INSTITUTE OF CERTIFIED PUBLIC ACCOUNTANTS OF RWANDA

Driving Sustainable Performance

CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE & ASSURANCE SERVICES

TUESDAY: 28 NOVEMBER 2017

INSTRUCTIONS:

1. **Time Allowed: 3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
2. This examination has two sections; A & B.
3. Section A has one Compulsory Question while section B has three (3) questions to choose any two (2).
4. In summary attempt three (3) questions.
5. Marks allocated to each question are shown at the end of the question.
6. All iCPAR Examination rules and regulations apply.

SECTION (A)

This is a compulsory question

QUESTION ONE
RWANDA MOTORS LIMITED (RML)

Rwanda Motors Limited (RML) is a company registered under the companies' law of Rwanda. The company is located in Kigali industrial area and its principal activities are truck and motor vehicle dealership and the leasing of motor vehicles. The company has the following departments that include finance and administration; sales and customer care; repairs and maintenance; and inventory management. You are the audit manager in KTL & Co, and you are in charge of the RML audit for the year ended 30 June, 2017.

Pre-audit meeting notes:

During the pre-audit meeting between the audit team and the management of RML, the following issues were discussed:

1. RML imports brand new vehicles from manufacturers in France and Japan under dealership arrangements. Rwanda Revenue Authority charges taxes (value added tax-VAT which is claimable and stamp duty which is a final tax) on all vehicle imports. All taxes are included in the cost of purchase of the vehicles under property and equipment.
2. RML purchased a software license from Germany at a cost of Frw 1.2 billion for tracking of all its vehicles under operating lease arrangement on 31 December, 2016. The license is intended to last 5 years from the date of purchase. Some of RML's vehicles are purchased by clients under lease arrangements with an option to purchase them at end of the lease term and RML has a responsibility to service those vehicles and therefore the need to track their movements. Due to some technicalities, however, the software was not able to be used until 1 March, 2017 but the license was recognised on 31 December, 2016 in the books of RML at its cost and amortised using the reducing balance method. Some of the clients are also finding the tracking devices in their vehicles inconveniencing due to noise and have raised complaints to RML to have the devices removed.
3. RML entered into a joint venture with BMK Motors Limited to supply to the government vehicles for a world conference held in Kigali in January, 2017. RML has 50% shareholding in RBMK Motors Limited, the new company jointly managed with BMK, at a cost of Frw 3.5 billion. RML has accounted for its shares in RBMK Motors Limited as a joint venture in its financial statements.

4. Included in the inventories of Frw 1.4 billion are spare parts that were intended to be used on one of the vehicle brands but management decided not to import these vehicles until further notice due to difficulty in finding market for such vehicles. Management took a decision during the year to dispose of these spare parts through sale.
5. Included in trade and other receivables is an insurance premium of Frw 3 billion. RML pays insurance premium to PTK Insurance Company every 1 January of year covering a period of 12 months.
6. Interest bearing loans and borrowings were acquired from foreign lenders and the principal and interest are payable in USD on a quarterly basis. When customers approach RML for vehicles under lease arrangements, RML then obtains a loan equivalent to the present value of the lease agreement signed with the client. RML has a right to substitute the vehicles under lease at any time during the lease period.
7. Withholding tax of Frw 500 million charged on vehicles purchased by the Government entities and other suppliers with the mandate to withhold is also included in trade and other receivables.
8. The company made a turnover of Frw 20 billion, and profit before tax of Frw 1 billion resulting into a net profit of Frw 601 million for the year ended 30 June, 2017. This is attributed to the company's strategic plan aimed at aggressive marketing. The company had earlier made losses in its first 5 years of operation and as a result have accumulated tax carried forward losses which now stand at Frw 1 billion.

Audit evidence on current audit file:
On completion of the field audit at RML, the audit team has handed over the current audit file to you for review which includes the information below:

1. Revaluation of land:

RML purchased 20 acres of land in the industrial park of Kigali at a cost of Frw 1 billion during the year ended 30 June, 2015. During the year ended 30 June, 2017 management realised that the 20 acres of land in the same area were selling at Frw 4 billion. Therefore, they decided to adjust the value of its land to Frw 4 billion. Land is therefore stated at the revalued amount in the financial statements basing on management estimates. The audit team was informed by the finance director that it is true that land in the industrial park has a market value of Frw 200 million per acre. A file note has been included among the working papers to support the revaluation by management.

2. **Provision for legal suit by a client:**
While auditing RML's trade and other payables, the audit team selected to audit material balances among them a provision of Frw 1 billion made by management in relation to the law suit by a client who claims to have been billed fictitious motor vehicle repairs and maintenance cost to the tune of Frw 100 million over a period of 3 years. Management is not sure whether they will win or lose the case but prefer to make a provision. The audit team inquired from management why a provision was made and the response was that it was safer to make a provision in case they lost the case. The audit work completed on provisions is a letter of representation from RML's directors.

3. **Related party transactions:**
While auditing trade and other receivables, the audit team selected material balances relating to related parties of RML. It was noted in the working papers of the audit team that KTL & Co. are the auditors for the other 3 companies related to RML.
The work done on related party balances was to reconcile and agree balances held by RML with the three related party companies and obtaining a letter of representation. The balances agree except for one company that used a different closing exchange rate to translate its balances to Frw from USD. An audit adjustment has been agreed upon with management to correct the balances relating to exchange rate.

4. **Purchase of inventory:**
The general manager/ CEO who is a principal signatory to RML's bank accounts makes direct payments to suppliers of spare parts in France and Japan after notification from the inventory manager of the need to buy inventory. The audit work completed on the purchase of inventory was to trace the payments on the bank statement back to inventory ledger.

5. **Intangible assets:**
The audit team selected to audit the software license purchased from Germany at a cost of Frw 1.2 billion. The audit work done on software license involved a review of board minutes for approval, review of payment voucher and all necessary supporting documents of which copies were filed on the current file. No further procedures were carried out.

The internal control system at RML:

1. **Inventory:**
   The general manager/ CEO makes direct payments to suppliers of the motor vehicle spare parts in France and Japan after making judgement of the need to purchase spare parts. The finance department gets to know about the transactions during their routine bank statement reconciliations.

2. **Cash receipts:**
   Some of RML's clients are walk in customers who pay cash for spare parts. The cashier receives the cash and issues receipts to the customers who proceed to the spare parts section to receive the items purchased. Cash received may be used for other operational purposes in the respective departments when the need arises and the balance banked if significant.

3. **Board of directors:**
   RML's board is composed of 5 members. Four of the board members are also board members of RML's associates and business ventures. Two of the board members are medical doctors and two are chemists while the fifth one is an accountant by profession. All the 5 board members are full time practitioners of their respective professions and do not sit on boards of any other companies. 4 of the directors are close friends with the majority shareholder.

4. **Interest-bearing loans and borrowings:**
   Interest payable on interest-bearing loans and borrowings to foreign lenders are subject to withholding tax as per the Income Tax Act. RML opted to pay the interest and principal to the lenders as RML does not want to get involved in tax issues for third parties. The following are RML's financial statements for the years ended 30 June, 2017 and 30 June, 2016.

Statement of financial position for the year ended 30 June:

	2017	2016
	Frw '000'	**Frw '000'**
Assets:		
Non-current assets:		
Property and equipment	12,960,500	11,658,000
Intangible assets	2,500,000	1,200,000
Investment in associate and joint venture	4,825,000	1,540,000
Non-current financial assets	2,086,000	350,700
	22,371,500	**14,748,700**
Current assets:		
Inventories	1,400,000	1,300,000
Trade & other receivables	9,265,000	9,193,000
Income tax	305,000	241,000
Cash and short-term deposits	179,000	1,457,300
Assets held for sale	200,000	200,000
	11,349,000	12,391,300
Total assets	**33,720,500**	**27,140,000**
Equity & liabilities:		
Equity:		
Issued capital	100,000	100,000
Capital reserves	35,000	35,000
Revaluation reserve	3,000,000	-
Retained earnings	5,367,000	4,766,000
Total equity	**8,502,000**	**4,901,000**
Non-current liabilities:		
Interest-bearing loans and borrowings	9,904,000	7,311,000
Net employee defined benefit liabilities	500	400
Other liabilities	2,000,700	1,800,600
Deferred tax liabilities	326,000	326,000
	12,231,200	**9,438,000**
Current liabilities:		
Trade and other payables	5,197,300	6,438,000
Interest-bearing loans and borrowings	7,790,000	6,363,000
	12,987,300	12,801,000
Total equity and liabilities	**33,720,500**	**27,140,000**

REQUIRED:

(a) Determine RML's materiality levels at the planning stage of the audit.

(2 Marks)

(b) With reference to the pre-audit meeting notes and RML's Statement of financial position, prepare brief notes to the engagement partner evaluating the audit risks relevant to the planning of the audit of RML. **(16 Marks)**

(c) With reference to the audit evidence on the current audit file, discuss with the audit team the:

(i) Sufficiency and appropriateness of audit evidence on the audit file. **(10 Marks)**

(ii) Further audit procedures to be performed by the audit team. **(10 Marks)**

(d) With reference to the internal control system of RML; draft a management letter (on the issues raised under inventory, cash receipts, board of directors and interest bearing loans and borrowings) to the board of RML highlighting the:

(i) Weakness in the internal control system. **(4 Marks)**

(ii) The implication of the weakness in the internal control system. **(4 Marks)**

(iii) The recommendations to the board aimed at improving the internal control system. **(4 Marks)**

(Total 50 Marks)

SECTION (B)

Attempt two questions from this section

QUESTION TWO

KIVU Supermarkets Limited (KSL) has been operating a chain of supermarkets in Rwanda for the past 7 years. Your audit firm RTGS & Co. has been the auditors of KSL since inception. KSL's financial year end is 31 March of a given year.

(a) The following e-mail was recently received from the country manager of KSL to CPA Tom Kamanzi, the engagement partner at RTGS & Co.

Dear CPA Kamanzi,

Hope you and your team are fine. In addition to planning your audit engagement, I am also requesting that you perform for us the following assignments:

1. Carry out a due diligence assignment following a request of a new investor in the company.
2. Stand as a witness in court in a case where a supplier of dairy products sued KSL for failure to pay for products supplied to its outlets over a period of 6 months. We need you to testify in court that KSL is a going concern and that the complainant will eventually be paid.

   Please let me know your fees regarding the above two issues.

   Kind regards,
   Pius Keza.

REQUIRED:
In relation to Pius Keza's e-mail, comment on the ethical and professional matters RTGS & Co. is likely to face should the firm accept the two additional assignments. **(4 Marks)**

(b) You are the audit manager in charge of the audit of KSL for the year ended 31 March, 2017. During the audit, the audit team brings to your attention information that KSL is currently indebted to the banks to a tune of Frw 10 billion. KSL has held meetings with the banks to reschedule its loans to enable KSL pay off the loans which the banks have now agreed to. That evening as you watched the 9.00 p.m news on one of the local Television stations, it was reported that the tax authority carried out a tax audit of KSL resulting into a tax liability of Frw 2 billion. On inquiry from KSL management the following day, the directors reassured you of the shareholders' commitment to offer loans and additional equity to KSL. On visiting two outlets of KSL, you found that some supermarket shelves were empty. On inquiring from some of the workers at the supermarkets, you were told that some of the suppliers have not been paid for months and therefore decided to stop supplying their products.

REQUIRED:
Recommend to the audit team additional audit procedures to enable RTGS & Co. obtain sufficient appropriate audit evidence as to whether or not KSL will be in operation in the next 12 months from signing the audit report. **(10 Marks)**

(c) KSL's inventory counting is carried out on a continuous basis. Inventory balance as at 31 March, 2017 was worth Frw 2 billion at cost. RTGS' assessment of closing inventory at net realisable value was Frw 1.5 billion. The variance of Frw 500 million was material.

KSL's inventory in the financial statements was stated at Frw 2 billion as management was not willing to make the adjustment to Frw 1.5 billion.

KSL's financial statements analytical review showed a net liability position of Frw 1.5 billion and a net loss of Frw 3.6 billion after the agreed audit adjustments suggested by the auditors to management. Note 6 of KSL's financial statements explain this and other issues in detail. KSL's financial statements are prepared in accordance with International Financial Reporting Standards (IFRS).

REQUIRED:

(i) Prepare a suitable audit opinion for KSL for the year ended 31 March, 2017. **(5 Marks)**

(ii) Prepare an emphasis of matter paragraph to be included in KSL audit report for the year ended 31 March, 2017. **(4 Marks)**

(iii) Discuss with your engagement partner the key audit matters to be included in RTGS & Co.'s audit report. **(2 Marks)**

(Total 25 Marks)

QUESTION THREE

The Africa Children Centre (ACC) is a Non-Governmental Organisation (NGO) established to carry out the work of promoting the human rights of vulnerable children and teenagers and environmental protection. ACC's year end is 30 June and over the past three years, it has received grants and donations from various donors/ funders as shown below:

Year	Frw 'million'
2015	4,000
2016	7,000
2017	9,000

The principal activities of ACC include the following:

1. Providing shelter to vulnerable children and teenagers abandoned by their parents.
2. Providing education to vulnerable children and teenagers in primary, secondary and tertiary institutions to enable them be self-sustaining and acquire the necessary skills to be competitive in the job market.
3. Finding job placements for those teenagers who have completed their tertiary education.
4. Their environmental protection policy requires them to plant a minimum of 100 trees annually. This is aimed at safeguarding the environment and is part of ACC's corporate social responsibility.

ACC's services are free of charge as long as the beneficiary satisfies the set policies, procedures and guidelines. There have been, however, accusations against the country director, Mr. Shema

Nkunda from a section of members of the general public in relation to abuse of office. Mr. Nkunda has been accused of taking bribes to include well-to-do beneficiaries on ACC's scholarship scheme. Information available indicates that the previous auditors had a disagreement about certain disclosures in the financial statements and the involvement of the country director in activities that are contrary to those of the organisation.

Your audit firm, CSK & Co. which only specialises in investigations and internal audit services, has been invited by the board of directors to investigate the allegations against Mr. Shema Nkunda and to carry out the statutory audit for ACC for the year ended 30 June, 2017. CSK & Co. has been providing internal audit services of ACC for the last 3 years. The board took a decision during the year to establish an internal audit department due to the increased volume of activities. Total revenue and budgeted expenditure is now Frw 9 billion. ACC has tasked CSK & Co. with the recruitment of staff for the internal audit department and to set up the department.

REQUIRED:

(a) Advise CSK & Co. on how to approach the investigation against Mr. Shema Nkunda. **(10 Marks)**

(b) CSK & Co. has a choice to either accept or decline the audit engagement. Discuss with the partners the factors they should consider in making this decision. **(6 Marks)**

(c) Evaluate the matters CSK & Co. will consider when recruiting employees of ACC internal audit department. **(6 Marks)**

(d) Set out the procedures the auditor will adopt to verify ACC's social corporate responsibility. **(3 Marks)**

(Total 25 Marks)

QUESTION FOUR

You are the audit manager at KYC & Co and your firm has been appointed to audit the financial statements of Top Financial Services (TFS) for the year ended 30 June, 2017. This is the first time your audit firm is undertaking an audit of a client in the financial services sector. TFS is a small-sized company offering financial services in Kigali province. At a pre-audit meeting held at TFS offices, George Biha, a board member made the following comments.

"The world today has witnessed corporations receive an unqualified audit report, and shortly thereafter collapse with the news that the financial statements were grossly misstated, for example, the recent scandals in South Africa. "How can this occur time and again unless there is something wrong with the way these companies are audited? Such is the question going through the minds of the public and the regulators. Audit failure cannot occur unless there is serious auditor error or misjudgment". At the same pre-audit meeting, the financial controller shared with KYC & Co the following actual and forecast cash flows for TFS for the periods then ended:

	June 2016	June 2017	June 2018
	Actual	**Actual**	**Projected**
	Frw '000'	**Frw '000'**	**Frw '000'**
Income:			
Interest on loans	1,095,000	1,100,000	1,298,000
Commission income	125,000	167,000	171,000
Other income	197,000	81,000	131,000
	1,417,000	1,348,000	1,600,000
Finance expenses:			
Interest on borrowed funds	295,000	286,000	286,000
Operating expenses:			
Salaries and benefits	755,000	788,000	843,000
Other operating expenses	411,000	434,000	458,000
Depreciation/ amortisation	50,000	49,000	73,000
Total operating expenses	1,216,000	1,271,000	1,374,000
Net operating profit/ (loss)	**(94,000)**	**(209,000)**	**(60,000)**

The following information was provided to support the forecasts:

Salaries and benefits are projected to grow at a rate of 7% in the year ending 30 June, 2018.

Interest on borrowed funds is expected to remain constant in the year ending 30 June, 2018.

Interest income is expected to grow at a rate of 18% in the year ending 30 June, 2018.

REQUIRED:

(a) Draft a memo to your engagement partner highlighting the matters that KYC & Co. should put into consideration to ensure that TFS audit engagement is effectively performed. **(9 Marks)**

(b) Discuss with your audit team the audit procedures that should be performed on the projected cash flow forecast of TFS. **(10 Marks)**

(c) Write an email to George explaining the causes of audit failure that is leading to corporate demise and the possible safeguards auditors can put in place. **(6 Marks)**

(Total 25 Marks)

End of question paper