CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: FRIDAY 30, MAY 2025

MODEL ANSWER AND MARKING GUIDE

SECTION A

QUESTION ONE

Marking Guide

Question 1

a) Business risks faced by RFD to be considered in the final audit

- Award up to 2 marks for every well explained business risk using information from the scenario "specific to RFD".
- The 2 marks for each business risk should be awarded as follows:
- Up to 1 mark where the business risk is both identified and explained correctly (otherwise award only 0.5 mark if the business risk is only identified but not explained)
- 1 mark for the implications of the business risk (e.g., due to the business risk there are potential cash flow shortages, adverse impact on revenues and/or profits etc.)
- Specific business risks include (where in any area below the points raised extend to two or more separate points and these are valid, then award the appropriate marks following the marking guide for each point on a business risk):
    - ❖ Compliance with national regulations for quality standards
    - ❖ Nature of product being sold – perishable packed juice sold
    - ❖ Exposure to fluctuating foreign currency exchange rates for the export sales
    - ❖ Potential challenges to meet the requirements for the planned stock listing
    - ❖ Entry of a new competitor in the market – non assurance of the raw materials from family farmers
    - ❖ Entry of a new competitor in the market – loss of market share
    - ❖ Entry of a new competitor in the market - Expected financial loss from RFD factory sales in Kicukiro
    - ❖ Closing Inventory – Goods close to the expiry date and the fully destroyed inventory
    - ❖ RFD's approved restructuring plan – a significant cash outflow required
    - ❖ The impact of the floods in the Western province – loss of assets and customers

Do Not Award:

Points that are generalized and therefore not aligned/related to the specific information regarding RFD as provided in the scenario (including speculative issues)

Reference to foreign exchange rate exposure to RFD where the candidate refers to purchases, non-current assets, liabilities etc. denominated in a foreign currency. The scenario is specific that the foreign exchange transactions are due to export sales which only impact on, sales revenue, receivables and cash/bank denominated in a foreign currency
Maximum Marks for Q1 (a) - using the guide provided above (14 Marks)

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

Award up to 3 Marks (except where valid points raised are two or more) using the ROMM marking guide provided below for the following ROMMs specific to the audit of RFD (but are not limited to):

- Export sales: Sales to a customer in a foreign currency
- Export sales: Trade receivables from a customer in a foreign currency
- Closing Inventory – Goods close to the expiry date and the fully destroyed inventory
- Approved closure of the factory in Kicukiro – the restructuring provision
- Assets held for sale (Factory PPE at Kicukiro) – classification requirements
- Assets held for sale (Factory PPE at Kicukiro) – events after the reporting date
- Approved closure of the factory in Kicukiro – the discontinued operation
- Destroyed PPE assets – Factory in the Western province

The ROMM marking guide for each correctly identified audit risk 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 RFD to "identify" the potential ROMM (taking 0.5 marks of the allocated 1 mark) and go ahead to explain or recognize how this is a ROMM (taking the other 0.5 marks of the allocated 1 mark).

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

Other points (marked outside the ROMM guide)

Management bias (maximum of 4 marks across the entire question)

Materiality marks: Award 1 mark for every reasonably correct "calculation" and correct "conclusion" that an item is quantitively material (Note that for the 1 mark to be awarded - BOTH the calculation and conclusion must be correct, otherwise, award no mark). The materiality mark can be awarded in either part (a) or part (b).

Other calculation marks (other than materiality): Award 0.5 marks for each correct calculation that has been USED in the answer. Note that the calculation mark is only awarded where the student goes ahead to use the figure in their explanation (it does not matter whether the explanation is correct or wrong). The calculation mark can be awarded in either part (a) or part (b)

Note: Do Not Award:

Generic (speculative) risks developed from rote-learning which are not supported by the information given in the scenario.

Accounting applications for listed entities such as IFRS 8 "Segmental reporting", IAS 33 "Earnings per share" etc. as RFD will not be a listed entity until next year.
Reference to foreign exchange accounting implications where the candidate refers to purchases, non-current assets, liabilities etc. denominated in a foreign currency. The scenario is specific that the foreign exchange transactions are due to export sales which only impact sales revenue, receivables, and cash/bank denominated in a foreign currency.

Other than the disclosure requirements for non-adjusting events under IAS 10, no marks shall be awarded for discussion of points relating to the accounting disclosure requirements supporting notes to the financial statements (e.g., contingent liabilities for redundancy provision, disclosure notes requirements for held-for-sale assets and discontinued operations etc.) as the requirement was specific to require that these should not be considered at this stage.

A discussion that indicates that the gain on the disposal of FRW 95 million has been recognized in the financial statements. Such a gain will not have been recognized in the financial statements of RFD as the PPE (assets) are still recognized in the financial statements as "held for sale assets".

A discussion requiring RFD to present the assets held for sale at the lower of the carrying amount and fair value less costs of disposal. Since the PPE assets in principle do not qualify as held for sale, then discussion for the fair value less costs of sale is not appropriate here and the scenario has indicated that RFD has recognized the assets at their carrying amount.
Maximum Marks for Q1 (b) - using the guide provided above (26 Marks)

Q1 c): Principal audit procedures - audit work to be performed in respect of the restructuring provision:

The audit procedures to be performed on the restructuring provision related to the closure of the branch in Kicukiro district (see marking guide for audit procedures below)

- 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 with 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. (5 Marks)

- Award 0.5 marks for a reasonable definition of the "balance-sheet audit approach"
- Award 1 mark for every point well developed explaining how the balance sheet approach will apply - with specific focus on the audit for RFD (only award 0.5 mark where the point given is not applied appropriately to RFD) up to a maximum of 2 marks
- Award 1 mark for every point well developed explaining how the balance sheet approach may not apply specifically on the audit for RFD (only award 0.5 mark where the point given is not applied appropriately to RFD) – to the maximum of 2 marks
- Award 1 mark for a reasonable conclusion based on the student's assessment of the pros and cons of applying the balance-sheet approach (i.e., this should be a "reasoned conclusion" in ONLY one direction - hence the conclusion cannot be given as an "either" "or" position in the same conclusion

Maximum Marks for Q1 (d) - using the guide provided above. (5 Marks)
Total marks for Question One (50 Marks)

Model Answers

Part (a): Business risks faced by RFD to be considered in the planning of the final audit for the year ended 31 December 2023.

Compliance with national regulations for quality standards

RFD operates in the production of packed fresh juice with the production process required to undergo regular inspections by the Government of Rwanda to ensure quality of the produced juice and safeness for human consumption. This means that if RFD fails to comply to the required standards in the national regulations, penalties including possible closure of RFD' production activities may be applied by the regulators. This will adversely impact on RFD's reputation and a potential loss of customers to the new competitor.

In addition, RFD is required to pay for the regular inspections across all the five factories operating in the provinces of Rwanda. It is possible that spontaneous inspections are conducted where there is a whistle-blower that RFD's production process is not in compliance to the regulator's standards for example the recent floods in the Western province where any ongoing production of RFD may have been affected and this may have been wide-spread by the national newspaper. Spontaneous inspections by the regulator will require cash flows to settle the inspection fees and also disrupt the production process resulting into a drain in RFD's cashflows.

Nature of product being sold – perishable packed juice sold

RFD's business is to produce and sell packed fresh juice which have an expiry date and RFD makes deliveries only after an order has been received. The deliveries of the packed juice cannot be made where the dispatch is within six (6) months to the end of expiry date of the juice. There are chances that the processed fruit juice does not receive any order or orders are received late and

RFD cannot make the deliveries if this is less than six months to the expiry date. This will impact negatively on RFD's financial performance and therefore a drain on its cash flows if the cash flows used in the production of such juice cannot be recovered.

In addition, if RFD delivered packed juice that is expired, then this will attract a penalty from the regulators and adversely affect RFD's reputation before its customers and the general public. This may result in the wholesalers in Rwanda switch to purchase the packed juice from RFD's competitors and this will impact negatively on the sales revenue and profits of RFD.

Exposure to fluctuating foreign currency exchange rates for the export sales

RFD makes export sales that comprise 40% of the total sales. Although in the past the revenue collections from the export sales were in the local currency (Rwanda Francs), this year RFD has allowed collections from export sales in a foreign currency, the Unites States Dollar (USD) and a significant amount of revenue collections from a major customer constituting 10% of the total sales are in the USD. This exposes RFD to potential exchange rate fluctuations especially considering that there have been significant fluctuations between the local currency and the USD in the year. This will be further worsened in the next year when majority or all export sales are received in the USD considering that the export sales customers are happy to start settling RFD in USD from the start of the next year (January 2024). If the exchange rate fluctuations are in RFD's disfavor, this will impact adversely on RFD's cash flows and other financial plans.

Note: Credit will be awarded for other relevant points raised on the export sales including:

- Differences in the quality requirements for the products as required by the regulators of the different countries including potential penalties for any non-conformity to the quality standards of those countries.
- Potential foreign exchange losses that may arise due to the three (3) month time lag between the date of delivery of the export sales and the actual receipts to RFD in a foreign currency considering that in the current year, there has been reported significant fluctuations in the USD and FRW currencies.

Potential challenges to meet the requirements for the planned stock listing

The Directors of RFD are planning for a stock listing on the Rwanda Stock Exchange (RSE) in the next year. It is a requirement of the stock market regulator and therefore an expectation from general public that a share floatation will be successful if the company has reported a stable financial performance and position in its financial statements. In respect of a number of business-related challenges faced by RFD in the year such as the adverse impact of the floods in the Western province, an entry of a major competitor who has taken a significant market share of RFD etc. there are high chances that this will poorly impact on RFD's financial performance and position in the financial statements of the year ended 31 December 2023.

The financial statements for the year ended 31 December 2023 will more likely be the reference for the stock market regulator to make a decision whether RFD is fit for a stock listing floatation. In addition, the potential shareholders will be using the same set of financial statements to make a decision of purchasing the shares on the floatation of RFD. Considering that a number of adjustments will have to be made on the financial statements, for example the impairment loss of the assets and a full write-down of the inventories damaged by the floods in the factory based in the Western province, there are chances that the financial performance has deteriorated this year. There are high chances that RFD's plans for the floatation of its shares scheduled for April 2024 may not be successful and failure to float the ordinary shares on the stock market will adversely impact on the required capital needed to increase the capital base. This will go against the planned increase of the export sales to more countries which also adversely impacts on future revenues and profits.

Closing Inventory – Goods close to the expiry date and the fully destroyed inventory

The financial statements of RFD indicate a significant increase of 104% for the closing inventory in the financial statements for the year ended 31 December 2023 compared to the prior year. Most of the closing inventory constitutes inventory with less than one (1) week to expire (70% of the total closing inventory) and the unfinished inventory that was fully destroyed in the factory located in the Western province due to floods (18% of the total closing inventory). It is reasonable to assume that these two elements of the closing inventory will not be saleable as the sale will not be in compliance to the national regulations on the quality of the product sold and the deadlines for the expiry requirements. The combined cost of these two elements of the closing inventory of (514m + 132m) FRW 646 million which combined constitutes 88% of the total closing inventory is a huge drain on the company's cash flows and in addition will adversely impact on the profits as these inventories are likely not to be sold to recover the cost incurred in the production.

Entry of a new competitor in the market – non assurance of the raw materials from family farmers

A new competitor with sufficient resources and capital has opened up a factory in Kicukiro district where majority of RFD's raw materials are sourced, and yet the family farmers producing the raw materials are not restricted from making their sales to the competitor. There is a risk that the family farmers will be tempted to sell their supplies to the new competitor rather than RFD especially, considering that the new competitor is well resourced and likely able to pay the farmers at a good price for the materials needed. This will adversely disrupt the operations of RFD as the company will not have adequate raw materials to effectively produce the packed fresh juice and therefore unable to fulfill customer orders. These further would impact adversely on RFD's future revenues, profits and cash flows.

Entry of a new competitor in the market – loss of market share

The entry of a major competitor in the market has significantly led to the loss of market share for RFD. This is further exacerbated by the temporary closure of RFD's larger factory and operations in the Western province. The loss of market share to the competitor imply that RFD has lost revenue, profits and cash flows that are important for the company's continued operations.

Note: Credit will be given where the candidate's answer refers to potential going concern challenges linked to the effects arising from the entry of a new competitor, and the temporary closure of the manufacturing unit in the Western province due to floods etc.

Entry of a new competitor in the market - Expected financial loss from RFD factory sales in Kicukiro

The factory based in Kicukiro district is expected to report a financial loss in the financial year ending 31 December 2023 as a result of a RFD's lost market share to the new competitor who is also based in Kicukiro. This is a clear indication of a factory struggling to make sales and this will impact negatively on the funding of the operations of the factory. The implication is that RFD may have to use financial resources of the other factories based in the other provinces to fund the continuity of the factory in Kicukiro till its planned closure, anticipated to be completed by 31 March 2024 is finalized. This becomes a financial burden and a drain on the cash flows of the other factories.

RFD's approved restructuring plan – a significant cash outflow required

The board of directors of RCD has approved a restructuring plan where a significant number of employees (80% of the factory personnel) based in the factory in Kicukiro will be made redundant and other personnel will be trained and relocated to the other factories. The total estimated cost of the restructuring plan of FRW 450 million will be a significant drain on the company's cash flows.

Though RFD is planning to realise disposal proceeds from the sale of the assets of the Kicukiro factory, this is only based on an optimistic assumption from the CEO (Mr. Jean Claude Twahirwa) that the disposal of these assets will attain proceeds of FRW 375 million and again this disposal is expected to be completed in the next year (by 31 March 2024), while the estimated redundancy costs of FRW 330 million may have to be settled by 31 December 2023 or before 31 March 2024.

The sale of the assets may probably realize a much lower amount of the proceeds of FRW 250 million compared to the targeted disposal proceeds of FRW 375 million assumed by the CEO which will further result into a loss on disposal of (280m – 250m) FRW 30 million. Therefore, it is realistic to assume that RFD will suffer a huge cash flow drain in settling the cost of the restructuring program by the end of the financial year (31 December 2023).

The impact of the floods in the Western province – loss of assets and customers

Due to the floods in the Western province, in May 2023, RFD lost the entire factory building, the inventories and the other non-current assets when they were destroyed beyond recovery. The loss of the building and other non-current assets will have a significant impact on the continued operations of RFD including the failure to satisfy customer orders that were allocated to that factory. This is further worsened by the poor publicity from the experts on disaster preparedness and the media who have negatively publicized RFD's poor disaster management practices that continue to expose RFD to future similar disasters making RFD a non-reliable supplier to major customers. This will result in a loss of customer confidence as it is currently evident with RFD's customers switching to the competitor who is considered to be more reliable.

In addition, the destroyed inventories in the factory at the time of the floods will result in a loss of capital and other resources that are necessary and were used by RFD in producing the inventories and the fact that these cash flows cannot be recovered. This is potentially a large drain on the company's cash flows in addition to the impact on the company's revenue and profits due to the failure to makes sales due to destroyed inventories.

b) Risks of material misstatement

Management bias

RFD is planning to obtain a stock listing on the Rwanda stock exchange in the following year. The stock listing requirements for a stable financial performance and position will create pressure for RFD to present a favorable financial information in the financial statements for the year ended 31 December 2023 to gain the listing status. This is especially the case where RFD's revenue and profit before tax have significantly increased this year by 39% and 47.5% respectively while the total assets have almost remained stable compared to last year.

In addition, RFD may practice management earnings in order to impress the potential shareholders to purchase the RFD shares by reporting a significant increase in revenue and profits in a financial year. This is in contrast to the fact that the company has faced business risk challenges like loss of a significant market share to a new competitor, the approved closure of the factory and operations in Kicukiro and the effects on the business suffered due to the floods in the Western province. Such fraudulent reporting could be aimed at presenting a favorable financial performance to impress the public so that they can purchase the RFD shares on their floatation and RFD is therefore able to raise the needed capital.

Note: Credit will be awarded accordingly where management bias is indicated in any other relevant point e.g., the CEO's (Mr. Jean Claude Twahirwa) attempt for earnings management in overstating the estimated gain on the disposal of the assets to manipulate the profits reported in the profit or loss.

Export sales: Sales to a customer in a foreign currency

In the year ended 31 December 2023, RFD commenced an arrangement to receive collections from export sales in a foreign currency, with a major customer in South Africa contributing 10% of the total sales paying RFD in the USD throughout the financial year.

Following IAS 21 *"The effects of changes in foreign exchange rates"* a transaction that is denominated in a foreign currency is translated to the entity's functional currency at the exchange rate on the date of the transaction (i.e., the spot exchange rate). The risk is that due to that fact that RFD is receiving revenue in a foreign currency for the first time and with little experience of translating such transactions, it is possible that a wrong exchange rate may have been applied in translating the export sales denominated in the USD to the local FRW currency for their recognition in the financial statements.

In addition, IAS 21 requires the use of an average exchange rate for the income and expense transactions only where there are no significant fluctuations in the exchange rates. There is a risk that RFD may have applied inappropriately the average exchange rate for the foreign exchange sales made in a foreign currency when it is evident that there were significant exchange rate fluctuations between the USD and the FRW during the period. RFD should have applied the spot exchange rates in these circumstances. This may have resulted in incorrect translated revenues recognized in the financial statements leading to misstated (overstated/understated) revenue and receivables on the sale transaction dates.

Export sales: Trade receivables from a customer in a foreign currency

In accordance with IAS 21 *"The effects of changes in foreign exchange rates"*, account balances that are considered to be monetary items (such as receivables) denominated in a foreign currency are retranslated at the reporting date using the exchange rate at the reporting date (i.e., the closing exchange rate) with any exchange differences recognized in the profit or loss.

The risk is that since RFD is reporting a trade receivable in a foreign currency for the first time in the financial statements, it is possible that either a retranslation has not been done or an incorrect exchange rate rather than the closing exchange rate at the reporting date has been used in retranslating the balances of any receivable from the customer in South Africa. This will result into a misstated (overstated/ understated) trade receivable balance and profits.

Note: Credit shall be awarded where the non-compliance to IAS 21 for the export sales in a foreign currency are linked to management bias (e.g., earnings management practices by the CEO in an attempt to present financial statements that will support the plan for a stock listing)

Closing Inventory – Goods close to the expiry date and the fully destroyed inventory

The financial statements of RFD indicate a significant increase of 104% for the closing inventory in the financial statements for the year ended 31 December 2023 compared to the prior year.

IAS 2 "Inventories" requires an entity to recognize the closing inventory at the reporting date at the lower of its cost and the net realizable value.

The risk is that RFD may have incorrectly recognized closing inventory in the financial statements for the year ended 31 December 2023 with inventory that has less than one (1) week to expire and the unfinished inventory that was fully destroyed in the factory located in the Western province due to floods. Both elements of this inventory total to (514m + 132m) FRW 646 million results in an overstated asset and understated expense in the profit or loss.

RFD may have intentionally not adjusted the closing inventory to avoid reducing the profits in the profit or loss by the significant amount of FRW 646 million which is more than half of the projects profits before tax as this will indicate a falling trend in the profits in the current year compared to the prior year. This financial performance will also impact negatively in the company's plans for stock listing next year where the listing requirements are that the financial performance published should be indicating an increasing trend rather than a decreasing trend in the reported profits.

The overstated inventory of FRW 646 million is a material amount as it is 14.8% of the revenue, 52% of the profits before tax and 9% of the total assets. In addition, the total closing inventory for the year of FRW 734 million is material to the financial statements as it is 17% of revenue, 59% of the profits before tax and 10% of the total assets.

Approved closure of the factory in Kicukiro – the restructuring provision

The meeting held on 1 November 2023 for the Board of Directors of RFD approved the closure of the factory in Kicukiro district and a restructuring plan to be implemented by the end of the financial year (31 December 2023) includes a cost for the 80% of the factory staff that will be made redundant of FRW 330 million and the other staff that will be trained and relocated to the other factories that are expected to continue operating at an estimated cost of FRW 120 million.

In accordance with IAS 37 "Provisions, Contingent Liabilities and Contingent Assets", a provision for a restructuring plan is recognized when a detailed formal plan is in place and the entity has started to implement it or has announced the main features of the plan to those parties affected. IAS 37 also requires the provision to be appropriately measured based on reliable estimates of the amount that is expected to be paid to settle the obligation.

RFD should recognize the provision for restructuring plan relating to the closure of the factory in Kicukiro as the Board of Directors approved the detailed plan in the Board meeting held on 1 November 2023 and this was formally communicated on 10 November 2023 to the staff in Kicukiro who are affected by the approved restructuring plan. The risk is that RFD may not have recognized the provision for the restructuring provision with a correct measure in its financial statements as this may have intentionally been understated especially as the company may not want to recognize such a significant expense that will reduce the profits while preparing to float the company shares on the stock market in April 2024 which is a few months after the end of the reporting date. This will result in understated liabilities and expenses.

The total estimated cost for the restructuring of FRW 450 million is 10.3% of revenue, 36% of profits before tax and 6.3% of the total assets. These therefore make them material to the financial statements.

Further IAS 37 does not allow the recognition of staff training and relocation costs as part of a provision for the restructuring plan as these costs relate to ongoing activities of an entity and do not commit the entity to a present constructive obligation at the reporting date. Such expenses are considered as future obligations and not present obligations.

The provision made by RFD for training and relocation of some of the personnel in the factory at Kicukiro does not meet the criteria for a provision as these are ongoing activities. The provision and the expenses are therefore overstated by FRW 120 million. The training and relocation costs are 10% of the profits before tax and 1.7% of the total assets making them material to the financial statements.

The provision for restructuring plan should only be restricted to the staff redundancy cost estimated at FRW 330 million and not the full costs of FRW 450 million. The estimated redundancy costs are material to the financial statements as these are 7.6% of revenue, 26% of the profits before tax and 4.6% of the total assets.

Note: Credit will be awarded in cases where:

- *An evaluation is validly done for risks of material misstatements in other areas directly related to the restructuring plan (e.g., provisions arising from constructive obligations regarding a valid expectation other than employees such as customers whose orders are being cancelled and the contractual terms require a penalty or suppliers who were issued with purchase orders that are being cancelled requiring a penalty for the cancellation of the purchase orders etc.)*
- Discussions are correctly *linked to management bias (e.g., earnings management practices by the CEO in an attempt to understate the restructuring provision in order to present financial statements that will support the plan for a stock listing)*

Assets held for sale (Factory PPE at Kicukiro) – classification requirements

The Board of RFD has approved the decision to sell all the property, plant and equipment in the factory located in Kicukiro as a result of the factory closure. Following IFRS 5 "Non-current assets held for sale and discontinued operations", an asset (or a disposal group of assets) is classified as held for sale when their carrying amount is to be recovered principally through a sale transaction.

Whilst this is the case with RFD, there are certain criteria which must be met before an asset (or group of assets) qualifies as being held for sale. These criteria which must ALL be met include:

- The assets must be available for immediate sale in their present condition.
- Management must be committed to a plan to sell.
- An active programme to locate a buyer must have been initiated.
- The assets must be actively marketed for sale at a reasonable price.
- The sale is highly probable within one year of classification.
- Actions required to complete the plan indicate that it is unlikely that plan will be significantly changed or withdrawn.

There is a risk that RFD has incorrectly classified the assets in the factory at Kicukiro as "held for sale" when some requirements are not satisfied for example the CEO guiding the sale at a significantly higher price of FRW 375 million compared to the reasonable price of FRW 250 million is a clear indication that the sale transaction is not highly probable.

Further, IFRS 5 states that assets cannot be reclassified until they meet all of the criteria above. As management will not advertise the PPE assets for sale until 10 January 2024, the assets do not qualify at year end and must therefore not be classified as assets held for sale in the financial statements for the year ended 31 December 2023.

The discussion above indicating non-compliance with IFRS 5 to classify assets as held for sale by the CEO indicates an inappropriate classification of the PPE as held for sale by RFD. In addition, this will result in understated PPE in the non-current assets and overstated current assets (or the presented held-for sale assets) by the carrying amount of the assets of FRW 280 million.

Further, it is possible that RFD may not have recognized a depreciation charge for the PPE assets located in the factory in Kicukiro on the basis that these assets have been classified as held for sale if the company has followed the IFRS 5 requirement to cease depreciation for assets classified as held for sale. The non-recognition of the depreciation charge in the profit or loss for these assets is incorrect as these assets did not qualify as held for sale assets on the reporting date (31 December 2023). This will understate the expenses and overstate the profits which may have been done intentionally with the instruction of the CEO to ensure a high profit is reported in preparation of the stock listing planned for the next year, 2024.

Assets held for sale (Factory PPE at Kicukiro) – events after the reporting date

IFRS 5 states that assets cannot be reclassified until they meet **all** of the criteria above. As RFD does not plan to advertise the PPE in the current financial year ending 31 December 2023, then this further implies management is not actively seeking a buyer for the PPE until when the advert is planned to be run from 10 January 2024.

The advert to be placed in the newspapers on 10 January 2024 will imply that this is a subsequent event that is considered a non-adjusting event under IAS 10 "Events after the end of the reporting date". IAS 10 requires an entity to disclose the non-adjusting events that are considered to be material as a disclosure note including the nature and monetary amounts for the event.

There is a risk that RFD has not disclosed the details of the held for sale assets (including the nature and monetary value of the held for sale asset) in the notes to the financial statements, and yet the PPE assets to be sold are quantitively material. This will result in inadequate disclosures or an inappropriate disclosure made for the "held-for-sale assets"

Note: Credit will be awarded in cases where:

- *An evaluation is validly done for potential impairment loss for the PPE in Kicukiro (arising from indicators like the entry of a new competitor in Kicukiro district taking away a market share for RFD; a reduction in the reasonable selling price of the PPE assets of FRW 250 million which is lower than the carrying amount of the PPE assets is FRW 280; etc.)*
- Discussions are correctly *linked to management bias (e.g., earnings management practices by the CEO in an attempt to classify the assets as held for sale which implies a reason for not recognizing a depreciation charge that will reduce the reported profits or reported PPE assets)*

Approved closure of the factory in Kicukiro – the discontinued operation

IFRS 5 defines a discontinued operation as a component of the entity that has either been disposed of or is classified as held for sale; and:

- Represents either a separate major line of business or a geographical area of operations
- Is part of a single coordinated plan to dispose of a separate major line of business or geographical area of operations, or
- Is a subsidiary acquired exclusively with a view to resale and the disposal involves loss of control.

Under the CEO's instruction, RFD plans to present the financial results of the factory in Kicukiro as a discontinued operation thereby removing the expected financial loss of this factory from the profits arising from continuing operations. Since the PPE assets of Kicukiro are not to be classified as held for sale, presentation of the financial results of this factory as a discontinued operation in the financial year ended 31 December 2023 is inappropriate. The financial results of the factory in Kicukiro should be reclassified as part of the continuing operations.

Based on the instruction of the CEO, RFD may be planning to exclude the expected financial loss related to the factory in Kicukiro as a way to report an increased figure for profits of continuing operations thereby improving the financial performance of the company compared to the prior year.

This implies a misstatement in the classification of the financial loss relating to the factory in Kicukiro which may be qualitatively material (material by nature) given the plans to float RFD shares on the stock market.

Further, closure of the factory in Kicukiro will not constitute a separate major line of business (as RFD continues to operate in the same business of producing and selling packed fresh juice) or constitute a separate geographical area of operations given another factory will remain operational in Kigali province. If this does not represent a separate major line of business and/or a separate geographical area of operation, then this should not be classified as a discontinued operation in the year to 31 December 2023.

Destroyed PPE assets – Factory in the Western province

PPE in the factory located in the Western province was damaged with a number of the PPE assets damaged beyond repair. The carrying amount of FRW 2.812 Billion for the PPE in the factory located in Western province is material as this represents 39% of the total assets.

In accordance with IAS 36 "Impairment of assets", an entity is required to conduct an impairment loss review for an asset (or a group of assets constituting a cash generating unit) where there are indicators of impairment. In addition, the asset (or a cash generating unit) should be measured at the lower of the carrying amount and the recoverable amount where the recoverable amount is the higher of value in use and the fair value less costs of disposal.

In terms of RFD, the floods that damaged a number of the PPE items in the Western province is an indicator of an impairment loss for the assets and all the assets in the factory constitute a cash-generating unit. RFD should have conducted an impairment review on the PPE assets in the factory located in the Western region after the assets were damaged by the floods.

The risk is that RFD may not have assessed the PPE assets in the factory located in the Western province for impairment loss which is incorrect considering that some of the PPE in this factory were damaged beyond repair. This will imply that RFD's assets are overstated and expenses are understated.

Note: Credit will be awarded where:

- *An evaluation of the risk of material misstatement refers to the potential impairment loss extending to the other factories that may have relied on the damaged factory for synergies in the production costs (e.g., another factory sharing some PPE items like delivery trucks with the damaged factory and the trucks were damaged in these floods etc.)*
- *Discussions are correctly linked to management bias (e.g., earnings management practices by the CEO in an attempt not to recognize impairment losses or understate the impairment loss so as not to reduce the reported profits or reported PPE assets in preparation for the upcoming stock listing process)*

Part (c): Recommended audit procedures on the restructuring provision related to the closure of the branch in Kicukiro district

- Obtain a copy of the board minutes to confirm the Board's approval of the restructuring plan and the date of the approval being within the financial year to 31 December 2023.
- Obtain and review a copy of the letter sent to the affected employees informing them of Board's decision to close the factory and a confirmation of the employees' acknowledgement of the communication received to confirm a present constructive obligation exists for RFD to recognize the provision in the financial statements.
- Inspect a sample of the copies of employee contracts from the Human Resource department for each job category showing any entitlements to the affected employees regarding redundancy to confirm redundancy costs calculated by the client are not lower than the required obligation.
- Review a breakdown of the FRW 330 million which has been provided for in respect of the redundancy costs and review any post-year end payments to assess accuracy of the amount recognized as a provision.

- Obtain and inspect copies of correspondence between RFD's legal advisers and employee representatives confirming the likely settlement amounts to support the value of the provision made.
- Recalculate the redundancy provisions to confirm its arithmetical accuracy.
- Obtain a breakdown of the staff training and relocation costs to assess whether these should all be considered as ongoing business costs, and none of the amounts are eligible to be included in the redundancy provision.

Part (d): Application of the balance sheet approach to the audit of RFD

The balance sheet approach (also referred to as "the statement of financial position approach") concentrates audit testing on the account balances in the statement of financial position (balance sheet) with a limited amount of testing on the profit or loss. This is on the basis that the difference between the opening and closing balance for a balance account in the statement of financial position amount is reflective of the transactions/movements during the year under audit (which is supportive of the profit or loss amounts in the year).

If the audit firm applies the balance sheet approach in the audit of RFD, an effective approach will be for the audit team to concentrate on the assets and liabilities of the client but supplemented to ensure that all sales revenue have been reviewed as well.

We can apply the balance sheet approach, if we have assessed and are confident of the effectiveness of RFD's internal control environment, and we have reasonable assurance that RFD's accounting records are complete and have a reasonable assurance that all incomes have been appropriately accounted for.

The balance sheet approach would be a cost-effective approach to the audit of RFD as we would seek to concentrate on testing the closing balance of account balances in the balance sheet while we rely on the opening balances that represent the closing balances that we audited last year thereby reducing the time spent on the audit. For example, it would be less costly to focus the audit for RFD on a highly substantive balance sheet audit approach than undertaking a business risk approach that involves a holistic review of the entire organization to plan audit procedures for the client which would be time consuming and very costly.

However, the balance sheet approach may not be appropriate for RFD for the following reasons:

- The balance sheet approach is more appropriate for small-sized audit clients who have few transactions and these are majorly non-complex transactions allowing the auditor to only concentrate on the simple movements in the year for the changes in the account balances of the assets and liabilities. This is not the case with RFD which is a company producing packed juice from six (6) large factories spread across all the provinces in Rwanda and with a large amount of export sales making 40% of its total sales on a receivable basis with potential to complex accounting techniques applied on assessment of potential impairment losses on the trade receivables. With RFD receiving some incomes in a foreign currency, there are possible chances that it is now involved in hedge arrangements and included hedge accounting in its financial statements which is a complex accounting technique that may not be effectively audited using a simple balance sheet audit approach.

- The balance sheet works effectively where the client has effective internal controls in place which may not purely be the case for RFD with a domineering CEO that will likely override the internal controls resulting into material misstatements in the financial statements. In the current year, there are high chances that internal controls may have been abused by the CEO, management and the Board in order to present financial statements showing an increase in the financial performance and financial position that is a requirement for the planned stock listing application in the following year.

In conclusion, the audit for RFD will only be cost-effective if the balance-sheet approach is applied in conjunction with the risk-based approach or a systems-testing approach at the planning stage of the audit to focus the audit on only those account balances that will have been assessed to be at a high risk of material misstatement.

The benefits of applying a balance-sheet approach to the audit of RFD for the financial year ended 31 December 2023 are:

- There will be added value in the audit service provided to RFD as the audit approach will focus on the business as a whole. This is because the audit plan will focus initially on the assets and liabilities of RFD which imply that changes in the carrying amounts of the assets and liabilities will be tested in detail allowing the audit team to extend the audit procedures to major transactions and events that encompass the entire company.

- Using a balance-sheet approach reduces exposure to an engagement risk and also reduces chances of being sued by the client or any other stakeholder on the basis of negligence of duty as the approach will allow the audit team obtain a broader understanding of FRD's business and processes.
- The application of the balance-sheet approach requires the testing of the major internal controls of the client in order to assess how these controls impact movements in the carrying amounts of the assets and liabilities. This means that the audit team attention on the high-level controls implemented by RFD and apply extensive use of the analytical procedures which will increase the audit efficiency, thereby reducing the costs on the audit team.
- The balance sheet approach is a much modern approach to an audit and using this approach on the audit of RFD, shall facilitate moving away from a focus on mere routine processes as our audit team applies technological developments like computer-assisted auditing techniques (CAATs) which reduce the audit being prone to errors that are associated with the old traditional audit approaches.

SECTION B

QUESTION TWO

Marking Guide

Q2.a) Auditor's responsibilities for corresponding figures and how these are discharged in an audit engagement for a new audit client (6 Marks)

- Award 1 mark for a reasonable meaning of corresponding figures
- Award 1 mark for every correct point raised as the auditor's responsibilities for corresponding figures (maximum of 3 marks)
- Award 1 mark for each correct point well developed explaining how an auditor discharges the responsibility for reviewing the corresponding figures in an initial audit (for a new audit client) – up to a maximum of 2 marks.

Q2.b) Matters to consider and audit evidence expected to be available in the review of working papers and the financial statements of MPRL for the year ended 30 June 2023. (19 Marks)

Brand name (Wall-masters paint)
Matters to consider:
Award 1 mark for materiality calculated and concluded correctly - (note: only award a mark where BOTH the calculation and conclusion are correct otherwise do not award).
Use the ROMM marking guide to award the marks for "matters to consider" that include:

- The correct/reasonable reference to an accounting treatment (up to 1 mark per correct accounting treatment).
- A correct application of the accounting treatment to the information presented in the scenario going ahead to explain the potential risk of material misstatement (up to 1 mark per point)
- Financial statement risks (award 0.5 marks for each element correctly referring a double-entry misstatement and/or 0.5 mark for a reference to a disclosure risk. 12 *marks*

Audit evidence: Award up to 1 mark per valid point raised as audit evidence expected to be available (where this is broken into 0.5 marks for correctly stating the "what/source" and the 0.5 marks for correctly giving the "why" the evidence is needed)

Total marks for Question Two **(25 Marks)**

Model Answer

a) The auditor's responsibilities for corresponding figures and these responsibilities are discharged in the audit of financial statements

According to ISA 710 "Comparative Information – Corresponding Figures and Comparative Financial Statements", corresponding figures are amounts and disclosures derived from the preceding (prior) financial statements, which are included with and are intended to be read in conjunction with the current period figures.

Auditor's responsibilities:

- The audit report in this case only refers to the financial statements of the current period, which encompasses the prior period figures and does not refer specifically to corresponding figures.
- The audit work on corresponding figures will be limited to ensuring that corresponding figures have been correctly reported or restated and appropriately classified.
- Where a prior period matter that was qualified remains unresolved, then the current period audit report should also be qualified in respect of the corresponding figures.
- But where the matter is resolved, an "emphasis of matter" paragraph may still be appropriate.
- If the corresponding figures are materially misstated, a qualified audit report should be given.

How is this responsibility discharged in an initial audit engagement (a new audit client)

In an initial audit, the auditor will not have previously obtained audit evidence to support transactions and accounting policies of the prior period as this being a new audit client, the auditor will not have audited the financial statements of the prior period.

Therefore, to obtain the necessary assurance on the opening balances, the auditor will carry out additional audit procedures that will include:

- A review of the client's working papers and accounting records of the prior year
- A request for the client's permission to contact the prior auditor (if any) in order to obtain the prior year's audit working papers for example the prior year's audited closing trial balance to confirm the figures reported in the prior year.
- Audit work on the current year's transactions and balances will also provide some evidence to support the completeness, valuation, existence and rights or obligations relating to the opening balances.

b) Matters to consider and audit evidence expected

i) Wall-masters paint - brand name

Matters to consider

The historical cost of the purchased brand "Wall-master paints" of FRW 4.8 Billion is material to the financial statements of MPRL as it represents 8.7% of the total assets. The annual amortization charge for Wall-masters paint is (FRW 4.8 Billion / 10 years) FRW 480 million is immaterial to the total assets (at 0.9% of total assets) but this is considered material as it is 6% to the profits before tax.

In accordance with IAS 10 "Events after the reporting period", details regarding adjusting events represent conditions that existed at the reporting date and therefore an entity is required to make adjustments for adjusting events in the entity's financial statements.

The fall in demand for the Wall-masters paint in July 2023 is considered an adjusting event under IAS 10 as this provides evidence about the valuation of the brand asset at the reporting date (i.e., as at 30 June 2023) due to the damaging publicity adverts that were run in the daily media in June 2023.

IAS 36 "Impairment of assets" requires an entity to conduct an impairment loss review for an asset (or a group of assets constituting a cash generating unit) where there are indicators of impairment. In addition, the asset (or a cash generating unit) should be measured at the lower of the carrying amount and the recoverable amount where the recoverable amount is the higher of value in use and the fair value less costs of disposal.

The fall in demand for the Wall-masters paint brand is an indicator of an impairment loss to the brand name as an intangible asset. MPRL should have conducted an impairment loss review on the Wall-masters paint brand on 30 June 2023 as it is highly probable that due to the fall in demand for the Wall-masters paint, then the recoverable amount of the brand name may be less than the carrying amount. It is therefore incorrect for MPRL to carry the Wall-masters brand name at its costs if the recoverable amount is assessed to be lower than the carrying amount.

IAS 2 "Inventories" requires an entity to carry inventories in the financial statements on the reporting date at the lower of the cost and net realizable value.

The quantities of Wall-master paint that remained in stock on the reporting date (30 June 2023) will likely have a net realizable value that is less than their cost due to the fall in the demand and therefore a need for MPRL to write down the inventory to its net realizable value if the financial statements still carry the inventory at its cost which is incorrect.

In addition, the implication of the fall in demand due to the customers' perception of the paints produced by MPRL, the other two purchased brand names of MPRL and products (the inventories) associated with all the other six (6) brands of MPRL may have lost value. It is incorrect if MPRL has not recognized the loss in value of the inventories for the other six brands if the impact of Wall-masters brand name has extended to these brand names in the year ended 30 June 2023.

If the impairment loss of the brand names and the associated fall in value for the inventory of paints on the reporting date is not recognized, then the assets and profits in MPRL's financial statements are overstated.

As auditors of MPRL, we also need to consider the plans of MPRL's Board and management in regard to the continuation with the brand of Wall-masters paint for example whether MPRL is planning to discontinue the wall-masters brand name or to sell the brand, or to promote it by addressing the negative publicity in a targeted marketing campaign that will overturn the negative perceptions of the customer over the brand.

In addition, we need to consider whether MPRL is considering taking legal action against the media house that developed and ran the brand-damaging advert, as this may likely result into a possible legal compensation to MPRL.

In accordance with IAS 37 "Provisions, contingent liabilities and assets" a contingent asset is a possible asset that arises from past events and whose existence will be confirmed by the occurrence of one or more uncertain future events not wholly within the entity's control. An entity is required to disclose details of a contingent asset in the financial statements including the nature and estimated amounts expected to be received/recovered by the entity from the contingent asset.

If MPRL has initiated any legal action against the media house regarding the adverts that have damaged the entity's brand name and this qualifies as a contingent asset at the reporting date, then there is a risk of material misstatement if the adequate disclosures for the contingent asset is not made in the notes to the financial statements for the year ended 30 June 2023. This will imply that the disclosures in the financial statements are inadequate or incomplete.

Audit evidence expected

- The opening balance of the brand name "Wall-masters paint" agreed to the audited closing trial balance picked from the audit working papers of the prior auditors.
- A review of the client's computation of the amortization charge to the Wall-masters brand name for the current year to confirm the accuracy of the charge based on the estimated useful life of ten (10) years.
- A copy of the amortization rates and periods (estimated useful lives) of similar brand names applied in the market to confirm the reasonableness of the ten-year useful life attached to the Wall-masters brand name.
- A recalculation of the amortization charge and the carrying amount of the brand name at the reporting date to confirm arithmetic accuracy.

Analytical review of the actual after-date sales and/or inventory turnover against the budget month-on-month for each brand name to identify:

- The impact of the fall in demand of the "Wall-master paint" brand name to the sales revenue
- Whether the other brand names have similarly been affected
- If the demand is picking again in the post-reporting period (July 2023 to date of the auditor's report)
- Copies of periodic sales analysis reports from the 50 hardware stores to confirm the fall in demand for the Wall-masters paint in the period after the adverts.
- A copy of the advert relating to the "Wall-masters paint" and copies of any media reports arising from the bad publicity.
- In case the "Wall-masters" brand name has been written down to its recoverable amount:
    - ❖ A copy of a binding agreement to sale to confirm the net selling price
    - ❖ A copy of calculations for the projected cash flow forecasts for the next five (5) years (or for the period covering the remaining useful life of the brand if shorter) to confirm the validity of the value-in-use figure applied in the recoverable amount.
    - ❖ A copy of the minutes for the Board meeting to confirm any decisions made and approved regarding actions by MPRL on the "Wall-masters paints" (e.g., to discontinue with the brand name, to counteract the damaging advert with a targeted marketing campaign aimed at improving the image of the brand, to take legal action against the media house etc.)
    - ❖ Evidence of any expenses incurred since the advert (or post-reporting date invoices) for example on a "new marketing campaign" to confirm MPRL's attempts to rectify the damage done.
    - ❖ A copy of any correspondence between MPRL and the media house that ran the damaging adverts and notes concerning a pending legal action and a legal expert's assessment of the possible quantified outcomes.

ii) **Statement of cash flows**

Matters to consider

In accordance with IAS 7 "Statement of cash flows", an entity's presentation of its periodic cash flows should be appropriately classified for each period under the relevant categories of activities including operating activities, investing activities and financing activities and these should be presented with comparative information.

IAS 7 allows the entity to report the cash flows from operating activities using either the "direct method" or the "indirect method". IAS 7 encourages the use of the direct method because this method provides information which is not available under the indirect method except where the provision of additional information is considered to be time-consuming and costly in which case the indirect method is applied as an alternative.

In accordance with IAS 8 "Accounting policies, changes in estimates and errors", it is permitted for an entity to change the accounting policy and in this case a change from applying the indirect method to a direct method is permitted when preparing the cash flows from the operating activities if the change provides more relevant information about the entity's cash flows.

Where a change in the accounting policy is implemented, IAS 8 requires the comparative information to be restated unless it is impractical to do so.

In terms of MPRL, it is appropriate that corresponding figures have been restated on the change in the presentation of the statement of cash flows where in the year ended 30 June 2023, the entity has adopted the direct method for the presentation of the net cash flows from operating activities. The issue to consider is whether the restatement has only been done for only the items relating to the operating activities as it will be incorrect for the cash flow items in the other activity categories including investing and financing activities. If the other activity line items have been restated. This will result in an inappropriate presentation of the statement of cash flows.

In addition, IAS 1 "Presentation of financial statements" requires the entity to provide the reason(s) justifying the change of the accounting policy as a disclosure note.

We need to consider whether MPRL has adequately disclosed in the notes to the financial statements for the year ended 30 June 2023, the reasons to justify the change from the indirect method to the direct method for the net cash flows arising from the operating activities. In the absence of this explanation or where the explanation is not adequate, this will result in an inadequate disclosure in the financial statements.

Audit evidence

- For the prior year, agreement or a reconciliation of the net profit before tax as adjusted for non-cash items (e.g., depreciation) and working capital changes to cash receipts from customers less cash paid to suppliers and employees.
- Schedules of cash receipts per analysis of cash book receipts agreed to the receivable ledger control account.
- Schedules of cash payments made to suppliers per analysis of the cash book payments agreed to the payroll control account and the payable ledger control account respectively.
- Analytical procedures such as the comparison of trade receivable days and payable days (i.e., average credit periods given to customers and received from suppliers) with prior year.

QUESTION THREE

Marking Guide

Q3. a) Matters to consider in accepting to a forensic investigation for KBL (10 Marks).

Award up to 2 marks for each matter/issue that is well explained (with 1 mark for a correct identified matter and the other 1 mark for a development of the matter with specific reference or example of the information given in the scenario) including (a maximum of FIVE matters/issues well explained):

- Scope of the investigation assignment
- Timeframe pressure for the assignment 1 (mark) linked to the fees to charge (1 mark) and/or linked to firm's availability of resources (1 mark)
- Interaction with criminal investigation
- Form and contents of investigation report
- Potential users of the investigation report
- Firm's professional competence
- CDD requirements/reputational risks (max 1 additional mark for specific examples of information required as part of CDD)
- Professional ethics: confidentiality
- Professional ethics: conflicts of interest

Q3. b

i) **Evaluation of deficiencies in control systems of KBL and how these have contributed to the fraud.** (6 Marks)

Award Up to 2 marks for each point well-explained (where 1 mark is for a correct identification of a relevant control deficiency existing in KBL and the other 1 mark is for explaining how this is a deficiency about the information in the scenario) for a maximum of THREE (3) deficiencies including:

- Lack of segregation of duties
- Lack of documentation
- Absence of reconditions (maximum of 3 marks here where the answers go on to provide explanations/illustrations for more than one specific evidence of lack of reconciliations specific to the scenario)
- Lack of a robust management monitoring system
- Additional implications (2 marks for each valid point well explained as "any other implications of the fraud").

ii) Recommendations to address the deficiencies in the internal controls of KBL.

Award 1 mark for each relevant recommendation relevant to the internal control deficiencies of KBL (these may be presented in a tabular format alongside the deficiencies provided in (b)(i) above or in a separate presentation) (3 Marks)

Q3. c) Discussion of the relevance and measurability of the information in KVTC's reported performance measurement report

Award 1 mark for each point that is well developed discussing the relevance and measurement of information provided in the performance measurement report (as provided in the model answer and any other relevant points assessed to be valid as raised in the student's answer) (6 Marks)

Professional marks (awarded for the format of the letter including 1 mark for the header, a reasonable introduction and conclusion).

Total marks for Question Three (25 Marks)

Model Answer

a) Report to the partner in charge of non-audit services

To the Partner, Non-Audit Services, Smith & Peters Associates

From: Manager, Non-Audit Services, Smith & Peters Associates

Re: An evaluation of the request to conduct non-audit engagements for Kite Bakers Limited (KBL) and Kigali Vocational Training Center (KVTC)

Introduction

The following response is addressing the requests from the potential client, Kite Bakers Limited (KBL) and Kigali Vocational Training Center (KVTC). In terms of KBL, the discussion looks at the matters that need to be considered before Smith & Peters Associates accepts to take on the forensic investigation assignment. On acceptance of the assignment to conduct the forensic assignment, an evaluation of the internal control weaknesses that resulted in the fraud and the notes also provide recommendation to manage the internal control weaknesses. Further, the notes provide a discussion of relevance and measurability of the information in KVTC's reported performance measurement report.

Matters to consider before accepting the invitation to conduct a forensic investigation for Kite Bakers Limited (KBL)

Scope of the investigation assignment

The following matters need to be considered in terms of the scope of the assignment:

- Smith & Peters Associates should establish the specific work which KBL expects them to perform. It is likely that the quantification of the loss represents an agreed-upon procedures engagement and these would need to be confirmed with KBL in advance.
- The identification and recommendation on controls issues is more likely to be of a consulting nature where the engagement process and outcomes will have to be agreed upon with KBL. The assignment may require specific competencies, such as the use of specialists in applying Computer Automated Tools and Techniques (CATTs), and this should be identified before acceptance of the engagement.
- Smith & Peters Associates would also need to establish the period KBL would like them to investigate. This will all affect the total fee charged.

Determining how the firm's investigation relates to the criminal investigations conducted by the authorities (i.e., the police's investigations)

If the quantification of the loss were to become a criminal investigation, then the relevant authorities would take the lead. It is not clear whether the authorities would require additional, professional support in their investigation and, if so, what sort of assistance they would require.

For example, it is possible that they would gather their evidence, but they may require the use of our firm in an "expert witness" role to verify their findings in court. It is therefore vital that, before any terms are agreed or engagement contracts are signed, Smith & Peters Associates speaks to the authorities to ascertain whether there will be any criminal investigation and, if so, what their role might be in the investigation, and how they might interact with any other experts appointed by the authority to assist in the investigation

The types/formats of investigation report and prospective users of the report

The following considerations need to be taken into account relating to the types of reports expected by KBL and whether these reports are to be shared with other parties other than KBL:

i) Our firm must confirm with KBL what types of report they would expect as a result of the engagement and any prospective users that the report would be distributed to. In forensic engagements, the procedures to be performed would normally be agreed-upon with the client and then the results of those procedures would be reported (a report based on "agreed-upon procedures").

ii) Where KBL and/or the prospective users expect an opinion to be given on the investigation results, then the assurance issued can only be limited to negative assurance and this needs to be confirmed with KBL before the assignment is accepted.
iii) In such assignments, the firm (Smith & Peters Associates) would usually expressly state that the report is not intended for use by third parties other than those known prior to the acceptance of the engagement. This needs to be confirmed with KBL before our firm accepts to take on the forensic investigation assignment.
iv) In this investigation, it is possible that the relevant authorities would want to use the results of the procedures to compile evidence for their case. It would, if this were the case, be important to establish whether additional reports would be required for this and this requirement and specific contents for the report need to be agreed with KBL and/or the police (with KBL's permission) before the assignment is accepted.
v) Management also wants additional reports relating to the deficiencies identified in the control environment and systems recommendations on how to strengthen controls in this area. The form and content of such a report must be agreed upon in advance of accepting the assignment.

Firm's professional competence

The following considerations need to be taken account of regarding our firm's "professional competence" before accepting to take on the forensic investigation assignment requested by KBL:

i) Before accepting to take on the assignment, Smith & Peters Associates must be certain that they have personnel with the requisite competencies to be able to conduct the investigation effectively. On the basis that our firm has a department that conducts forensic investigations, the firm probably has personnel with the required professional competence to conduct the forensic investigation assignment requested by KBL.
ii) If the assignment is to be conducted as a criminal investigation, it is also vital that the personnel used have sufficient experience about the gathering and safeguarding of evidence. This is especially the case as it will always be in the interest of the parties implicated in the fraud to destroy the evidence collected to disrupt any subsequent criminal investigations conducted by the authorities (or evidence that needs to be submitted to the court proceedings). Any failure to follow the relevant protocol may render the evidence useless to the legal case.

Time pressure, deadlines and resource availability

As well as having staff with the requisite competencies to conduct the engagement, it is also vital that those staff are available to be able to investigate in the time frame suggested. For example, to subsequently conduct criminal investigations by the police, a time frame and deadlines may be set for the initial investigations by our firm. If the relevant authorities conduct an additional criminal investigation, Smith & Peters Associates must consider the extent of the possible investigation and whether our firm can commit the necessary resources without adversely affecting our commitments to the other clients.

Client due diligence

Since KBL is not an existing audit client, Smith & Peters Associates will be required to perform client identification procedures as part of the national anti-money laundering regulations including the know-your-client (KYC) requirement. Therefore, our firm must explain the need to obtain information about the company and its directors before KBL can be accepted as a client. If KBL is unable, or the directors of company refuse to comply to the requirement, then Smith & Peters Associates would not be able to take on KBL as a client or proceed with the engagement

Professional ethics perceptive

Confidentiality: Firms providing professional services must always ensure that information relating to clients is not given to third parties without the permission of the client. In preparing the report for the use of the police, Smith & Peters Associates will need permission from KBL to disclose the information to the police. In addition, an investigation such as this, it is highly likely that all of the evidence collected will have to be submitted to the authorities to assist with their criminal investigation. It is therefore vital that before Smith & Peters Associates accepts the assignment, they obtain permission from KBL.

Conflicts of interest: Our firm needs to consider whether we may have other clients in the same bakery products production and selling sector as KBL that may expose our firm to sharing confidential information with the competitors of KBL without KBL's consent or the other clients and this will result into a breach of our duty of confidentiality. Therefore, we can only accept this engagement if both KBL and the other clients in direct competition with KBL agree to sign confidentiality agreements.

b)

i) Deficiencies in control systems of KBL that have contributed to the fraud

Lack of segregation of duties

There is a lack of control over the stores and procurement departments, particularly concerning authorization and approval of the purchase requests (raised by the stores officer) and the procurement orders (raised by the procurement officer) that are linked to 'emergency' procurements. The fact that the stores officer and the procurement officer can raise spontaneous purchase requests and procurement orders respectively for emergency procurements without authorization of their department managers and the procurement committee has allowed fictitious procurements to be made for KBL.

Lack of authorizations

There are no authorizations for the purchase requests raised by the stores officer and the purchase orders raised by the procurement officer which has allowed the two officers to make fictitious procurements labelled as "emergency" procurements and ultimately exposing KBL to potential fraud.

Lack of reconciliations

The stores officer raises purchase requests without evidence that reconciliations have been made with the stock records and/or the quantities of raw materials with the production teams at the start of the large production.

Further, there is no evidence of records of the emergency materials recorded on the stock records (like the stock card) at the point of delivery and on dispatch of the materials from the stores to the production teams.

It is possible that if any physical stock-taking exercises are conducted, these items are never tracked back to the store records.

Finally, there is lack of reconciliation of the emergency purchase orders to the amounts invoiced based on the official price lists by the accounts department before payments are made which exacerbates the possibility of payments made, based on incorrect and non-approved prices for the materials.

Lack of a robust management monitoring system

The existence of the procurement system allowing direct transfer of the procurement order information to the accounting system for direct payment without any review checks allowed incomplete information to be relayed further up within the business. While this in itself is not an issue, it means that any management reviews of the procurement and accounting reports does not act as a means of review of the inventory management, procurement details and dispatch system of goods from the stores.

In many businesses, a system which links the inventory movements, procurement orders with the accounting and the management information system should allow reports to be generated to monitor any unusual trends. This is absent for KBL and in the absence of the ability to process such reports for reviews before payments being processed allows fraud to take place without any oversight of these processes. In terms of KBL, a proper monitoring system would have flagged that fictitious purchase requests, purchase orders, delivery notes, goods received notes and the stores dispatch notes for the 'emergency' procurements and in particular should have identified that last-minute procurements labelled "emergency" procurements have consistently happened when large productions have begun which could have been investigated and monitored by management.

Other implications of the fraud to KBL

In addition to the monies stolen by the stores officer and the procurement officer, KBL is not holding accurate records of its inventory, meaning that it may be in breach of the requirement to keep proper records of inventories (assets) and payables to the suppliers (liabilities), and therefore assets and liabilities are misstated. This may or may not be a material amount.

There is also a business risk arising from the payments for the fictitious purchases as the stolen cash may lead to liquidity challenges for KBL at the time they need available cash to settle genuine obligations as these arise. Though this is not indicated in the information provided, the fact that the fictitious supplies are intended to support the large production processes and this is potentially repeated for most or all the large productions that have taken place in the year could indicate a huge amount of cash flows have been stolen in the fraud scheme which is a drain on KBL's cash flows.

ii) Recommendations

- Integrate the orders/requests for purchases of the stores department, the purchase orders from the procurement department and the payment system into the management information system to allow for monitoring of the transactions in the three departments to be monitored by KBL's management.
- There should be a system of required authorization by line department managers for all purchase requests raised by the stores officer and purchase orders raised by the procurement officer regardless of whether the procurements are an emergency or not.

- KBL should ensure that there is a system in place that allows an instant creation and regular reviews of exception reports and unusual trends for procurements of "small-quantity" materials with such reviews conducted by higher level management to identify irregular or suspicious patterns in all procurements especially emergency procurements.
- Stock and other records should be promptly and adequately updated for any changes in the movement of raw materials for example, for all the items procured, an update of the stock records should be made with the store's manager signing off the updated store records.
- There should be a different person in the stores department (other than the stores officer who raises the purchase request) to independently receive the delivered materials from the suppliers or a system where two separate officers (with one of the officers from the accounts department) while receiving materials from the suppliers, to ensure segregation of duties is strengthened.
- KBL should implement regular inventory counts which should be performed by staff independent of the stores and procurement departments.

c) The relevance and measurability of the information in KVTC's reported performance measurement report

Financial statements of profit–oriented organizations provide a useful source of information to shareholders – as it is here that most relevant criteria for success (e.g., sales growth, margins, customer relations, employee relations etc.) come together in the "bottom line". In addition, in the recent times, non-financial performance measures have become relevant and useful tools to the users of that information while measuring the performance of the companies (e.g., rate of retention of customers, employees' morale, suppliers' relationship etc.).

In the case of KVTC, the following factors will be important to consider while evaluating the relevancy and measurability of the information provided in the performance measurement report:

Relevancy of KVTC's quality of the courses to students

- There is likely to be a wide range of interested parties including current and potential future students who are interested in the quality of the teaching approaches applied by KVTC and the likelihood of securing employment upon completion of the 2-year diploma course.
- The current and future potential students will be interested in KVTC's performance measures like the graduation rate and the employability rate as this will provide information on the students' success in completing their diploma course and obtaining a job thereafter. This is important because students pay tuition fees to attend KVTC courses, and therefore, they would be interested in confirming that their investment in the education will likely result in employment. However, some students may be more interested in using the KVTC diploma as a minimum requirement for a higher degree course after their graduation and so employability measures will be of less relevancy to such students.

- Students will be interested in the proportion of students who achieve a distinction for example first-class pass rates as these may lead to prospects of better employment, and hence a better return on their investment (in terms of time and money) in their education with KVTC.
- The performance measurement on course satisfaction will be important to students (current and future students) as these would indicate the number of students that rate KVTC's courses as high quality which is an important factor in deciding whether to register on that diploma course.

Relevancy of KVTC's performance measurement indicators to other stakeholders to support decision-making

Other interested parties will include the Government of Rwanda which contributes part-funding to KVTC. Other regulatory bodies (e.g., the local regulators that oversee higher education, vocational tertiary institutes etc.) and any other organization that supports KVTC's work (e.g., vocational graduate employers) will likely be interested.

Stakeholders other than the students (current and future students) may find other performance measurement information more relevant to them such as the potential vocational graduate employers may be interested in the level of work experience provided by KVTC to the students as a basis for their employment plans for these vocational graduates.

Other factors

Comparability of the performance measurement - It would be more useful if KVTC's performance measures are compared to equivalent measures of the prior years and for other similar tertiary institutions. Currently KVTC has not been producing these performance measurement report in the past year and therefore it will not be possible to evaluate KVTC's performance over time. In addition, if KVTC does not provide comparative information (and this is likely to be the case), it will be difficult to evaluate KVTC's performance against other similar institutes.

Measurability of the performance indicators - In terms of the need to measure most of KVTC's performance measurement indicators as given, it is sometimes difficult to precisely measure the performance information. Some measurement indicators are very subjective for example, the rating a student gives to a course is usually subjective as it is driven by personal opinion and difficult to substantiate (e.g., the difference between a course rating of "excellent" and "very good"). In addition, defining "vocational graduate-level employment" could be subjective. Some measures will be easier to quantify e.g., the diploma completion percentage which is supported by facts rather than an opinion.

Availability of information - There may be challenges with gathering some information which affects the validity of the information e.g., only a few students may have completed and submitted the course evaluation forms and/or possibly the most satisfied students were selected to fill and submit the evaluation forms intentionally to ensure a good measure is reported in KVTC's performance measurement report.

Conclusion

The above evaluation has evaluated the matters that our firm needs to consider before accepting the engagement to provide a forensic investigation and without these considerations, our firm cannot accept the engagement. In accepting the engagement and after a review of the weaknesses in the internal controls, several gaps have been identified and these are responsible for the potential fraud involving fictitious supplies suffered by KBL. However, a couple of recommendations have been proposed for KBL to mitigate re-occurrence of the fraud in future.

In addition, the discussion above has looked at the relevance and measurability of the information in KVTC's reported performance measurement report.

QUESTION FOUR

Q4	MARKING GUIDE TO QUESTION FOUR:	Marks
A	**Describe the steps that KAKU & Associates should undertake prior to accepting the audit engagement of DURABLE Supply Ltd** 1 mark for each correct identified step to be undertaken up to a maximum of 7 marks (*0.5 marks for a valid step not well explained*) *Do not award any mark for a general explanation not linked to the case study provided.*	7 Marks
B	**i) Discuss the ethical threats which may affect the independence of Robert Associates Ltd.** 0.5 marks for each correct ethical threats listed and related to the case study up to a maximum of 3 marks. **Describe the steps an audit firm should perform prior to accepting a new audit** 1 mark for each steps listed and linked with the case study provided. 0.5 marks on general step provided, not linked with the scenario provided up to a maximum of 2 marks.	5 Marks
	i) **Describe the risk assessment procedures to be performed by Robert & Associates Ltd in relation to the fraud that took place.** 1 mark for appropriate introduction and 1 mark for each correct identified risk assessment procedure to be performed up to a maximum of 7 marks.	8 Marks
	ii) **Discuss professional liabilities for auditors** 1 Mark for a correct description of auditors' liability. 2 marks for a well explained auditors' liability under criminal offences and 2 marks for possible civil offences.	5 Marks
	Total	**25 Marks**

a) Describe the steps that KAKU & Associates should undertake before accepting the audit engagement of DURABLE Supply Ltd.

ISA 210 *Agreeing the terms of audit engagements* guides KAKU & Associates on the steps they should take in accepting the new audit client, DURABLE Supply Ltd. It sets out several processes that the auditor should perform prior to accepting a new engagement, in addition to considering whether preconditions for the audit are in place.

KAKU & Associates should consider any issues which might arise which could threaten compliance with the Code of Ethics and Conduct or any local legislation, including conflict of interest with existing clients. If issues arise, then their significance must be considered.

KAKU & Associates should consider whether they are competent to perform the work, and whether they would have appropriate resources available, as well as any specialist skills or knowledge required for the audit.

KAKU & Associates should consider what they already know about the directors of DURABLE Supply Ltd. They need to consider the reputation and integrity of the directors. If necessary, the firm may want to obtain references if they do not formally know the directors.

KAKU & Associates should consider the level of risk attached to the audit of DURABLE Supply Ltd and whether this is acceptable to the firm considering that the firm's remuneration is linked to the company's profit and they are not allowed to contact the previous auditor.

They should consider whether the expected audit fee is adequate concerning the risk of auditing DURABLE Supply Ltd. KAKU & Associates should communicate with the outgoing auditor of DURABLE Supply to assess if there are any ethical or professional reasons why they should not accept the engagement.

KAKU & Associates should obtain permission from DURABLE Supply Ltd's management to contact the existing auditor; if this is not given, then the engagement should be refused. Further, considering the familiarity and ethical threat in the company and the assignment its self, the assignment should be refused.

b)

i) Discuss the ethical threats which may affect the independence of Robert &Associates Ltd and describe the steps an audit firm should perform prior to accepting a new audit

The threats are that independence will be compromised by:

Self-interest: The firm remuneration based on the company's profit;

Self-review and familiarity: KAKU & Associates will sub-contract with the Tax Advisor who is a brother of the Partner to carry out the audit of DURABLE Supply Ltd;

Intimidation: To increase the firm remuneration based on the condition not to contact the previous auditor;

Actual threats need to be considered, and also situations that might be perceived as threats by a reasonable and informed observer.

From the case study provided: the following are ethical threats that may affect auditor's independence:

- Staff discount
- Secondment
- Total fee income
- Finance director and partner being good friends socially
- Outstanding fees
- Senior account of audit client who is the wife to the Audit Partner

Before accepting a new audit engagement, an audit firm should conduct a thorough review, including assessing client integrity, potential conflicts of interest, the client's business and industry, and their ability to perform the audit, and then communicate with the previous auditor and prepare an engagement letter.

ii) Describe the risk assessment procedures to be performed by Robert & Associates Ltd in relation to the fraud that took place.

Robert & Associates Ltd 's approach to fraud involves identifying fraud risk factors, followed by tailored responses to address those risks, such as modifying audit procedures and seeking corroborating evidence and a proactive risk assessment process, including brainstorming, understanding management's perspective.

The following are some of the procedures that should be performed:

- **Identifying Fraud Risk Factors**

Robert & Associates Ltd looks for indicators that suggest a higher risk of fraud, such as:

- ✓ **Motivation -** Incentives or pressures that could lead to fraud (e.g., meeting earnings targets).
- ✓ **Opportunity -** Situations that allow fraud to occur (e.g., weak internal controls).
- ✓ **Rationalization -** The ability of individuals to justify their fraudulent actions.

- **Documenting Risk Assessment**

Auditors should document the assessment of fraud risks, including the identified risks and their responses. Basically, Robert & Associates should ensure that this is done too.

- **Fraud Brainstorming**

Robert & Associates Ltd should engage in discussions with engagement team members to identify potential fraud risks and vulnerabilities.

- **Understanding Management's Perspective**

Robert & Associates Ltd should assess management's fraud risk assessment processes, including their anti-fraud controls and monitoring activities.

- **Leveraging Fraud Expertise**

Robert & Associates Ltd may utilize internal or external expertise to assist with fraud risk assessment, including identifying potential fraud schemes and risk factors.

- **IT Risk Assessment**

Robert & Associates Ltd should consider the organization's IT risk posture, as there's a significant risk of fraud in the information technology arena.

- **Evaluating Accounting Policies**

Auditors should evaluate accounting policies for potential bias or manipulation and this is also something that Robert & Associates Ltd should consider undertaking.

iii) Briefly discussion auditors' liability for Robert & Associates Ltd

Auditors are potentially liable for both criminal and civil offences.
Normally, criminal law governs relationships between entities and the state. Civil law, in contrast, deals with disputes between individuals and/or organizations.

Criminal offences

Like any individual or organization, Auditors are bound by the laws in the countries in which they operate. Under current criminal law auditors could be prosecuted for acts such as fraud and insider trading.

Audit is also subject to legislation prescribed by the Company law. This includes many sections governing who can be an auditor, how auditors are appointed and removed and the functions of auditors.

One noteworthy offence from the Companies Act is that of 'knowingly, or to include any matter that is misleading, false or deceptive in a material effect. This means that auditors could be prosecuted in a criminal court for either knowingly or recklessly issuing an inappropriate audit opinion.

Civil offences

An auditor could be sued by the shareholders.
There are two pieces of civil law of particular significance to the audit profession; contract law and the law of torts. These establish the principles for auditor liability to clients and to third parties, respectively.

Under contract law parties can seek remedy for a breach of contractual obligations. Therefore, shareholders can seek remedy from an auditor if they fail to comply with the terms of an engagement letter.

Under the law of torts, auditors can be sued for negligence if they breach a duty of care towards a third party who consequently suffers some form of loss.

End of Marking Guide and Model Answers