CAT

Certified Accounting Technicians Examination

Stage: Level 2 L2.5

Subject Title: Auditing

Examination Format Revision Pack

iCPAR
INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA
Driving Sustainable Performance

AUDITING

LEVEL 2

L2.5 EXAMINATION FORMAT REVISION QUESTIONS & SOLUTIONS

NOTES

You are required to answer ALL THREE questions in Section A and TWO of the four questions in Section B (If you provide answers to more questions than required in Section B, you must draw a clearly distinguishable line through the answers not to be marked. Otherwise, only the first two answers to hand will be marked.)

TIME ALLOWED:
3 hours, plus 10 minutes to read the paper.

INSTRUCTIONS:
During the reading time you may write notes on the examination paper but you may not commence writing in your answer book.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

Start your answer to each question on a new page.

You are reminded that candidates are expected to pay particular attention to their communication skills and care must be taken regarding the format and literacy of the solutions. The marking system will take into account the content of the candidates' answers and the extent to which answers are supported with relevant legislation, case law or examples where appropriate.

List on the cover of each answer booklet, in the space provided, the number of each question(s) attempted.

Editor's note: Your answer should show that you understand the subject matter displayed in the question. The longer the answer (the more verbose it is) the harder it will be for the examiner to mark. So be succinct and leave out the padding unless you deem it really necessary!

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THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

L2.5- AUDITING

EXAMINATION FORMAT-REVISION QUESTIONS AND SOLUTIONS

SECTION A – Questions 1, 2 and 3 are compulsory.

QUESTION 1

Your client is the property company To Let Ltd (TL Ltd) which specialises in developing run-down commercial properties and letting these out to various tenants. The company has 12 centres with a total of 80 available units, most of which are fully let.

All leases provide for a fixed rent plus a percentage of sales (net of VAT), up to a maximum amount agreed with each tenant. Each lease also provides that TL Ltd may engage a professional accountant to audit all records of the tenant for assurance that sales are being properly reported to it.

You have been requested by TL Ltd to audit the records of the tenant, "Restaurant Ltd" to determine that it's reported sales, totalling RWF 628,325 for the year ended 31 March 2012, have been properly reported to TL Ltd. Restaurant Ltd and TL Ltd entered into a 5-year lease on 1 January 2011.

Restaurant Ltd offers take away and table service only. Although alcohol is not served, it has a 'bring your own' policy. Take away meals are recorded in the cash register and a till receipt is provided to each customer. The restaurant has three permanent waitresses and up to three casual staff who are paid in cash from the daily takings. The waiting staff prepare handwritten, pre-numbered restaurant dockets for the customers.

All sales are for cash and payment is made at a cash register (staffed by the owner and his wife), as the customer leaves. The owner's wife is also the bookkeeper and she deposits all takings in the bank, the morning following the previous evening's business.

You have ascertained that complete files are kept of restaurant dockets and cash register rolls. A sales day book and general ledger are also maintained.

REQUIREMENT:

(a) On the basis of the information above, assess aspects of Restaurant Ltd's system for processing and accounting for the restaurant and take away sales which may be indicative of control weaknesses.

(6 marks)

(b) Discuss the main risk for your client TL Ltd., regarding its lease with Restaurant Ltd.

(2 marks)

(c) Identify and explain the appropriate audit procedures to test the annual sales of Restaurant Ltd.

(12 marks)
(Total: 20 Marks)

QUESTION 2

The CPA firm ABC Ltd, has been asked to tender for the annual audit of the financial statements of Antiques Ltd, a retailer of specialist goods including Persian rugs and antique tapestries. ABC Ltd has been performing other services for Antiques Ltd over the past three years, namely management consulting and tax advice. In addition, there have been disputes in the past between the management consulting and taxation departments of ABC Ltd and the management of Antiques Ltd. Most of these disputes revolved around the level of services provided and the fees charged.

One of the audit managers in ABC Ltd was previously employed by Antiques Ltd in the finance department. Apart from the audit manager previously employed by Antiques Ltd, no-one in the assurance department has experience in the antique and specialist goods industry. Some members of ABC Ltd have shares in Antiques Ltd.

REQUIREMENT:

(a) Assess the potential threats to the independence of ABC Ltd if the company were to undertake the audit of Antiques Ltd.

(10 marks)

(b) Explain the procedures which ABC Ltd should conduct to determine if the company is sufficiently independent to audit Antiques Ltd.

(5 marks)

(c) Identify the safeguards ABC Ltd could implement in order to reduce the threats to the company's independence outlined in (a) above.

(5 marks)
(Total: 20 Marks)

QUESTION 3

You are the auditor of XYZ Ltd, whose financial year ended on 31 December 2011. Your auditor's report was signed on 12 March 2012 and the financial statements were issued on 3 April 2012. Listed below are events that occurred or were discovered after the end of the financial year. Assume that each has a material effect on the financial statements.

(i) On 10 March 2012, you discovered that a customer of XYZ Ltd went bankrupt. The balance due at 31 December 2011 is considered to be non-collectable and there were no other sales to this customer after the year end.

(ii) On 25 March 2012, a lawsuit was filed against XYZ Ltd by an employee for damages in relation to an event that occurred before 31 December 2011. From the solicitor's confirmation letter, there is likely to be a significant pay-out to the employee.

(iii) On 26 March 2012, you discovered that one of XYZ Ltd's subsidiaries was sold on 16 March 2012. This subsidiary accounted for more than 30% of XYZ Ltd's assets at the year-end.

(iv) On 5 April 2012, a fire destroyed one of XYZ Ltd's warehouses. This resulted in a loss of 60% of the inventory that was on hand at that date.

REQUIREMENT:

(a) Explain what is meant by a subsequent event and discuss the procedures an auditor undertakes to test subsequent events.

(5 marks)

(b) For each of the above events, evaluate the auditor's responsibilities and indicate what additional procedures (if any) the auditor should undertake.

(15 marks)
(Total: 20 Marks)

SECTION B– Answer 2 questions from 4,5,6 and 7.

QUESTION 4

You were assigned by your CPA firm, Audit & Co., to attend the inventory count of Company Ltd. at their inventory warehouse on 3 January 2012. Company Ltd's year-end was 31 December 2011 and it uses a perpetual inventory count system. However, for the 2011 year-end Company Ltd. has also decided to do an annual count in addition to the perpetual inventory account, to make sure the inventory system was operating effectively. Prior to the count, you reviewed the inventory memo sent by Company Ltd. to all staff involved in the inventory count. You then arrived at the warehouse at 8.00 am and began your work.

Once you completed your inventory observation, you documented your findings in the audit work programme for inventory observation. Several days later, you received a complete listing of Company Ltd's inventory from its Finance Manager. It appeared that the physical count adjusted to 31 December 2011 had a cost of RWF 561,888 and yet the company's perpetual records indicated that the inventory held should have been RWF 568,403. So there was a downward adjustment of RWF 6,515 to be made. Your working paper with the reconciliation of the figures is shown below:

Reconciliation of Company Ltd.'s Physical Inventory per the warehouse to the perpetual records as at 31 December 2011.

	RWF
TOTAL COST OF INVENTORY – WAREHOUSE	565,176 @
Less: Inventory Received on 1/1/12 & 2/1/12 (from Receiving Reports)	(20,765)
Add: Inventory Shipped Out on 1/1/12 & 2/1/12 (from Despatch reports)	49,502
TOTAL COST OF INVENTORY – 31/12/11- WAREHOUSE	593,913 T
Less: Adjustment for Discount Taken on Inventory Purchases from main suppliers	(32,025) R
TOTAL ADJUSTED COST OF INVENTORY – 31/12/11 - WAREHOUSE	561,888 T
INVENTORY IN WAREHOUSE PER PERPETUAL INVENTORY RECORDS	(568,403) A
INVENTORY ADJUSTMENT (REDUCTION)	(6,515) T

<u>Key for Procedures undertaken:</u>

@ Agreed to Inventory Listing

T Total agreed

R Recalculated

A Agrees to Trial Balance

Audit Conclusion: The inventory balance is fairly stated.

REQUIREMENT:

(a) Contrast a perpetual inventory count with an annual / year-end inventory count.

(4 marks)

(b) Explain, with reasons why the physical count of Company Ltd’s inventory produced a different figure than that indicated by the company’s own perpetual records.

(7 marks)

(c) Would the RWF 6,515 difference, referred to above, be considered material enough to warrant further investigation by the auditors? Justify your answer.

(6 marks)

(d) Document the journal entry required by Company Ltd. to adjust the inventory in the company’s financial statements.

(3 marks)
(Total: 20 Marks)

QUESTION 5

You are the audit manager performing the audit of Tyres Ltd, a large manufacturer of retread tyres. You are currently performing a review of some of the work performed by the audit senior, Adisa Ayim, on accounts payable.

Background information and the related working paper are given below. In prior years, material unrecorded liabilities were discovered due to problems with non accruals of unpaid suppliers’ invoices.

Accounts Payable as at 31 March 2012 amount to RWF 1,875,517. As in prior years, four major suppliers comprise 80% of the accounts payable balance. Adisa Ayim has prepared the following working paper:

Tyres Ltd			AP-5
Accounts Payable			Prepared by: AA
31-Mar-12			Date:
Testing of supplier balances The four major suppliers were selected from the accounts payable ledger as at 31 March 2012. The ledger balances were as follows:			
Supplier name	**Ledger balance RWF**	**Statement balance RWF**	**Comment RWF**
AX Ltd	410,800	405,719	1
BBD Pty Ltd	372,100	n/a	2
789 Partners	461,900	527,100	3
BJC Ltd	260,590	260,590	Balance agreed to statement - no further audit work needed

1. Statement dated 27 March 2012. Difference of RWF 5,081 immaterial given two days extra trading until year-end cut-off

2. No statement issued. Instead, a sample of invoices as per the ledger balances was agreed to original supplier invoices. No discrepancies noted.

3. Balance per statement RWF 527,100. Last cheque paid 30 March 2012 (RWF 65,200). Balance per
ledger RWF 461,900. Cheque in transit.

REQUIREMENT:

(a) Evaluate the above audit work performed on the supplier balances.

(7 marks)

(b) Discuss the further audit procedures necessary to ensure that accounts payable are fairly stated in the financial statements.

(7 marks)

(c) Outline three examples of Computer Assisted Audit Techniques (CAATs) that could be used to make substantive testing more efficient and effective in respect of the audit of accounts payable.

(6 marks)
(Total: 20 marks)

QUESTION 6

You are an audit senior in a CPA firm of accountants and registered auditors and you have been asked by one of the audit partners to prepare some training materials for the new audit trainees in relation to how risk impacts on audit strategy.

You have been specifically requested to start with the Audit Risk Model and how the various components of it will impact on the overall audit strategy. You are aware that the auditor may adopt either a predominantly substantive audit strategy or a strategy which relies on controls within the client system for an audit.

REQUIREMENT:

Prepare a note for trainees with relevant diagrams and examples which:

(a) Explains to trainees the various components of the Audit Risk Model and how they affect the development of the audit strategy, including the design and timing of substantive procedures.

(15 marks)

(b) Distinguishes between inherent risk at the financial statement level and at the account balance level, giving examples to support your discussion with audit trainees.

(5 marks)
(Total: 20 Marks)

QUESTION 7

Ada Jalloh has completed her audit field work for the audit of Food Ltd, an international food packaging company for the year ended 31 December 2011, and is now in the process of preparing her "Matters for the Attention of Partner" and determining whether to include possible modifications to the audit report. Presented below are two independent, unrelated situations which have arisen.

Situation 1

In September 2011, a lawsuit was filed against Food Ltd by the Health and Safety Inspectorate to have the court order the company to install pollution-control equipment in one of its older plants. Food Ltd's solicitors has informed Ada Jalloh that it is not possible to forecast the outcome of this litigation; however, Food Ltd's management has informed Ada Jalloh that it cannot afford the new equipment and that the plant will have to be closed if it loses the lawsuit.

Situation 2

During 2011, Food Ltd was in the process of developing a new range of bio-degradable packaging. It is currently in the final stages of development but Food Ltd has capitalised all the costs associated with the development including research expenses which, under International Accounting Standards, should have been expensed in the financial statements. The level of research expense is material.

REQUIREMENT:

(a) Identify the key items that should normally be included in a "Matters for the Attention of Partner" working paper.

(5 marks)

(b) Discuss the general considerations Ada Jalloh needs to take into account when deciding on the type of audit report modification, if any, that should be made.

(5 marks)

(c) Select and justify the type of audit report for Situation 1 and Situation 2 in terms of the considerations covered in (b) above and other appropriate considerations. Assume each situation is adequately disclosed in the financial statements. Each situation should be considered independently.

(10 marks)
(Total: 20 Marks)

SUGGESTED SOLUTIONS

SOLUTION 1

(a) The lack of separation of duties in the Restaurant, as evidenced by the combination of cash handling and accounting duties in the hands of the proprietor and his wife makes it necessary that the auditor perform a more detailed examination of transactions and detailed records than might be necessary in a larger organisation.

Deposits are made the morning after the night's takings, which could lend itself to theft. They should be kept overnight in a safe or bank night safe.

Although there is a bring your own policy, there is normally a corkage charge for this and it is not clear how this is accounted for.

Waiting staff paid cash from daily takings is also a weakness in control. How is this accounted for and reconciled to till rolls.

Are all take away meals receipted? Again it is not clear if the takings are reconciled to the cash register details. Hand written dockets are given to restaurant customers but is there a duplicate kept and is this reconciled to the cash register also.

1 mark for each valid control weakness up to a maximum of 6.

(b) The main risk for TL Ltd concerns whether the restaurant has understated its sales for the year, it is possible that the records have been falsified to support the understated figure. It is therefore desirable that the auditor, in addition to making detailed tests of the records, also carry out overall tests of reasonableness. In particular, he should use any outside sources available to substantiate the accounting records.

2 marks for discussion over main risks to TL Ltd.

The auditing procedures to be performed may include the detailed examination of accounting records e.g.

(1) Read the lease contract to determine the sales to be included in the computation of the annual rent.

(2) Trace the annual sales as reported by the restaurant to sales in the financial statements and the general ledger.

(3) Tot/Cast/Foot (add the columns and comment on) the general ledger account for sales and trace the individual postings to the daily sales journal.

(4) Trace selected daily totals recorded in the sales journal to the supporting documents such as cash register rolls.

(5) For selected days, compare the cash register rolls with the total of pre-numbered sales dockets.

The tests of overall reasonableness of the restaurant's accounting records may include the following analytical procedures to determine the completeness of sales:

(1) Obtain copies of the restaurant's income tax return and sales tax reports to determine whether the sales reported to tax authorities agree with the sales reported in the computation of rents.

(2) Compute the cost of food purchased on an annual basis; and by applying an appropriate mark-up percentage, estimate the sales for the year.

(3) Compare the total bank deposits as shown on the restaurant's bank statements with the reported sales.

(4) Review the quarterly social security reports to ascertain the number of employees throughout the 12 months under audit and compare with the trends in sales.

(5) Determine representative sales figures for each day of the week and investigate any significant variation from the usual sales level. For any such unusual sales figures, total the pre-numbered restaurant dockets for the day.

(6) Investigate the total number of sales checks acquired from the printer and the number on hand at year- end, and reconcile the serial numbers used with the number of sales dockets used on representative days.

(7) Calculate the ratio of take away meals to the restaurant meals and identify if the cash register correlates to this and observe a typical day to see if all take away meals are receipted.

Any other valid procedures identified.

1 mark for each valid procedure up to a maximum of 12.

SOLUTION 2

(a) Potential threats to independence include:

(i) Levels of non-audit service fees compared with audit fees might be too high and compromise auditor's independence as this would result in a self -interest threat.

(ii) Further self-interest threats could arise due to assurance staff having shares in the audit client, it will depend on their role in the audit and the level of shares held and the percentage of their wealth covered by the investment, but in general no one on the audit team should have shares in any audit client.

(iii) There is a potential familiarity threat depending on how long the audit firm have known the client. From the question it would appear to be at least three years so this would need to be verified.

(iv) Depending of the previous employee's role and how long they have left the employment of Antique Ltd will determine if there is a potential self -review threat. Normally 2 years lapse is sufficient.

(v) There could still be ongoing disputes and unpaid fees for this client and this again would be a self-interest threat as unpaid fees are considered to be a loan to the client.

(vi) Lack of experience in his industry may also compromise the exercise of due care in the audit.

Assessment of the value of antiques requires special skills. An auditor need not be a specialist appraiser since an appraiser may be hired if necessary. However, the team should have the professional expertise to judge the assessor's work. One experienced person on the team is not sufficient, particularly when that person may be removed from the team due to their previous employment with the client.

2 marks for each threat covered (1 mark if discussion is Ltd) up to a maximum of 10 marks

(b) Procedures ABC Ltd might employ include:

(i) a check on personal financial investments of partners and employees such as a signed agreement from each member of the assurance department saying there was no direct investment in the audit client.

(ii) Review employment records of any members of the assurance team who have previously worked for the client to identify the areas they would have been involved in and whether these areas or levels of experience within the finance department of

ABC Ltd might threaten the audit independence. In addition, the timing will need to be checked to identify the time lapse between working for the client and then the audit firm.

(iii) Review the non-audit services the audit firm are providing or have recently been providing to this potential client as they might threaten independence by their nature e.g. possible advocacy threats from consulting side.

(iv) Identify the extent of the fees provided by these non-audit services as again the level of non-audit services fees might compromise independence.

(v) Discuss the nature of the disputes and whether they have been resolved.

(vi) Review levels of experience in this industry across the firm as it might be possible to access further experience within the audit firm without compromising auditor's independence.

(c) Safeguards include:

1 mark for each well-made point up to a maximum of 5 marks

(i) Audit staff agreements in place to ensure they don't hold shares in audit clients.

(ii) Second partner review and additional partner supervision over the audit manager's work if the manager is to be a part of the audit team for this job.

(iii) Do not undertake the audit until outstanding disputes are settled and all unpaid fees paid.

(iv) Remove the audit manager with previous employment from the audit team for this work

(v) Ensure the audit committee and/or those charged with governance are content at the level of non-audit fees when compared with audit fees.

(vi) Check that the audit committee are content that the assurance team are sufficiently independent.

(vii) Outsource an assessor or buy in other expertise for this industry – get additional training for the assurance team.

(viii) May have to not undertake the tender as independence is threatened and cannot be sufficiently managed by appropriate safeguards.

1 mark for each safeguard up to a maximum of 5 marks

Solution 3

(a) Subsequent events are transactions and other pertinent events that occurred after the balance sheet date, which affect the fair presentation or disclosure of the statements being audited. Subsequent events can be either adjusting or non-adjusting.

(1 mark)

The audit procedures include:

- Obtaining an understanding of any procedures management has established to ensure that subsequent events are identified.
- Inquiring of management and those charged with governance as to whether any subsequent events have occurred which might affect the financial statements.
- Reading minutes of Board meetings, that have been held after the date of the financial statements and inquiring about matters discussed at any such meetings for which minutes are not yet available.
- Reading the entity’s latest subsequent interim financial statements, if any
- Enquiries of management
- Other procedures e.g.:
    - Review of large entries after year end and latest financial statements
    - Review minutes of the Board after year end
    - Evidence from solicitor’s confirmation letter
    - Latest management information, budgets, cash flows etc.

0.5 mark for each procedure up to a maximum of 4.

(b) In relation to the events identified the auditors responsibilities and additional procedures are noted below:

(i) On 10 March 2012, you discovered that a customer of XYZ Ltd went bankrupt. The balance due at 31 December 2011 is not considered to be collectable and there were no other sales to this customer after the year end. The auditor has a responsibility for identifying and evaluating events up until the date of the auditors' report. This is a subsequent event affecting the value of a receivable's balance at year-end that will require adjustment to the provision for doubtful debts (unless it has already been included). The auditor will have to confirm the balance at the year end and the fact that no other sales were made since the year end. The auditor should also get a management representation letter point on this issue.

3 marks for discussions

(ii) On 25 March 2012, a lawsuit was filed against XYZ Ltd by an employee for damages in relation to an event that occurred before 31 December. From the solicitor's confirmation letter, there is a danger of a significant pay out to the employee. This is a subsequent event occurring after the date of the auditors' report but before issuance of the financial statements. The auditor has no responsibility to look for these events but must consider them if he or she becomes aware of them. This is a subsequent event that relates to conditions that existed at balance sheet date. The auditor should consider and discuss with management the need to amend the financial statements by including the lawsuit in a note. If the financial statements are amended, the auditor must carry out necessary auditing procedures, including extending the review of after balance date events, and reissue the auditors' report at the date of approval of the amended financial statements.

4 marks for discussions

(iii) On 26 March 2012, you discover that one of XYZ Ltd's subsidiaries was sold on 16 March. This subsidiary accounted for more than 30% of XYZ's assets at the year end. This is a subsequent event occurring after the date of the auditors' report but before issuance of the financial statements. The auditor has no responsibility to look for these events but must consider them if he or she becomes aware of them. In this case it is a subsequent event that does not relate to an event before the balance sheet date and as such it is a non- adjusting event. However, due to its potential impact on the business a disclosure note in the financial statements would be necessary. The auditor should consider and discuss with management the need to amend the financial statements by including the subsequent event note. If the financial statements are amended, the auditor must carry out necessary auditing procedures, including extending the review of after balance date events, and reissue the auditors' report at the date of approval of the amended financial statements.

4 marks for discussions

(iv) On 5 April 2012, a fire burnt down one of XYZ Ltd's warehouses. This resulted in a loss of 60% of the inventory that was on hand at that date. The auditor was made aware of this event after the financial statements have been issued. In this case the event occurred after the auditors' report was signed so the auditor has no responsibility in relation to the event. No disclosure required. However, the auditor would want to check the extent of any inventory destroyed that was held at the year end as this may indicate an adjusting event.

4 marks for discussions

SOLUTION 4

(a) Many organisations find it difficult to close down their operations for an annual inventory count and practice continual/perpetual inventory counts. They count every item of inventory and compare it to the inventory records at least once in a year, in a systematic and orderly fashion. This type of inventory check is useful for organisations that have fully integrated computerised inventory systems with strong controls over the system e.g. large supermarket chains etc. This type of inventory check is acceptable to the auditor provided there are strong records of stock movements in the intervening period which can be examined and substantiated.

An annual inventory count happens as close to the year end as possible and in general it operates as the company's control to ensure that all the stock on hand is counted and agreed to the year-end balance.

4 marks

(b) A number of reasons could explain a difference between the physical inventory count and a company's perpetual inventory records. When faced with any discrepancy such as this, the auditor should consider all possible causes:

(i) The perpetual records may be in error. A large volume of transactions are processed during the course of a year, and some amount of human error is to be expected in the recording.

(ii) The cost flow assumption may have been improperly applied in the perpetual records.

(iii) The inventory may have been counted incorrectly by the company at the year end.

(iv) Inventory might be out on consignment.

(v) Inventory might have been stolen.

(vi) Damaged or obsolete inventory may have been disposed of by the company without recording a reduction in the subsidiary ledger.

(vii) Goods in transit could have been incorrectly handled in either the perpetual records or the physical inventory.

(viii) The rollback procedure used to arrive at the December 31, 2011 year end figure may have been incorrectly applied.

(ix) The specific cost assigned to each inventory item might have been incorrect in certain cases.

(x) The final inventory listing may have been extended or totted erroneously.

1 mark for each valid reason up to a maximum of 7 marks.

(c) The question as to whether the RWF 6,000 difference warrants further attention is subject to the auditor's judgment. Since the financial records are adjusted to agree with the physical inventory, the auditor is primarily interested in potential errors contained in the counted figure. If the auditor has appropriately observed the taking of the physical count, the possibility of errors in the quantity of inventory should be at a minimum. Additional testing, such as verifying the costing, the extensions, and the footings will further reduce the risk of a material error in the figure to be reported.

2 marks

The presence of perpetual records adds another dimension to the inventory verification. By comparing the ending figures from the physical count with the perpetual records, the auditors can determine whether differences are connected with the quantity or the unit cost for the individual inventory items. If the RWF 6,000 is primarily created by quantity differences, the auditors should consider the need for selected recounts. Conversely, if the difference is based on costing variances, the auditors will concentrate on establishing the validity of those particular figures.

2 marks

A question may be raised as to the reasonableness of a RWF 6,000 difference between the physical count and the perpetual inventory records. For a company having a warehouse with over RWF 560,000 in inventory, this difference is not significant in size even with the use of a perpetual system. A more important issue would be the composition of the difference. If a great number of items are not in agreement with the records and simply net to a RWF 6,000 variance, the auditors have reason to be concerned. Conversely, if only a few items display differences, verification is much easier.

2 marks

(d) Journal entry required is:

Dr Cost of goods RWF 6,515

Cr Inventory in the balance sheet /SOFP RWF 6,515

Being adjustment to reduce the inventory value to the cost of that held at 31 December

3 marks for correct journal with descriptor, 2 if descriptor missing and marks removed for poor journal format

SOLUTION 5

(a) The first weakness is that selection based on materiality is not an appropriate sole criterion for performing the audit of payables. As a liability the audit risk in general is that the liability is understated, by selecting the largest balances we are testing for overstatement. Ideally selecting the largest suppliers by total supplies would be a better approach. In addition, the auditor should have considered including in the sample other accounts that met different criteria.

3 marks

Other weakness includes:

- The work paper does not include an objective or an overall conclusion
- There is no date on the working paper and no sign of adequate review of Adisa Ayim's work.
- Comment (1) – The supplier's reconciliation could be performed as at 27/3 and the difference to 30/3 could be vouched to invoices. To ignore the error by saying it appears reasonable shows lack of professional scepticism and exercise of due care and attention.
- Comment (2) – The auditor should consider sending a supplier's confirmation to this supplier because of the materiality of the balance. The selection of a sample of invoices does not provide any evidence in relation to completeness of trade payables as you are sampling a sample. If a confirmation isn't returned then other audit procedures should be undertaken e.g. review of post year-end payments, agreement to Goods received and invoices for all items comprising the balance etc.
- Comment (3) – The cheque of RWF 65,200 should be traced to the cash payments journal and to the subsequent period's bank statement.

1 mark for each relevant comment made up to a maximum of 7

(b) The sample needs to be increased. The auditor should select some trade payables with small balances, accounts with zero balances, or accounts that have changed significantly since the prior year.

The auditor should also perform the extra work discussed in (a) to address the problems with comments (1) to (3).

3 marks

Work also needs to be performed to ensure that cut off has been properly performed and there are no unrecorded liabilities. This is particularly important because of the prior year's problems in relation to unpaid suppliers' invoices. The following work could be performed:

Select a sample of recorded purchase transactions from the accounts payable ledger from several days before and after year-end and examine delivery notes, suppliers' invoices and receiving reports to determine that purchases were recorded in the proper period.

Observe the number of the last receiving report issued on the last business day of the audit period and trace a sample of lower and higher numbered receiving reports of related purchase documents to determine whether transactions were recorded in the proper period.

Examine subsequent payments between the balance sheet date and the end of fieldwork and, when related documentation indicates the payment was for an obligation in existence at balance sheet date, trace to the accounts payable listing.

Investigate unmatched purchase orders, receiving reports, delivery notes and suppliers' invoices at year-end. Particular attention should be focused on reviewing for unpaid suppliers' invoices.

Other relevant procedures identified including substantive analytical procedures.

1 mark for each relevant procedure identified to a maximum of 7

(c) Three examples of CAAT to make substantive testing more efficient in auditing accounts payable could include: Common Applications such as:

- Sampling
- Analytical procedures
- Preparation of confirmations if being used for accounts payable
- Identify gaps in sequencing
- Verify aging
- Identify all debit balances in A/P
- Identify invalid characters in data fields

More specifically for Accounts Payable CAATs could be used to:

- Search supplier payments for duplicate payments.
- Search for unusual patterns on purchase/undelivered orders or contracts, such as unusually large numbers or amounts.
- Scan general/sub ledger accounts for activity being posted from unexpected sources (e.g., a journal entry when none is expected)
- Search for transactions initiated from unexpected sources
- Search for unapproved transactions

1 mark for CAAT and 1 mark for its specific use for Accounts Payable audit for 3 examples chosen

SOLUTION 6

(a) Audit Risk Model is represented by:

AR= IR x CR x Dr

ISA 200 Overall objectives of the independent auditor and the conduct of audit in accordance with ISAs (UK and Ireland) which requires the Auditor to 'plan and perform the audit to reduce audit risk to an acceptably low level that is consistent with the objective of an audit'. As a result Audit risk has to be acceptable. The auditor will, at the planning stage of the audit, assess inherent risk and control risk within the organisation to be audited. Once this assessment is made then detection risk will be managed to ensure audit risk is acceptable.

Inherent risk is the risk that a material misstatement will occur in the absence of controls. It is inherent to the business i.e.: a riskier business will have a higher inherent risk e.g. large amounts of estimated figures or values, high levels of easily misappropriated items, highly complex business etc.

Control risk is this risk that material misstatements will not be prevented, detected or corrected by the accounting and internal control system.

Detection risk (comprises sampling and non-sampling risk). It is the risk that material misstatements will not be detected by the auditor. It is the only component of audit risk that the auditors have any control over!

3 marks

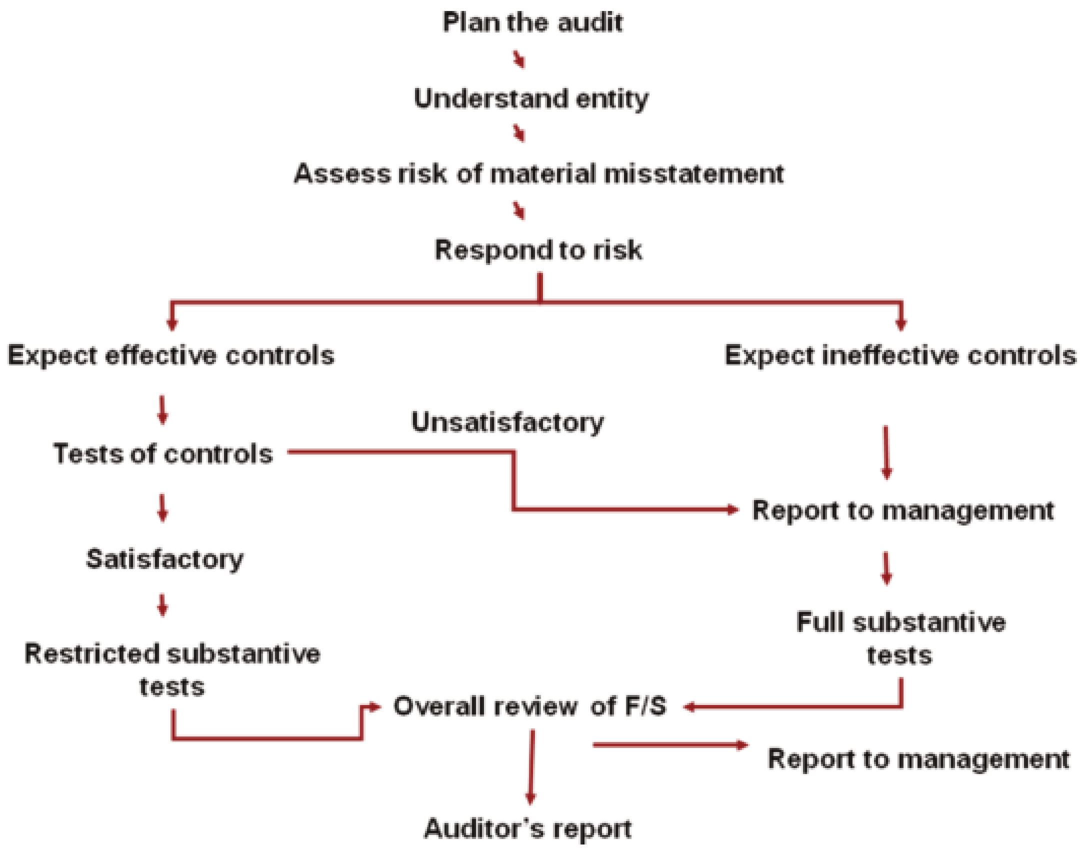
(i) Effect of assessment of inherent and control risk on the audit strategy

The auditor's selection of audit strategy is based on the assessment of risk. The higher the auditor's assessment of risk, then all of the evidence needed to reduce audit risk to the level required for the expression of an opinion on the financial statements must be derived from a predominantly substantive approach.

If the control risk is assessed as high, then the auditor will not undertake a strategy that places reliance on these controls and performs tests of control on the system but will instead adopt a substantive audit approach. On the other hand, if the auditor expects that there is a lower risk that a material misstatement may arise because an entity has effective controls and the auditor intends to design substantive procedures based on the effective operation of those controls, then the auditor performs tests of controls to obtain audit evidence about their operating effectiveness. If the tests do not confirm their operating effectiveness, then the auditor will need to reconsider the audit strategy and increase the level of use of substantive procedures as appropriate.

Substantive tests will always be necessary but the extent of them can be reduced if a reliance strategy is selected. This requirement reflects the fact that the auditor's assessment of risk is judgmental and may not be sufficiently precise to identify all risks of material misstatement. Further, there are inherent limitations to internal control including management override. Accordingly, while the auditor may determine that the risk of material misstatement may be reduced to an acceptably low level by performing only tests of controls for a particular assertion related to a class of transactions, account balance or disclosure, the auditor always performs substantive procedures for each material class of transactions, account balance, and disclosure.

4 marks



The above diagram represents the discussion above.

2 marks

In relation to the effect of the assessment of inherent and control risk on the design and timing of substantive procedures we need to consider ISA 315 Identifying and Assessing the Risks of Material Misstatement Through Understanding the Entity and Its Environment which requires the Auditor to obtain an understanding of the business and its internal control. In addition to ISA 330 The Auditor's Responses to Assessed Risks which requires the Auditor to determine overall responses to assessed risk at the financial statement level and design and perform further audit procedures to respond to assessed risks at the assertion level. ISA 330 requires that where there is a greater risk of material misstatement, then the greater the extent of substantive procedures required. Because the risk of material misstatement takes account of internal control, the extent of substantive procedures may be increased because of unsatisfactory results from tests of the operating effectiveness of controls.

The auditor should perform substantive procedures that are specifically responsive to the assessed risk. For example, if the auditor identifies that management has a tendency to inflate profits since their performance bonuses are based on this, then they will focus their testing on the possibility of overstated or inflated revenue, aggressive revenue recognition policies and potentially understating expenses. In these circumstances, the auditor might e.g. check in detail sales agreements and contracts, revenue recognition policies in line with industry standards; review post year end credit notes and test for unrecorded liabilities at the year end.

Where risks are low and controls are well established and when tested are operating effectively, then in some cases the substantive tests may consist entirely of substantive analytical procedures and this may be sufficient to reduce the risk of material misstatement to an acceptably low level.

In relation to timing, in some circumstances, ISA 330 notes that substantive procedures may be performed at an interim date. This would only be acceptable where the assessment of inherent and control risk was low. In general, interim audit work would comprise testing controls rather than substantive tests.

1 mark for each relevant discussion point up to a maximum of 6

(b) Inherent risk at the financial statement level

At this level inherent risk relates to factors affecting the susceptibility to misstatement of all account balances or transactions classes. In assessing inherent risk at the financial statement level the auditors will consider factors such as:

- The nature of the entity's business e.g. construction business may be more risky in today's climate.
- The quality and experience of the management team.
- The level of competition in the marketplace.
- The complexity of the operations.
- The levels of cash or high value items held.

- Trading history of the business.

Inherent risk at the account balance level

Inherent risk at this level relates to factors specific to that account balance or transaction class that affect its risk of misstatement relative to other account balances and transactions classes. The auditors will consider factors such as:

- The susceptibility of these account balances or classes of transaction to misappropriation.
- The complexity of the transactions.
- The degree of judgment involved and the extent of estimation necessary.
- Errors found in previous audits.

1 mark for each point up to a maximum of 5.

SOLUTION 7

(a) In general this document is there to ensure all relevant matters are attended to before the audit report is signed and to consider the total of all unadjusted errors.

It will include an overview of the business for the period with a commentary on significant changes during the year and reference to final analytical review.

It will identify problems with the financial statements such as:

- Failure to comply with statute or other regulations
- Failure to comply with GAAP, International Financial Reporting Framework etc.
- Significant changes in accounting policies
- Significant estimates/ judgements used in the financial statements

And include details of audit issues arising such as:

- Particulars of significant changes to the audit strategy including risk and materiality
- Information re: significant audit queries or matters still to be resolved
- Summary of adjustments agreed and made in the financial statements.
- Summary of unadjusted errors - aggregate of auditors estimates of likely misstatement
- Overall conclusion on the implications of this misstatement on the audit opinion.
- Conclusion on pending litigation
- Information on non-compliance with laws/ regulation
- Inconsistencies in other information e.g. Directors Report, Chairs Statemen
- Any other matters of importance for the Partner’s consideration.

1 mark for each well made point up to a maximum of 5 marks

(b) In deciding the type of report or modification, if any, Ada Jalloh will take into account such considerations as follows:

- Uncertainty of outcome
- Likelihood of error.
- Expertise of the auditor and evidence used or additional evidence required in order to reach a conclusion
- Discussions with management/ those charged with governance in relation to the item.
- Pervasive impact on the financial statements
- Inherent importance of the item and its materiality.

1 mark for each point up to a maximum of 5 marks

(c) Situation 1

In gathering her evidence Ada Jalloh would have confirmed the uncertainty of the outcome of the lawsuit with Food Ltd's solicitors through a solicitor's confirmation letter. With Foods Ltd's consent Ada might want to get an opinion of another solicitor. If legal solicitors cannot give an opinion on the outcome of the lawsuit, it would be unreasonable to assume Ada will have the expertise necessary to make this decision.

But she should have the expertise to evaluate the effect on the financial statements if the lawsuit is lost. In this evaluation she should consider the impact of the uncertainty or possible closure on the business. Her evaluation of the aggregate effect of an adverse decision will determine the type of report she will issue. If she concludes that the consequences of losing the lawsuit are of such a widespread nature as to have a pervasive impact on the financial statements and that the company cannot continue as a going concern, she will most likely issue a disclaimer of opinion because she does not have the expertise to evaluate the outcome of the case.

In reaching her decision, Ada must consider the validity of the statements made by management – namely, that the purchase of the required equipment is not economically feasible, that the plant would have to be closed, that the plant and equipment would have only minimal resale value, and that the production could not be recovered at other plants. In this respect, Ada should consider any past experience of Food Ltd's or other similar companies. For example, if Food Ltd had been required to install pollution-control equipment in other plants and had done so economically, Ada may consider Food Ltd's statement on the current situation as overreacting. If this were the case, Ada may need to re-evaluate the relative magnitude of the monetary impact of closing the plant in relation to an independent evaluation of the economic feasibility of installing the pollution-control equipment.

Ada must also consider how long it will take before there is an impact on the financial statements. There may be evidence that the case will be litigated for a number of years; or, if the case is lost, that the court may allow Food Ltd an extended period of time to install the pollution-control equipment. Under these circumstances Ada may consider the possible outcome to have little effect on decisions applicable to the current financial statements and would also give the company time to increase its ability to absorb the impact of an adverse decision. Thus, this exception may not be relevant to the current year's report.

1 mark for each well made point up to a maximum of 5 marks

Situation 2

In situation 2, Ada must again consider the relative magnitude of the monetary effect in relation to other items in the financial statements. We are told that the level of expense not recorded in the Income Statement / Profit and Loss Account is material. Since it was capitalised instead of being expensed, it means that the profits and assets in the financial statements are overstated by a material amount. This is a disagreement with accounting treatment and Ada needs to consider the extent of the error. If it is material but not pervasive then a qualified audit report is needed outlining that "except for" the disagreement the financial statements are true and fair. However, if it is so material as to be pervasive / fundamental to the financial statements then and adverse opinion is needed.

In reaching a decision, Ada must evaluate the underlying documentation and especially the levels of expenditure on research and development. Ada should have studied invoices supporting the recorded amounts and also minutes where the project is discussed.

In addition, while gathering evidence for reaching this decision, Ada might want to consider whether any of the expense warrants capitalisation and to do so it needs to all the criteria for development, including having a marketable product.

Ada should also consider the nature of the item – is there a question of whether Food Ltd can continue as a going concern e.g. if it cannot market the new product?

1 mark for each well made point up to a maximum of 5 marks

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AUDITING
LEVEL 2
L2.5 EXAMINATION FORMAT REVISION QUESTIONS & SOLUTIONS

NOTES
You are required to answer ALL THREE questions in Section A and TWO of the four questions in Section B (If you provide answers to more questions than required in Section B, you must draw a clearly distinguishable line through the answers not to be marked. Otherwise, only the first two answers to hand will be marked.)

TIME ALLOWED:
3 hours, plus 10 minutes to read the paper.

INSTRUCTIONS:
During the reading time you may write notes on the examination paper but you may not commence writing in your answer book.

Marks for each question are shown. The pass mark required is 50% in total over the whole paper.

Start your answer to each question on a new page.

You are reminded that candidates are expected to pay particular attention to their communication skills and care must be taken regarding the format and literacy of the solutions. The marking system will take into account the content of the candidates' answers and the extent to which answers are supported with relevant legislation, case law or examples where appropriate.

List on the cover of each answer booklet, in the space provided, the number of each question(s) attempted.

Editor's note: Your answer should show that you understand the subject matter displayed in the question. The longer the answer (the more verbose it is) the harder it will be for the examiner to mark. So be succinct and leave out the padding unless you deem it really necessary!

THE INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

L2.5 - AUDITING

EXAMINATION FORMAT-REVISION QUESTIONS AND SOLUTIONS

SECTION A – Questions 1, 2 and 3 are compulsory.

QUESTION 1

You are currently planning the audit of Glass Ltd, for the year ended 31 August 2011. Glass Ltd manufactures glassware to sell to retailers throughout the country. You are drafting the audit programme for inventory and have obtained the following information from the previous audit files, the client's draft financial statements and discussions with the client's management and staff:

- Year-end inventory is expected to be as follows:

	RWF '000
Raw materials	630
Work in progress	625
Finished goods	1,110
Goods bought for resale	540
	2,905

- Inventory at the end of year represents 30 % of total assets.
- Inventory is stored in five warehouses, one is situated in the manufacturing plant close to your firm's offices but the other four are situated around the country. Once goods are manufactured they are transported to the other warehouses for storage. This enables Glass Ltd to supply all their customers in a timely and cost effective manner.
- A fully integrated inventory and work in progress system is used. This was upgraded during the year and appears to be working well. There were some problems with a breakdown in the system prior to the upgrade.

- In the previous year's audit, there was a large adjustment made for damaged finished goods. It was also decided to reduce slow moving goods for resale down to their net realisable value.
- At the year end, there will be a full inventory count taking place. A perpetual inventory system is used.
- From your experience in previous years, you know that the company has strong controls over inventory and a reliable inventory system.

REQUIRED:

(a) From the information provided, identify three key financial statement assertions for the audit of inventory at Glass Ltd. and explain the risks / issues associated with these key assertions.

(6 marks)

(b) Describe the audit procedures which should be undertaken to address the specific issues and the assertions identified above.

(14 marks)
(Total: 20 marks)

QUESTION 2

ISA 320: Materiality in Planning and Performing an Audit was revised under the Clarity project to ensure greater consideration of not just the size of an item, but also the nature and circumstances surrounding the item.

REQUIRED:

(a) Explain what is meant by "materiality" and "performance materiality".

(5 marks)

(b) Appraise each of the following situations and based on the information provided calculate the materiality, detailing the judgements used in each case.

(i) Spring Limited has been a client of your firm for over 4 years. It operates in the telecommunications sector and has maintained good results over the last three years, when other competitors have had declining profits. Its revenue for this year is RWF 15 million, with net profit of RWF 1.5 million. It has total assets of RWF 7.5 million of which RWF 3 million relates to development costs. You notice from previous audit files that there have been few audit adjustments arising over the last 4 years, due to the excellent control system operated by Spring and their well-qualified accounts team.

(5 marks)

(ii) Summer Limited is a large national charity which has been a client of your firm for several years. They get some government funding but are successful due mostly to the very large level of public donations they manage to secure every year. This year is no exception. They rent premises and do not have large levels of administration overheads. Most of the funds received are spent within 12 months. They have total income this year of RWF 22 million (last year RWF 18 million) of which RWF 4 million relates to government funding (last year RWF 6 million). The Statement of Financial Position has a balance of RWF 2 million consisting almost entirely of bank and cash balances. This is similar to last year.

(5 marks)

(iii) Autumn Limited is a property development company and a new client for your firm this year. They have declining revenue due to the current economic climate. At the beginning of this year, they held in inventory, a large bank of unsold properties. During the year they have started to rent the properties out and have transferred them from inventory to investment property. Revenue this year is RWF 10 million with net profit of RWF 0.5 million. They have total assets of RWF 17.5 million, of which RWF 12.5 million relates to investment property and total liabilities of RWF 11.5 million consisting almost entirely of bank loans.

(5 marks)
(Total: 20 marks)

QUESTION 3

You have completed the audit work for Caravan Limited, a company which operates caravan parks. The following two situations may have an impact on the audit report to be issued to the company for the year ended 30 June 2011.

(i) In three particular sites many of the caravans are nearing the end of their useful economic lives. The caravans have previously been depreciated at 10% straight line but the company has decided to change the rate to 5% per year for the year ended 30 June 2011.

(ii) Caravan hopes to upgrade many of their sites in the coming year and is in discussions with the bank to extend their existing loans. The bank is currently unwilling to do this without seeing further private investment in the company. At the year end, this additional investment has not been forthcoming, but the directors believe they will be able to secure it in the next few months.

REQUIRED:

(a) Outline the six types of audit report and explain under what circumstances these should be issued. Give one example of each type of circumstance to support your explanation.

(12 marks)

(b) Discuss the impact of the two situations noted above on your auditor's report for Caravan Ltd for the year ending 30 June 2011.

(Note: Candidates are not required to reproduce the audit report / audit opinion paragraph.)

(8 marks)
(Total: 20 marks)

SECTION B– Answer 2 questions from 4,5,6 and 7.

QUESTION 4

Your firm of Certified Public Accountants audits CashCow Ltd. It is now 5th August 2011 and you are currently in charge of auditing the bank and cash section and have received the following bank reconciliation from the client as at 30 June 2011. The client performs quarterly bank reconciliations and their year-end is 30 June 2011. You have revised the bank reconciliation received to show the 'date through bank' (the date the cheques and lodgements appeared in July's bank statement).

			Dr	Cr
			RWF	**RWF**
Balance per bank statement 30 June 2011				29,685
Add: Outstanding lodgements:				
Cash Book Date		**Date through Bank**		
20-Jun		05-Jul	6,890	
24-Jun		30-Jun	3,335	
27-Jun		01-Jul	2,350	
28-Jun		05-Jul	135	
29-Jun		06-Jul	1,897	
30-Jun		07-Jul	733	
30-Jun		Not yet cleared	362	
				15,702
Less: Outstanding cheque payments:				
Cheque Book Date	**Cheque No**	**Date through Bank**		
30-Dec	1171	Not yet cleared	1,612	
24-Apr	2163	Not yet cleared	2,672	
30-Jun	2164	19-Jul	10,567	
30-Jun	3175	18-Jul	9,330	
30-Jun	3176	20-Jul	1,231	
30-Jun	3177	21-Jul	20,750	
30-Jun	3180	19-Jul	15,988	
30-Jun	3181	21-Jul	9,525	
30-Jun	3182	Not yet cleared	7,500	
				-79,175
Unreconciled balance carried forward from 31 March 2011				5,690
Balance per client's records at 30 June 2011				-28,098

REQUIRED:

(a) Which matters should cause concern with the client's bank reconciliation and what investigations should be carried out on these items?

(14 marks)

(b) Discuss the procedures that must be followed prior to obtaining a bank confirmation and detail the evidence that should be obtained from such a confirmation.

(6 marks)
(Total: 20 marks)

QUESTION 5

Your firm of Certified Public Accountants has had a large number of applicants for a recently advertised vacancy. It has been decided to test applicants' knowledge of some aspects of auditing in the initial interview. The senior partner has asked you to prepare sample answers to the following questions that will be used by the interview team in the initial screening interviews:

REQUIRED:

(a) What is the difference between a test of transactions and a test of balances?

(4 marks)

(b) What are the key considerations for an auditor in addressing sampling risk?

(4 marks)

(c) Explain why an auditor performs cut-off testing on purchases and accounts payable.

(4 marks)

(d) State FOUR follow-up procedures where an auditor has not received a response to an accounts receivable confirmation.

(4 marks)

(e) Identify what should be included in an audit working paper.

(4 marks)
(Total: 20 marks)

QUESTION 6

Cosmo's Chemicals Limited (CCL) provides laboratory services to a wide range of clients such as cosmetics and pharmaceutical companies. Typical services include testing of new drugs and products on humans and animals.

The annual audit is nearly complete. As audit senior, you have reported to the engagement partner that CCL is having some cash flow difficulties. In addition, in the Statement of Comprehensive Income for the year, income has fallen due to the adverse effect of two high-profile court cases, where CCL's processes where found to be both incomplete and inconsistent with ethical standards. Not only did this provide adverse publicity for CCL, but a number of major clients withdrew their contracts. A senior employee then left CCL, stating lack of investment in new methods of testing, increasing the risk of loss of market share.

A cash flow forecast prepared internally shows CCL requiring significant additional cash within the next 12 months to maintain even the current level of services. The bank has requested that CCL's auditors provide a review of this forecast.

REQUIRED:

(a) Define 'going concern' and discuss the auditor's responsibilities in respect of going concern.

(5 marks)

(b) Discuss the audit procedures that should be carried out to try to determine whether or not CCL is a going concern.

(8 marks)

(c) Explain the audit procedures the auditor should take where the auditor has decided that CCL is unlikely to be a going concern.

(4 marks)

(d) In relation to the review of the cash flow forecast, explain what a review engagement means for the auditor and for CCL's bank.

(3 marks)
(Total: 20 marks)

QUESTION 7

Your firm of Certified Public Accountants have recently gained a new audit client, Fedal Limited (Fedal). The previous external auditors identified some employee fraud which had been perpetrated by a group of employees over several years. The fraud was only discovered in last year's audit. As a result of the extensive fraud, Fedal have developed an internal audit function comprising a highly experienced chief internal auditor and two part-qualified staff. Your audit partner is keen to ensure that this year you will work closely with the new internal audit function to ensure that any further fraud is identified.

You are aware that ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements, deals with an external auditor's responsibilities however, both internal and external auditors are required to deal with risks to the entity and this includes risks associated with fraud and error.

REQUIRED:

(a) Explain how this new internal audit function can help Fedal deal with the risk of fraud and error.

(4 marks)

(b) Discuss the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements.

(12 marks)

(c) Identify what additional roles the internal auditors may have within Fedal.

(4 marks)
(Total: 20 marks)

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SUGGESTED SOLUTIONS

SOLUTION 1

(a) Identify the key financial statement assertions for the audit of inventory at Glass Ltd.

Completeness

- There was a breakdown in the system during the year which may pose problems identifying that the inventory is complete at the end of the year.

Existence

- Inventory comprises 30% of total assets so it would therefore be material.
- There would be difficulty in ensuring the existence assertion because there are 4 warehouses which are not located close to your offices.

Valuation or measurement

- Work in progress would be very difficult to measure for this type of product.
- There would be concerns about valuation because of the susceptibility of the product to breakage and damage.
- There is potentially a valuation problem with the goods bought for resale as this was a significant adjustment in last year's audit.
- Breakdown in the system may pose problems for inventory valuation.

(1 mark for the assertion and 1 mark for each point made up to a max.of 6 marks)

(b) Describe the audit procedures you would undertake to address the specific issues and the assertions identified above.

Specific Issue	**Assertion**	**Audit Procedures**
System breakdown	Completeness	Review the process used by the client to ensure all balances were maintained following the breakdown in the system. Use the information from the full count to ensure the final balance on the system is reliable. Take a sample of goods from order to GRN to the system to ensure the system records the items received correctly. Use analytical procedures to

		compare margins to previous years and to similar industries. Compare balances held at the end of the year over each category to ensure balances are reasonable. At the inventory count select a sample of goods from the floor and trace to the sheets to ensure completeness of stock. After the audit, agree the sample to the system to ensure they are recorded correctly.
Inventory represents 30% of total assets and is therefore material.	Existence	The auditor needs to attend the inventory count because inventory is material. For the 4 sites not close to the offices, associated firms could be used to assist or the audit staff will need to attend if the stock held is material.
Inventory is stored at warehouses not close to your offices	Existence	The auditor should select a sample of the largest inventory locations and observe (or arrange for another auditor – see above) to observe the physical count of the goods.
Upgraded system	All assertions	Review the controls operating over the new system. If reliance can be placed on the system it may reduce the required work at year-end.
Work in progress is difficult to measure. Where work in progress is material (as this is) reliance should not be placed on accounting records only.	Valuation (will also help with existence)	The auditor should ensure that there are no inventory movements during the inventory count. The auditor should observe all material items of work in progress and ensure that the percentage of completion allocated is reasonable.

Susceptibility of product to breakage and damage	Valuation	At inventory count review the condition of the breakage and damage inventory and ensure damaged or broken items are adjusted. Review provisions for damaged goods and ensure they are reasonable for the industry.
Goods bought for resale	Valuation	Identify any slow moving items via stock movement reports after the year end. At inventory count look for items that may potentially be difficult to sell. For a sample of goods test that NRV is > cost.

1 mark for each procedure up to a max. of 14 marks.

SOLUTION 2

Materiality: An item is considered material if its misstatement, omission or error would influence the economic decisions of the user of the information. Materiality is considered at the overall Financial Statements level as well as at the individual account balance/class of transaction level. Materiality is set at the planning stage but is reviewed throughout the audit. 10% or more of a particular balance is normally considered material at the individual account balance or class of transaction level.

(1 Mark)

Performance materiality: Planning the audit solely to detect individually material misstatements overlooks the fact that the aggregate of individually immaterial misstatements may cause the financial statements to be materially misstated, and leaves no margin for possible undetected misstatements. Performance materiality (which, as defined, is one or more amounts) is set to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements in the financial statements exceeds materiality for the financial statements as a whole. Many firms are using 60% of overall materiality as their performance materiality level.

(2 Marks)

Determining Materiality and performance Materiality when planning an audit

When establishing the overall audit strategy, the auditor shall determine materiality for the financial statements as a whole. If, in the specific circumstances of the entity, there is one or more particular classes of transactions, account balances or disclosures for which misstatements of lesser amounts than materiality for the financial statements as a whole could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements, the auditor shall also determine the materiality level or level to be applied to those particular classes of transactions, account balances or disclosures. (Ref: Para. A2-A1)

(2 Marks)

The auditor shall determine performance materiality for purposes of assessing the risks of material misstatement and determining the nature, timing and extent of further audit procedures. (Ref: Para. A12)

(b) (i) Spring limited has been a client of your firm for over 4 years. It operates in the telecommunications sector and has maintained its good results over the last three years when other competitors have had declining profits. Its revenue for this year is RWF 15 million with net profit after tax of RWF 1.3 million. It has total assets of RWF 7.5 million of which RWF

3 million relates to development costs. You notice from previous audit files that there have been very few audit adjustments arising over the last 4 years, due to the excellent control system operated by Spring and their well-qualified accounts team.

As a previous client with few adjustments in the past and a good accounting and internal control system, it is expected that materiality will be at the higher end of the range due to the low risk surrounding this client, although it is in a risky industry with high competition levels they do appear to be investing well in research and development with 40% of total assets comprising development costs.

(2 marks)

It is best to take an income statement measure here as it is predominantly a trading business.

(1 mark)

		RWF
1% of revenue	=	150,000
10% PAT	=	130,000
2% Total assets	=	150,000

It would appear reasonable to take RWF 150,000 (1% of revenue) as the figure for planning materiality based on the low levels of risk and the fact that it is a trading business.

(1 mark for calculation and 1 mark for final selection based on appropriate judgment.)

Tutorial note: Although the revised standard doesn't stipulate that a range should be used to get a reasonable figure, and one measure is acceptable under the standard, candidates may still feel comfortable looking at a range and selecting from this. For this purpose of this question, both methods are acceptable and marks will be awarded for strength of judgment and the calculation used, based on either one calculation or a range.

Summer limited is a large national charity which has been a client of your firm for several years. They get some government funding but are successful due mostly to the very large level of public donations they manage to secure every year and this year is no exception. They rent premises and do not have large levels of administration overheads, most of the funds they get are spent within 12 months. They have total income this year of RWF 22 million (last year RWF 18 million) of which, RWF 4 million relates to government funding (last year RWF 6 million). The Statement of Financial Position has a balance of RWF 2 million consisting almost entirely of bank and cash balances, this was similar to last year.

As a charity relying on donations, predictability of income is difficult. It would appear to be a low risk client in general but since there appears to be a large increase in public donations this year RWF 18 million compared with RWF 12 million last year (an increase of 50%).

With the economy in difficulties this would need to be investigated further and so for this year a higher level of risk should probably be taken, resulting in the lower range of materiality percentages being used. You could possibly base the materiality calculation over average figures but in this case, this may lower materiality further and result in excessive testing.

(2 marks)

It is best to take an income statement measure here as it is a charity with little reserves and a very light Statement of Financial Position consisting almost entirely of bank and cash balances.

	RWF
0.5% of income	= 110,000

(1 mark)

Lower materiality % of revenue being taken based on unpredictability of income and the usual results for this year.

(2 marks)

Autumn is a property development company and is a new client for your firm this year. They have declining revenue due to the current economic climate. As a result of their large bank of unsold properties held in inventory they started to rent them out and this year they have transferred them from inventory to investment property. Revenue this year is RWF 8 million with net profit of RWF 0.5 million. They have total assets of RWF 17.5 million of which RWF 12.5 million relates to investment property and total liabilities of RWF 11.5 million consisting almost entirely of bank loans.

New client in a risky industry this year and they have had to change strategy also this year so a high level of risk should be used resulting in lower materiality percentages being used. As it is an investment/ development business, it is best to use an asset based measure for materiality rather than a trading figure.

(2 marks)

	RWF
1% of Total assets RWF 17.5 million	= 175,000
2% of Net assets(Total assets RWF17.5 million- total liabilities RWF1.5 million)	= 120,000

For comparison

0.5% of revenue	= 40,000

It is best as mentioned to take an asset based figure here. The lower figure of RWF 120,000 should probably be taken as this is our first year and we would want to ensure we get a thorough understanding of the business and examine the business sufficiently well so the lower figure is the most appropriate to use this year.

(3 marks)

SOLUTION 3

(a) The six types of report are:

- Unmodified report. This report is used where the financial statements give a true and fair view or are fairly presented in all material respects. For this type of report to be issued the auditor should have been able to obtain sufficient, appropriate audit evidence suitable to base their opinion on. They should be able to give reasonable assurance that the financial statements are free from material misstatement whether caused by fraud or error. In addition they should be content that the financial statements are prepared under an applicable accounting framework including relevant laws and that the accounting policies used are appropriate.

- ISA 706 deals with emphasis of matter paragraph within the audit report. In this case the audit report is not qualified but is modified by the addition of an emphasis of matter paragraph. e.g. fundamental uncertainty regarding the company's ability to continue as a going concern.

- There are 2 types of qualified report. The report is qualified where the issue is material. Qualifications can arise under disagreement e.g. disagreement with an accounting policy or disagreement with accounting treatment or disclosure. Or the qualification can arise from a limitation in scope e.g. non-attendance at year-end inventory count where inventory is material but not fundamental to the financial statements.

- There is an adverse report where the disagreement is so significant that it is pervasive to the whole financial statements e.g. An error of such magnitude that the financial statements are misleading.

- The sixth type of report is a disclaimer of opinion, whereby the limitation in scope is so significant that it is pervasive to the financial statements e.g. destruction of banking records etc.

(1 mark for each report type and 1 mark for example up to a max.of 12 marks.)

(b) The first issue relates to a disagreement about accounting treatment. As the assets are nearing the end of their life it seems inappropriate to extend this life and reduce the depreciation charge. The impact would have to be reviewed against materiality to identify if it is a material error. If it is, then discussion with the directors would need to be undertaken to see if they are willing to revert to the previous treatment. If the directors are unwilling to change then the audit report would include an except for qualification since the impact is unlikely to be fundamental or pervasive to the financial statements but may be material. If the impact is not material then the issue can be ignored.

(1 mark for each well-made point up to a max.of 4 marks.)

The second issue relates to a potential fundamental uncertainty. The company already has loans and wish to get additional funding which at the year end is not forthcoming. Discussions with directors and a review of the going concern status of the company will have to be undertaken to identify if the company can survive in the future without this additional investment. If it seems that there is a fundamental uncertainty then this would require disclosure in the notes to the financial statements. From the detail given there would appear to be an impact on the going concern of the company and an emphasis of matter paragraph is needed although the audit report will not be qualified in this respect. If the Directors refuse to disclose the fundamental uncertainty then the report would be a qualified report under the basis of disagreement with accounting standards. If it is considered not to be a going concern issue following your review and discussion, then an unmodified report could be issued.

(1 mark for each well made point up to a max.of 4 marks.)

SOLUTION 4

(a) What are matters that cause you concern on the client's bank reconciliation and what investigations will you carry out on these items?

Matters of concern

Outstanding Lodgements:

- The late banking of lodgements. The delay appears on average to be about a week but in some cases it is taking longer for the lodgement to clear the bank and the last one has not yet cleared and it is now August. This could indicate fraud due to teeming and lading.

Outstanding Cheques:

- The delay in clearing cheque payments to vendors. The delay appears to be between 2 to 3 weeks. It seems probable that the cheques were sent out after the year-end, rather than before the year-end. This could be a potential misallocation between cash and payables.

- There is one very old outstanding cheque dated Dec which has not yet cleared. As it is over 6 months old it needs to be written back to the supplier's account if it was a supplier cheque otherwise write back to expenses. There is also one dated April which has not yet cleared the bank and this should also be investigated as it might merit write back also.

- There appears to be a break in sequence for those cheques dated 30 June (from 3177 to 3180) this needs investigation as could indicate missing cheques, poor controls over cheque sequencing or fraud, since it's unlikely that a cheque dated 30 June would have cleared the bank the same day.

Other:

- The unreconciled balance of RWF 5,690 does not appear to have been investigated and adjusted and has been carried forward for one quarter now.

- Quarterly bank reconciliations would not be appropriate for a business of this apparent size and where bank overdraft is almost RWF 30k.

(1 mark for each point of concern up to a max of 6)

Investigations

- Delays in banking

Check the date stamped by the bank on the paying in slip. If this is the same date as on the bank statement, then this is the actual date the cash was paid into the bank.

Check the amount banked agrees with the remittances/ receipts for the date shown in the cash book. This will determine whether there is a delay in banking cash received. If there is a delay you should ask if there is cash for sales which are unbanked and how it is held. If there is no cash, a fraud is probably taking place.

- Uncleared cheques

For old outstanding cheques not yet cleared, discuss with the accountant, the possible reasons for the supplier not cashing the cheque. Review the supporting documentation and subsequent cheques and invoices for the particular supplier to determine if a write back is required. Do this also for the April cheque.

For the delay in cashing cheques, check the client's procedures for sending cheques to suppliers if there appears to be a review of cheques before mailing it could indicate a delay at the year end and may warrant a write bank as suggested above. Ask the accountant if cheques are held before release to supplier as this might also require a write back. Review the types of suppliers to the company, if many of the suppliers are foreign then a two to three week period to cash is not unusual. Review last year's work to see if a similar pattern appeared then.

Review the suppliers' statements and check the date cheques were received per their records. If this date is similar to the bank statement it is further evidence that cheques were not posted before the end of the year.

- Sequencing

Request sight of the cheque book and identify when the unsequenced cheques were written. This would indicate if they were written and cashed prior to the year end and you can make inquiries as to why such a break in cheque writing sequence has happened. You can request return paid cheques for the bank for further evidence as to what these cheques were used for and who signed them.

The cheque book might indicate that these are cancelled cheques and as such you would like to see the original cancelled cheque still in place.

If they are cheques that had a post year end date on them you would review later bank statements to see when they were cleared but it would also beg the question as to why the sequence was broken, and may require a point in the letter of recommendation to management in relation to lapsed controls.

- Other

You would want to see the investigation by the client into the unreconciled balance and why they were not in a position to clear this amount. If the investigation was insufficient then this may require a point in the letter of recommendation to management in relation to poor controls. You would also make the point that monthly reconciliations are a stronger control for this company.

You should review the July reconciliation (if there is one – unlikely with quarterly reconciliations) or wait until the September reconciliation to see if the amount has been subsequently cleared. If not then it should be noted on the summary of unadjusted errors for later review or if material it should be adjusted as it causes the bank balance to be overstated by RWF 5,690.

(1 mark for each investigation up to a max of 8)

(b) Outline procedures that must be followed prior to obtaining a bank confirmation and what evidence you will obtain from such a confirmation.

The banks will require explicit written authority from the client to disclose the information requested by the auditor and the auditor needs to refer to this in their letter. The client's authority to permit disclosure should be obtained before the standard bank letter is sent. The auditor prior to the year-end date should request directly from the clients bankers, confirmations detailing the following:

- All accounts held by the client, e.g. current accounts, deposit accounts, loan accounts, foreign currency accounts and other advances or facilities.
- All accounts closed during the year.
- Accrued charges e.g. bank charges and accrued interest.
- Analysis of charges i.e. the separation.
- Set off i.e. the right to set a current deposit balance off against a facility granted by the bank.
- Security for any bank overdrafts/loans including details of charges, mortgages or other claims.
- Liens – any assets held by the bank for safe custody may be subject to some form of banker's lien

- Dates of the next loan/overdraft review.

The evidence gained from the confirmation (as outlined above) will cover the existence assertion and will help with valuation, rights and obligations and completeness.

(1 mark for each point made up to a max of 6.)

SOLUTION 5

(a) What is the difference between test of transactions and test of balances?

Tests of transactions are audit procedures related to examining the processing of particular classes of transactions through the accounting system and are usually performed for income statement areas such as sales, purchases and payroll but also for accounts such as property and equipment, long-term debt, and equity.

(2 marks)

Tests of balances are substantive tests that either provide reasonable assurance of the validity of a general ledger balance or identify a misstatement in the account. When testing balances the auditor is concerned with overstatement or understatement of the balance in the financial statements. These tests are used to examine the actual details making up high turnover accounts such as bank and cash, accounts receivable, accounts payable, etc. Tests of balances are important because the auditor's ultimate objective is to express an opinion on financial statements that are made up of account balances. In audits of small businesses, auditors may rely exclusively on tests of balances.

(2 marks)

(b) The following are the key considerations in addressing sampling risk:

- There is no magic formula that can be used and each situation will be different depending on such factors as the materiality and the number of items in the population being tested, inherent risk of errors arising etc.
- In light of the above the auditor needs to exercise judgment in selecting the sample in order to lower sampling risk.
- The risk that the auditor may not select a sufficient sample to detect errors –i.e. the risk of "incorrect acceptance"
- The need to ensure sample is selected from entire population and throughout the period
- The risk of "incorrect rejection" which arises when the sample indicates a higher level of errors than is actually the case. This situation is usually resolved by additional audit work being performed and alternative testing procedures being used.

(1 mark for each point made up to a max of 4.)

(c) The following are the reasons why an auditor performs cut-off testing on purchases and accounts payable:

- Ensures appropriate valuation in the accounts.
- Addresses risk of misstatement in the current years accounts and in the following years accounts.
- Partially addresses completeness audit objective on testing of accounts payable.
- Reduces the risk of manipulation of results when no proper cut off procedures carried out.

(1 mark for each point made up to a max of 4.)

(d) Where an auditor has not received a response to a receivables circularisation they would possibly carry out the following procedures:

- Follow up phone call to confirm balance directly.
- Review subsequent cash received post balance sheet date in an effort to confirm the existence and valuation of the debtor and amount at the year end.
- Review account history for payment patterns to mitigate the risk that it may be a bad debt.
- Verification of account balance to invoice/delivery dockets.
- Receipt of fax/email confirmation of existence of customer.

(1 mark for each point made up to a max of 4.)

(e) The working papers should contain at a minimum:

(1) information on planning the audit work;

(2) the nature, timing, and content of the audit procedures performed;

(3) the results of the audit procedures; and

(4) the conclusions drawn leading to an opinion.

(1 mark for each area identified up to a max of 4.)

SOLUTION 6

(a) Going concern means that the enterprise will continue in operational existence for the foreseeable future. It is one of the fundamental accounting concepts used by auditors and stated in IAS 1 Presentation of Financial Statements.

(1 mark)

The auditor's responsibility in respect of going concern is explained in ISA 570 Going Concern. The ISA states 'when planning and performing audit procedures and in evaluating the results thereof, the auditor should consider the appropriateness of management's use of the going concern assumption in the preparation of the financial statements'.

(1 mark)

The auditor's responsibility therefore falls into three areas:

(i) To carry out appropriate audit procedures that will identify whether or not an organisation can continue as a going concern.

(ii) To ensure that the organisation's management have been realistic in their use of the going concern assumption when preparing the financial statements.

(iii) To report to the shareholders and those charged with governance, where they consider that the going concern assumption has been used inappropriately, for example, when the financial statements indicate that the organisation is a going concern, but audit procedures indicate this may not be the case.

(3 marks)

(b) Audit procedures regarding going concern:

– Obtain a copy of the cash flow forecast and discuss with the directors.

– Discuss with the directors their view on whether CCL can continue as a going concern. Ask for their reasons and try and determine whether these are accurate.

– Enquire of the directors whether they have considered any other forms of finance for CCL to make up the cash shortfall identified in the cash flow forecast.

– Obtain a copy of any interim financial statements of CCL to determine the level of sales/income after the year-end and whether this matches the cash flow forecast.

– Enquire about the possible lack of investment within CCL identified by the employee leaving. Review current levels of investment with similar companies.

- Consider the extent to which CCL relied on the senior employee who recently left the company. Ask the human resources department whether the employee will be replaced and if so how soon.

- Obtain a solicitor's letter and review to identify any legal claims against CCL related to poor standards.

Where possible, consider the financial impact on CCL and whether insurance is available to mitigate any claims.

- Review CCL's order book and client lists to try and determine the value of future orders compared to previous years.

- Review the bank letter to determine the extent of any bank loans and whether repayments due in the next 12 months can be made without further borrowing.

- Review other events after the end of the financial year and determine whether these have an impact on CCL.

- Obtain a letter of representation point confirming the directors' opinion that CCL is a going concern.

(1 mark for each valid procedure up to a max. of 8)

(c) Audit procedures if CCL is not considered to be a going concern

- Discuss the situation again with the directors. Consider whether additional disclosures are required in the financial statements or whether the financial statements should be prepared on a 'break up' basis.

- Explain to the directors that if additional disclosure or restatement of the financial statements is not made then the auditor will have to modify the audit report.

- Consider how the audit report should be modified. Where the directors provide adequate disclosure of the going concern situation of CCL, then an emphasis of matter paragraph is likely to be appropriate to draw attention to the going concern disclosures.

- Where the directors do not make adequate disclosure of the going concern situation then qualify the audit report making reference to the going concern problem. The qualification will be an 'except for' opinion or an adverse opinion depending on the auditor's opinion of the situation.

(1 mark for each point up to a max of 4)

(d) Review engagement

A review engagement will result in some level of assurance for the bank. The report provided will give what is called negative assurance. This means that nothing has come to the attention of an auditor which indicates that the cash flow forecast contains any material errors. The assurance is therefore given on the absence of any indication to the contrary.

In contrast, the audit report on statutory financial statements provides positive or reasonable assurance; that is the financial statements do show a true and fair view.

Using negative assurance, the auditor is warning users that the cash flow forecast may be inaccurate. Less reliance can therefore be placed on the forecast than the financial statements, where the positive assurance was given.

With negative assurance, the auditor is also warning that there were limited audit procedures that could be used; the cash flow relates to the future and therefore the auditor cannot obtain all the evidence to guarantee its accuracy. Financial statements relate to the past, and so the auditor should be able to obtain the information to confirm they are correct; hence the use of positive assurance.

(1 mark for each point up to a max of 3)

SOLUTION 7

(a) Internal audit can help management manage risks in relation to fraud and error by commenting on management's own risk management processes and the appropriateness and effectiveness of these processes.

They can also periodically review and audit the systems and/or operations to determine the risks of fraud and error and make recommendations for improvement in these systems and operations.

Internal auditors can also specifically test areas where the management or audit committee believe there is a serious risk of fraud or error and report back to management or the audit committee on their findings.

In practice, the work of internal audit focuses heavily on the systems of control set in place to ensure adequate procedures are there for preventing, detecting and reporting of fraud and error and as such they have a responsibility for identifying and reporting on fraud and error. However, it should be recognised that many significant frauds by-pass normal internal control processes e.g. management override of controls or management involvement in fraud. These are much harder for the internal auditor to identify and report.

(1 mark for each well made point up to a max. of 4 marks)

(b) External auditors: fraud and error in an audit of financial statements

(i) External auditors are required by ISA 240 The Auditor's Responsibilities Relating to Fraud in an Audit of Financial Statements to consider the risks of material misstatements in the financial statements due to fraud. Fraud is classified into two categories:

- Misstatements arising from fraudulent financial reporting and
- Misstatements arising from misappropriation of assets.

(ii) Their audit procedures will then be based on a risk assessment. Regardless of the risk assessment, auditors are required to be alert to the possibility of fraud throughout the audit and maintain an attitude of professional scepticism, notwithstanding the auditors' past experience of the honesty and integrity of management and those charged with governance. Members of the engagement team should discuss the susceptibility of the entity's financial statements to material misstatements due to fraud.

(iii) The auditor is required to consider, as part of the planning, risk identification and assessment process, the accounting and internal control systems that management has put in place in order to address the risk of material misstatements in the financial report arising from fraud. The auditor needs to be aware of the distinction between management and employee fraud and where they uncover fraudulent activity they need to report to the appropriate level of management - normally the Board or Audit Committee.

(iv) Auditors should consider fraud risk factors, unusual or unexpected relationships, and assess the risk of misstatements due to fraud, identifying any significant risks. Auditors should evaluate the design of relevant internal controls, and determine whether they have been implemented.

(v) Auditors should determine an overall response to the assessed risk of material misstatements due to fraud and develop appropriate audit procedures, including testing certain journal entries, reviewing estimates for bias, and obtaining an understanding of the business rationale of significant transactions outside the normal course of business. Appropriate management representations should be obtained.

(vi) Auditors are only concerned with risks that might cause material error in the financial statements.

External auditors might therefore pay less attention than internal auditors to small frauds (and errors), although they must always consider whether evidence of single instances of fraud (or error) are indicative of more systematic problems.

(2 marks for each area covered (1 mark if discussion is limited) up to a max. of 12 marks)

(c) Additional roles internal auditors have within a business:

Internal audit can:

- Assist with risk management, establishing and maintaining good systems of internal control.
- Help with implementation of new accounting standards.
- Review all policies and procedures to ensure best practice and better performance for the organisation.
- Audit areas not audited by external auditors specifically operational areas.
- Liaise with external auditors to improve audit quality and audit economy.
- Identify efficiencies in systems and processes through e.g. VFM or Best value audits.
- Any other areas identified.....

(1 mark for each point up to a max. of 4 marks)