit should be rectified as soon as possible. Attention should be focused on ensuring that members of the audit team are carrying out their work in accordance with the planned approach to the engagement.

Significant matters should be brought to the attention of senior members of the audit team.

Documentation should be made of key decisions made during the audit engagement.

5. Review

The review process is one of the key quality control procedures. All work performed must be reviewed by a more senior member of the audit team. Reviewers should consider for example whether:

- Work has been performed in accordance with professional standards
- The objectives of the procedures performed have been achieved
- Work supports conclusions drawn and is appropriately documented.

The review process itself must be evidenced.

6. Consultation

Finally, the engagement partner should arrange consultation on difficult or contentious matters.

This is a procedure whereby the matter is discussed with a professional outside the engagement team, and sometimes outside the audit firm. Consultations must be documented to show:

- The issue on which the consultation was sought; and
- The results of the consultation.

Part (d) (ii): Problems faced by small firms in implementing quality controls and the applicable solutions to overcome the problems

Area	Problems faced in implementing quality control procedures in a small firm	Solutions to the problems
Consultation	It may not be possible to hold extensive consultations on specialist	Arrangements with other practices for consultation may

	issues within a small firm, due to a lack of specialist professionals.	be necessary
	There may be a lack of suitably experienced peers to discuss issues arising on client engagements.	
Training/Continuing Professional Development (CPD)	Resources may not be available, and it is expensive to establish an in-house training function	External training consortia can be used to provide training/CPD for qualified staff, and training on non-exam related issues for non-qualified staff
Review procedures	It may not be possible to hold an independent review of an engagement within the firm due to the small number of senior and experienced auditors.	In this case an external review service may be purchased
Insufficient specialist experience	Lack of specialist experience in the industry the client will be operating from	Where special skills are needed within an engagement; the skills may be bought in, for example, by seconding staff from another practice. Alternatively, if work is too specialized for the firm, the work could be sub-contracted to another practice
Working papers	The firm may lack resources to establish an in-house set of audit manuals or standard working papers	In this case documentation can be provided by external firms or professional bodies

SECTION B

QUESTION TWO: MUZUNGU AGRO LTD (MAL)

Marking guide

Marks

(a): Advantages of having an audit committee to MAL

Award 1 mark for every valid advantage of an audit committee specific to MAL; otherwise, award only 0.5 marks if the student answer only provides generic advantages without specific reference to MAL. Max is 5 marks

5

(b)(i): Explanation of weaknesses in that sales system

Award up to 1 mark for each internal control weakness identified and explained to a maximum of 4 marks (otherwise award only 0.5 marks where the student's answer only "identifies" the weakness but does not explain how this is a weakness to the sales system). There will be no mark for weakness that are not relevant to the sales system and/or not specific to the sales system of MAL.

4

(b)(ii): Explanation of the possible effect of each weakness

Award up to 1 mark for each implication well identified and explained specifically for each internal control weakness in Q2(b)(i) above to a maximum of 4 marks (otherwise award only 0.5 marks where the student's answer only "identifies" the impact of the weakness but does not explain how this is an impact arising from the identified weakness to the sales system). There will be no mark for explaining an impact that is not relevant to the identified weakness and/or not specific to the sales system of MAL.

4

(b)(iii): a recommendation to alleviate each weakness

Award 1 mark for each valid recommendation given for each specific internal control weakness in Q2(b)(i) above to a maximum of 4 marks. There will be no mark for providing a recommendation that is not relevant to the identified weakness to the sales system of MAL.

4

Note: A separate presentation for each of the three parts in Q2 (b) is accepted. Similarly, a presentation of the three requirements in Q2(b) of a tabular format similar to the model answer is also accepted

Award up to 2 professional marks in Q2(b) that includes 1 mark for the report format and 1 mark for clarity

2

(c): Factors to consider by MAL when appointing an external consultant

Award 1 mark for each factor specific to MAL that needs consideration when appointing an external consultant - up to a maximum of 6 marks.

6

Specific factors can include:

(i) Qualifications

(ii) Experience

(iii) References

(iv) Project management skills

(v) Access to information

(vi) Acceptance by other staff

Note: Any other valid factor explained and is both relevant and specific to MAL shall be granted 1 mark

Total marks for Question Two

25

Model Answers

Part (a): Advantages of an audit committee

Advantages of having an audit committee to Muzungu Agro Ltd include:

- It provides the internal audit department with an independent reporting mechanism compared to reporting to the directors who may wish to hide or amend unfavorable internal audit reports.
- The audit committee will assist the internal auditor by ensuring that recommendations in internal audit reports are actioned.
- Shareholder and public confidence in published financial information is enhanced because it has been reviewed by an independent committee.
- The committee helps the directors fulfil any obligations under corporate governance to implement and maintain an appropriate system of internal control within MAL.
- The committee should assist in providing better communication between the directors, external auditors and management by arranging meetings with the external auditor.
- Strengthens the independence of MAL's external auditor by providing a clear reporting structure and separate appointment mechanism from the board of MAL.

Part (b)

Report to audit committee

Inventory control and Sales System

Seed division

Introduction

The internal audit report below provides record on the weaknesses identified in the inventory and sales system along with their potential implications and our recommendations to address the weaknesses:

(i) Weakness	(ii) Potential effect of weakness	(iii) Recommendation
<p>Recording of orders: Orders placed on the Internet site are transferred manually into the inventory and sales system. Manual transfer of order details may result in</p>	<p>Customers will be sent incorrect goods resulting in increased customer complaints.</p>	<p>The computer systems are amended so that order details are transferred directly between the two computer systems. This will remove manual transfer of details limiting the possibility of</p>

<p>information being transferred incompletely or incorrectly, for example, order quantities may be incorrect or the wrong product code recorded.</p>		<p>human error.</p>
<p>Control over orders and packing lists: Each order/packing list is given a random alphabetical code. While this is useful, using this type of code makes it difficult to check completeness of orders at any stage in the dispatch and invoicing process.</p>	<p>Packing lists can be lost resulting either in goods not being dispatched to the customer (if the list is lost prior to goods being dispatched) or the customer's Bank debit card not being charged (if lost after goods dispatched but prior to the list being received in the accounts department).</p>	<p>Orders/packing lists are controlled with a numeric sequence. At the end of each day, gaps in the sequence of packing lists returned to accounts should be investigated.</p>
<p>Obtaining payment: The customer's Bank debit card is charged after dispatch of goods to the customer, meaning that goods are already sent to the customer before payment is authorized.</p>	<p>MAL Co will not be paid for the goods dispatched where the credit company rejects the payment request. Given that customers are unlikely to return seeds, MAL will automatically incur a bad debt.</p>	<p>Authorization to charge the customer's Bank debit card is obtained prior to dispatch of goods to ensure MAL Co is paid for all goods dispatched.</p>
<p>Completeness of orders: The computer system correctly ensures that order details are available for all charges to customer Bank debit cards. However, there is no overall check that all orders recorded on the inventory and sales system have actually been invoiced.</p>	<p>Entire orders may be overlooked and consequently sales and profit understated.</p>	<p>The computer is programmed to review the order file and orders where there is no corresponding invoice for an order, these should be flagged for subsequent investigation.</p>

Conclusion:

We look forward to arranging a meeting to discuss these weaknesses with you in more detail.

Part (c): Use of expert

Qualification

The consultant should have a relevant qualification to show ability to undertake the work. In this case, the consultant should possess adequate qualification in Information Technology (IT) systems integration or being a member of a relevant professional body.

Experience

The consultant should be able to show relevant experience from previous projects for example, upgrading or amending integrated system for other clients.

References

It will be important for the consultant to provide references from previous employers showing capability to undertake the work.

Project management skills

The consultant should be able to display appropriate project management skills as managing a team will be an important element of the systems integration work.

Access to information

The consultant will need access to important and sensitive information in MAL. The heads of department for the relevant staff such as the sales, accounts, procurement and IT departments must ensure that this information will be made available to third parties. The consultant will have to sign a confidentiality agreement.

Acceptance by other staff

Employing a consultant can be difficult as the internal staff of MAL staff (such as the IT staff) may feel threatened or resentful that a consultant has been employed. The heads of divisions/department and supervisors must ensure that the reasons for employing the consultant are understood by members of their division staff.

QUESTION THREE: TICK CONSULT

Marking Guide

Marks

(a): Matters to consider before accepting an engagement to conduct a due diligence review of Tick Consult

Award up to 1 mark for each specific matter that should be considered before accepting the engagement to conduct a due-diligence review (a maximum of 12 marks). The 1 mark is split to include 0.5 marks for "identifying a valid matter or issue relevant to due-diligence engagement of Tick Consult" and the other 0.5 marks for explanation the reason (or justification) for the matter. No mark should be awarded where the student's answer is only generic and not specific the information relating to Tick Consult as provided in the case scenario

12

Note: In addition to the matters raised in the model answer, any other valid matter raised in the student's answer that is relevant and specific to Tick Consult shall qualify for up to 1 mark

(b): Inquiry and analytical procedures to apply in the due diligence review of Tick Consult

Award 1 mark for every valid review procedure that is relevant to apply in the due-diligence review of Tick Consult (restricted to procedures under "inquiries" and "analytical reviews"). A maximum of 13 marks to be awarded

13

Note: In addition to the review procedures raised in the model answer, any other valid review procedure raised in the student's answer that is relevant and specific to due-diligence review of Tick Consult shall qualify for 1 mark

Total marks for Question Three

25

Model Answer

Part (a) Matters to be considered (before accepting the engagement)

- Information about Alexis Mugabo - It is important to establish the relationship of the Chief Finance Officer to PPL (e.g. whether he is on the PPL management board) and ascertain what authority he is approaching Rukundo & Partners to undertake this assignment
- The purpose of the assignment must be clarified. Alexis Mugabe's approach to Rukundo & Partners is 'to advise on a bid'. However, Rukundo & Partners cannot make executive decisions for a client but only provide the facts of material interest. PPL's management must decide whether or not to bid and, if so, how much to bid.
- The scope of the due diligence review - It seems likely that PPL will be interested in acquiring all of Tick Consult's business as its areas of operation coincide with PPL's (e.g. Tick Consult operates in Europe and Asia which is similar to PPL). However, it must be confirmed that PPL is not merely interested in acquiring only the National or International business of Tick Consult.

- Rukundo & Partners’ competence and experience – Rukundo & Partners should not accept the engagement unless the firm has experience in undertaking due diligence assignments. Even then, the firm must have sufficient knowledge of the territories in which the businesses operate to evaluate whether all facts of material interest to PPL have been identified.
- There is need to establish whether Rukundo & Partners has sufficient resources (e.g. representative / associated offices), if any, in Europe and Asia to evaluate Tick Consult’s International business segment. Rukundo & Partners operates with affiliates in various countries world-wide and hence it is important to establish whether our firm has affiliate offices in the exact countries in which Tick Consult operates from.
- Any factors including ethical and other professional barriers which might impair Rukundo & Partners’ objectivity in reporting to PPL the facts uncovered by the due diligence review. For example, if Alexis Mugabo is closely connected with a partner in Rukundo & Partners or if Rukundo & Partners is the auditor of Trinity Publishers.
- PPL’s rationale for wishing to acquire Tick Consult. Presumably it is significant that Tick Consult operates in the same territories as PPL. Therefore, PPL may be interested in the extensive training programs in management, communications and marketing provided by Tick Consult to its workforce of PPL.
- The business relationship, if any, between PPL and Tick Consult in any of the territories. PPL may be a major client of Tick Consult. That is, PPL may be currently out-sourcing training to Tick Consult. Hence acquiring Tick Consult would bring training in-house at PPL.
- Time available – Rukundo & Partners must have sufficient time to find all facts that would be of material interest to PPL before disclosing their findings.
- The acceptability of any limitations – whether there will be restrictions on Rukundo & Partners’ access to information held by Tick Consult (e.g. if there will not be access to board minutes) and personnel.
- The degree of secrecy required – this may go beyond the normal duties of confidentiality not to disclose information to outsiders (e.g. if unannounced staff redundancies could arise).
- There is need to confirm why PPL’s current auditors have not been asked to conduct the due diligence review especially as they are responsible for (and therefore capable of undertaking) the group audit covering the relevant countries.
- Rukundo & Partners should be allowed to communicate with PPL’s current auditor:
 - o to inform them of the nature of the work they have been asked to undertake; and
 - o to enquire if there is any reason why they should not accept this assignment.
- We need to consider the possibility of other follow-up assignments on completion of the due diligence assignment for example by taking on PPL as a new client Rukundo & Partners may have a later opportunity to offer external audit and other services to PPL (e.g. internal audit).

Part (b) Due diligence review - procedures

Inquiries:

Note: The inquiries should be focused on uncovering facts that may not be revealed by the audited financial statements (e.g. off balance sheet finance, contingencies, commitments and contracts) especially where knowledge may be confined to management.

- Inquire whether any members of Tick Consult's senior/executive management have contractual terms that will result in significant payouts to them (e.g. on change of ownership of the company or their being made redundant)
- Inquire of management whether there are any contracts with clients that will lapse or will be made void in the event that Tick Consult is purchased from Trinity Publishers
- Inquire whether there are any synergies or inter-company trading currently existing between Tick Consult and Trinity Publishers for example, Trinity Publishers may be the publishers of Tick Consult's training materials. It is important to establish if such can smoothly be taken over by PPL (as the new owners of Tick Consult) without causing major disruptions in the operations of Tick Consult.
- Inquire if there are any major clients who are likely to be lost if Tick Consult is purchased by PPL (e.g. any competitor publishers or their business associates in the countries in which PPL operates)
- Ascertain the principal terms of the operating leases relating to the international business's premises to confirm whether these will need to be continued with
- Confirm what penalties should be expected to be incurred if operating leases and/or contracts with training consultants are terminated
- Establish whether Tick Consult has entered into any purchase commitments since 31 December 2021 (e.g. to buy or lease further premises)
- Establish the best or relevant trainers that PPL should seek to retain after the purchase of Tick Consult
- Determine if there are any events since the audited financial statements to 31 December 2021 were published that have made a significant impact on Tick Consult's assets, liabilities, operating capability and/or cash flows (for example, storm damage to premises, major clients defaulting on payments, significant interest/foreign-exchange rate fluctuations, etc.)
- Ascertain if there any unresolved tax issues and any other probable litigations that have not been provided for in full or disclosed in the financial statements
- Establish if there is any effect that the purchase of Tick Consult may have on any existing loan covenants for example, term loans may be rendered repayable on a change of ownership.

Analytical procedures:

- Review the trend of Tick Consult's profit (gross and net), earnings per share and gearing for (say) the last five years.
- For both the National and International business segments of Tick Consult compare:

- Gross profit, net profit, and return on assets for the last five years (say);
- Actual monthly revenue against budget for (say) the last 18 months. Similarly, for major items of expenditure such as:
 - full-time salaries;
 - freelance consultancy fees;
 - premises costs (e.g., depreciation, lease rentals, maintenance, etc);
- monthly revenue (also costs and profit) per training center.
- Review projections of future profitability of Tick Consult against net profit percentage at 31 December 2021 for:
 - The National business segment (i.e., FRW 1820m / 17500m x 100% = 10.4%);
 - The international business segment (i.e., FRW 3360m / 8820m x 100% = 38.1%); and
 - overall ((Frw 1820m + 3360m) / (17500m + 8820m)) x 100% = 19.7%).
- Review of disposal value of owned premises against book values.
- Compare actual cash balances with budget on a monthly basis and compare borrowings against loan and overdraft facilities.
- Compare the average collection period for international's trade receivables month on month since 31 December 2021 for example this is slightly over seven months, (i.e. FRW 5180m / 8820m x 365 days = 214 days) and compare with the National business segment.
- Compare financial ratios for each of the 18 national training centers against the National business overall (and similarly for the International Business). For example:
 - Gross and net profit margins;
 - Return on center assets;
 - Average collection period;
 - Average payment period;
 - Liquidity ratio.
- Compare key performance indicators across the centers for the year to 31 December 2020 and 31 December 2021 up to date. For example:
 - Number of corporate clients;
 - Number of delegates;
 - Number of training days;
 - Average revenue per delegate per day;
 - Average cost per consultancy day.

QUESTION FOUR: SONGA ENTERPRISES

Marking Guide

Marks

(a)(i): Internal controls objectives for the payroll department at Songa Ent

Award 1 mark for each valid / correct internal control objective relating to the payroll department at Songa Ent that is well explained (granted as 0.5 marks for "identifying the valid internal objective" and the other 0.5 marks for a justification for the internal control objective). Maximum of 4 marks. No mark shall be granted where the internal control objective is not relevant to the payroll department at Songa Ent

4

(a)(ii): Internal control environment and internal control procedures in place to achieve the internal control objectives in (a)(i) above

Award 1 mark for each:

- Correct issue raised and explained as a relevant Internal control environment to ensure the internal control objectives for the payroll department of Songa Ent are achieved
- Valid internal control procedures explained as a relevant to ensure the internal control objectives for the payroll department of Songa Ent are achieved

MAXIMUM MARKS FOR Q4(a)(ii)

6

Note: A separate presentation for each of the two parts in Q4(a) is accepted. Similarly a presentation of the two requirements in Q4(a) of a tabular format is also accepted

(b)(i): External auditor's audit objectives for the payroll charges and payroll balances

Award 1 mark for each well-developed audit objective. No mark is awarded where the student's answer only identifies the audit objective WITHOUT a justification to support the objective

5

(b)(ii): Tests of control and substantive procedures to apply in order to achieve the audit objectives identified in Q4(b)(i) above

Award up to 1 mark for each valid procedure (tests of controls and/or substantive procedures) based on the model answer and/or any other valid procedure(s) provided by the student answers (where the 1 mark includes 0.5 marks for a correct "what - supported a valid source where applicable" and the other 0.5 marks for a valid "why or reason" relating to the assertion being tested - same application as marking for audit procedures in Q1(c) above)

MAXIMUM MARKS FOR Q4(b)(ii)

10

Note: A separate presentation for each of the two parts in Q4(b) is accepted. Similarly, a presentation of the two requirements in Q4(b) of a tabular format similar to the model answer is also accepted

Total marks for Question Four

25

Model Answer

Part (a)(i) Internal control objectives

Control objectives include policies and procedures designed by management to:

- Achieve the orderly and efficient running of the business including adherence to internal policies: this would include the regular, accurate processing and recording of payroll payments.
- Safeguard assets: this includes the physical safeguarding of cash and safeguarding money held in bank accounts by means of other controls.
- Prevent and detect fraud and error: where fraud and error would include incorrect payments or deductions from the payroll and payments of incorrect amounts for tax and social insurance, payments for work not performed for example payments to ghost employees.
- Achieve accuracy and completeness of the accounting records and timely preparation of reliable financial information: this would include making correct payments and deductions from the payroll, correct payments for tax and social insurance, and making payments for work performed only (e.g. not to ghost employees), in order that quarterly or half-yearly accounts can be prepared (possibly), but in any case in order that annual accounts can be prepared within the time limits for small companies.

Part (a) (ii) Internal control environment and control procedures

The control environment relates to:

- Management's overall style in encouraging awareness of the need for good controls implementing a positive tone to compliance to internal controls right from the top management
- The existence of organizational controls such as review of the payroll by an independent person such as the chief executive officer, and the rotation of the payroll duties amongst staff responsible for processing the payroll.
- Segregation of duties and supervisory controls to avoid the misappropriation of cash and avoid fraudulent collusion to create for example ghost employees or to make inflated payments. This prevents the loss of assets and/or inaccurate records.

The internal control procedures include:

- Limiting direct physical access to the cash, such as the use of a security firm to deliver cash, locking doors to areas where cash is held, keeping cash in a fire-proof safe and the protection of the computer by password controls. This will help safeguard assets and ensure the completeness and accuracy of the records and financial statements.
- Controls over computerized applications, checking the arithmetic accuracy of documents and the maintenance of control accounts. This can be achieved by for example the use of timesheets or clock cards, the use of reliable software with programmed controls for the calculation of deductions, and the use of batch and hash totals for information that is input

into the computer system. This helps achieve the orderly and efficient running of the business and the accuracy and completeness of records and financial statements.

- Approval and control of documents, such as the authorization of the payroll and authorization for the bank to make transfers and to deliver cash.

Part (b): Audit objectives, tests of control and substantive procedures

(i) Objectives	(ii) Tests of control and substantive procedures
<p>Existence: of assets and liabilities such as cash on hand and in the bank, and of the liability to pay staff and the associated tax and social security liabilities</p>	<ul style="list-style-type: none"> - Testing of controls over the security of cash to ensure that they are operating effectively throughout the relevant period. - Performing cash counts, with reconciliations to the records and observing cash payments to staff, ensuring that appropriate signatures are obtained and that unclaimed cash is promptly re-banked - Making checks on the physical existence of staff to ensure that the related expenses and liabilities are genuine. - Checking after-date (post-monthly) payments to staff; and for taxes (e.g. PAYE) and social security contributions etc
<p>Occurrence: payroll transactions occurred during the relevant accounting period</p>	<ul style="list-style-type: none"> - Performing cut-off tests to ensure that payroll costs incurred during the period have been recorded during the period by examining entries in the payroll records immediately before and after the period end (e.g. monthly) and checking back to source documentation like timesheets and clock cards
<p>Completeness: there are no unrecorded:</p> <ul style="list-style-type: none"> - assets (e.g., cash on hand and in the bank); or - liabilities (e.g., to pay staff and the associated tax and social security liabilities); or - transactions (e.g., payroll payments); or - undisclosed items (e.g., unrecorded payroll liabilities) 	<ul style="list-style-type: none"> - performing starters and leavers tests to ensure that staff are not paid before they join the company and the staff are not paid after the leave the company. This involves checking the payroll for two separate periods and examining entries relating to starters and leavers in the intervening period. - Manually checking the accuracy of payroll calculations to ensure that correct payments and deductions are being made with the approved pay rates and approved deduction rates for taxes (e.g., PAYE) and social security contributions - Reviewing evidence of authorization controls to ensure that the payroll has already been checked
<p>Measurement: transactions such as payroll payments are recorded at the correct amounts and are recorded in the correct period.</p>	<ul style="list-style-type: none"> - Tests are similar to the tests for completeness above, and checking to ensure that the payroll has been properly authorized and reviewed. - Checking entries relating to the days, hours, or time worked in the payroll to source documentation.
<p>Presentation and disclosure: an item is disclosed and described</p>	<ul style="list-style-type: none"> - Reviewing the financial statements with the aid of a

in accordance with accounting standards and legislation

disclosure checklist to ensure that disclosure requirements have been met.

- Reviewing the overall presentation of payroll transactions and balances

END OF MARKING GUIDE AND MODEL ANSWERS