

**CERTIFIED PUBLIC ACCOUNTANT
INTERMEDIATE LEVEL EXAMINATION**

II.4: AUDITING

FRIDAY: 4 DECEMBER 2020

INSTRUCTIONS:

1. **Time Allowed: 3 hours 15 minutes** (15 minutes reading and 3 hours writing).
2. This Examination is divided into two sections (A & B)
3. Section A has **three** Compulsory Questions while B has three questions of which **two** Should be attempted.
4. In summary attempt **Five** questions.
5. Marks allocated to each question are shown at the end of the question.

SECTION A

QUESTION ONE

You are the audit manager of Trump Audit Firm (**TAFI**) and you are planning the audit of Mategura Construction Company (**MCCo**) for the year ended 31st July 2020. The MCCo specialises in building affordable houses in Kigali and provide a five-year warranty to its customers. Your audit director has held a planning meeting with Chief finance Officer. She provided you with the following notes of her meeting and the draft financial statement extracts of MCCo for the year ended 31st July 2020.

The MCCo has had a difficult year, where house prices have fallen due to COVID-19 pandemic and, as a result revenue has dropped. In order to address this, management has offered significant extended credit terms to their customers. However, demand has fallen such that there are still some completed houses in the inventory where the selling price may be below cost. During the year, in calculating the depreciation, the directors extended the useful lives of plant and machinery from three years to five years. This reduced the annual depreciation charge.

The directors need to meet target profit before interest and taxation of Rwf 500,000,000 in order to be paid their annual bonus. Furthermore, to try to improve profits, the MCCo changed its main material supplier to a cheaper alternative. This has resulted in some customers claiming on their building warranties for extensive repairs. To support with operating cash flow, the directors borrowed Rwf 1,000,000,000 from a bank during the year. This is due for repayment at the end of 31st July 2020.

Extract of financial statements for the year 31st July 2020.

Description	Draft, 2020	Actual, 2019
	Rwf “000”	Rwf “000”
Revenue	12,500,000	15,000,000
Cost of sales	(7,000,000)	(8,000,000)
Gross profit	5,500,000	7,000,000
Operating expenses	(5,000,000)	(5,100,000)
Profit before interest and taxation	500,000	1,900,000
Inventory	1,900,000	1,400,000
Receivables	3,100,000	2,000,000
Cash	800,000	1,900,000
Trade payables	1,600,000	1,200,000
Loan	1,000,000	-

Required:

- a. Explain the steps the auditor must take when identifying and assessing the risks of material misstatement. (2 Marks)
- b. Calculate five (5) ratios for both years which would assist you in the planning of the audit (5 Marks)
- c. Using the information provided and the ratios calculated, describe five (5) audit risks, and explain the auditor's response to each risk in planning of Mategura Construction Company *Hint: use two column table in structuring your answers.* (10 Marks)
- d. Define a significant risk and provide factors which could indicate that the risk might be significant. (3 Marks)

(Total: 20 Marks)

QUESTION TWO

It is well accepted in auditing that throughout the conduct of the ordinary audit, it is essential to obtain the large amount of information from management and to rely heavily on management's judgements. After all, the financial statements are management representation, and simple, it is extremely difficult, if not impossible for the auditor to evaluate the obsolescence of inventory as well as management cannot in highly complex business. Similarly, the collectability of accounts receivable and continued usefulness of machinery and equipment are heavily dependent on management's willingness to provide reliable representations to the auditors.

Required:

- a. Reconcile the auditor's responsibility for discovering material misrepresentations by management with these comments in case of estimates. (4 Marks)
- b. What are the procedures the auditor can perform in evaluating the accounting estimates involving the complexity related to management's use of a complex method (including complex modelling), or when management's method otherwise involves the use of specialized skills or knowledge? (6 Marks)
- c. Distinguish between client letter of representation and management letter and state the purpose of each. (2Marks)
- d. Discuss the items that might be included in each letter stated above. (8Marks)

(Total: 20 Marks)

QUESTION THREE

- i. Distinguish between a qualification opinion, adverse and a disclaimer of opinion, and explain the circumstances under which each is appropriate. (6 Marks)
- ii. Your firm acts as the auditor of National Pharmacy Ltd. The chief finance officer (CFO) has prepared the financial statements of the company for the year ended 31st October 2020 which shows a profit before taxation amounting to Rwf 450 million. You have been informed that

the board of directors has approved the financial statements and decided that no amendments should be made thereafter. As senior auditor responsible for the audit, you have noted the following matters during your review of the financial statements and audit files:

Required:

Explain how each of the following issues will impact auditor's opinion in audit report.

- a. The freehold property which was included at cost in previous year's statement of financial position has now been restated at professional valuation of Rwf 125 million carried out during the year. **You are satisfied with the valuation and the relevant figures have been correctly adjusted and the necessary information disclosed to the notes to the financial statements.**
(2 Marks)
 - b. An amount Rwf 45 million due from customers in respect of sales during the year is included in the receivables but, from the information available to you, **you concluded that no part of this debt will be recovered. Furthermore, no allowance has been made in respect of this amount.**
(3 Marks)
 - c. **The financial statements do not disclose the existence of a loan of Rwf 36 million made by the company to its chief finance officer which remains outstanding from 1 November 2019.**
(3 Marks)
 - d. During the audit, the team discovers that 1 of 5 development projects, valued at Rwf 9.8 million included in intangible assets, doesn't meet the criteria for capitalisation. **The CFO does not want to advise the board to change the accounting treatment adopted as she considers this an immaterial amount.**
(3 Marks)
- iii) **Define what is meant by management assertion about financial statements and identify the categories of management assertion you may rely on in the review of financial statement**
(3Marks)
(Total: 20 Marks)

SECTION B

QUESTION FOUR

Fraud and error present risks to an entity. Both internal and external auditors are required to deal with risks to the entity. However, the responsibilities of internal and external auditors in relation to the risk of fraud and error differ.

Required:

- a. **Explain the responsibilities of external auditors in respect of the risk of fraud and error in an audit of financial statements.** (9 Marks)
- b. Gerayo Amahoro Ltd is an independent travel agency which doesn't operate the business itself. It takes commission on holidays sold to customers through its chain of street shops. Staffs are partly paid on a commission basis. Well established tour operators run the holidays that Gerayo Amahoro Ltd sells. The networked reservation systems through which holidays are booked and computerized accounting system are both well-established systems used by many independent travel agencies. Payments by customers, including deposits, are accepted in cash and by debit and credit card. Gerayo Amahoro Ltd is legally required to pay an amount of money into a central fund maintained to compensate customers should the agency cease operations.
 - i. **Describe the nature of the risks to which Gerayo Amahoro Ltd is subject to arising from fraud and error.** (5 Marks)
 - ii. Suppose the Managing Director of Gerayo Amahoro Ltd approached your audit firm with a proposal to audit financial statements and provide the audit report within 3 days.

Required:

Advice your audit firm on the pre-appointment procedures you need to consider before accepting this assignment.

(6 Marks)

(Total: 20 Marks)

QUESTION FIVE

Elaborate the five substantive procedures you would perform while auditing each of the following components:

- a. **Revenues from sales;** (5 Marks)
- b. **Wages and salaries;** (5 Marks)
- c. **Investment and market security;** (5 marks)
- d. **Inventory.** (5 Marks)

(Total: 20 Marks)

QUESTION SIX

Your client, Mr. Alpha, has written to you saying that he has been considering setting up an audit committee department but he has heard from his CPA brother that he would be better off abandoning this idea and employing qualified staff with CPA and ACCA in all finance, audit and operations departments. Further, his brother has advised Mr. Alpha that having a Board of

Directors who are also qualified is sufficient to play an oversight on the whole business. *In an email to Mr. Alpha (from his brother), he explained the following: The objective of corporate governance is to secure the effective, sound and efficient operation of companies. This objective transcends any legislation and the board of directors are the only ones to play vital role. Good corporate governance embraces not only making the company prosper but also doing business in legal and ethical manners. Thought, a key element of corporate governance is the audit committee; the audit committee is a committee of the board of directors and is of voluntary nature who cannot add value to the company.*

Mr. Alpha is reluctant to agree with the advice of his brother and is seeking your advice.

Required:

- i. State any 4 disadvantages to Mr. Alpha's business for not institutionalizing the corporate governance principles. (8 marks)**
- ii. Explain the roles and responsibilities of an audit committee in a company (6 Marks)**
- iii. Discuss the problems of ensuring the independence of the members of the audit committee (6 Marks)**

(Total: 20 Marks)

QUESTION SEVEN

Siyasa Ltd is a rapidly growing company which has recently approached your audit firm, SKY & Co for audit services.

The directors of Siyasa Ltd are Bwenge and Nzobere, who met at Heaven University. They are innovators who developed a niche product and then started selling it during COVID-19 Pandemic period. They have no business experience. Their product has proved very successful and business is growing rapidly with a number of staff involved in production.

Initially Bwenge and Nzobere were able to oversee all aspect of the business, but with the growth of the business this is not possible. The directors are keen to set up a control system so that the assets are safeguarded and financial records are properly maintained, now that they can no longer control everything themselves. They believe this will protect their business from fraud.

Nzobere used to be in charge of sourcing all raw materials, and they were always been brought from the same supplier. However, recently the supplier has been unable to meet Nzobere demands on time, which led to some business disruptions. Siyasa Ltd has therefore recently employed a procurement manager tasked with diversifying Siyasa Ltd suppliers and obtaining the best terms possible for the company.

Bwenge directly receives suppliers' invoices for goods, records them and pays. However, Bwenge and Nzobere are keen to divert profits into further development and have therefore also employed an accounts controller to deal with invoicing of both sales and purchases, and maintenance of accounting records, so they can focus on development. They have requested your firm to provide support on setting the internal controls.

Required:

- a. **Define segregation of duties and explain how it might operate at SIYASA LTD.** (4 Marks)
- b. **List and explain three (3) limitations of internal controls.** (3 Marks)
- c. In respect of procurement system:
 - i. **Outline four objectives you would expect the system to have.** (4 Marks)
 - ii. **For each objective, set out a control relevant to Siyasa Ltd which would meet the objective.** (4 Marks)
- d. **Explain the factors the partner of SKY & Co should consider in relation to giving advice on internal controls to an audit client.** (3Marks)
- e. **Describe what is meant by an audit program for account receivable and state the elements an audit program for Siyasa Ltd's account receivables should have.** (2 Marks)

(Total: 20 Marks)

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