CERTIFIED ACCOUNTING TECHNICIAN

STAGE 3 EXAMINATIONS

S3.4: AUDIT AND ASSURANCE

DATE: TUESDAY 28, NOVEMBER 2023

MARKING GUIDE AND MODEL ANSWERS

SECTION A

Marking guide

QUESTION	ANSWER
1	D
2	C
3	D
4	C
5	B
6	A
7	C
8	B
9	D
10	A

Each question has **2 Marks**
Total marks for this section **20 Marks**

Model answers

QUESTION ONE
Correct answer is D
Data Given:
Level of audit risk at 5%
Level of inherent risk at 60%
Level of control risk at 40%

Audit Risk Model
Audit Risk (AR) = Inherent Risk (IR) * Control Risk (CR) * Detection Risk (DR)

$$\text{Detection Risk (DR)} = \frac{\text{Audit Risk (AR)}}{\text{Inherent Risk (IR)} * \text{Control Risk (CR)}}$$

$$\text{Detection Risk (DR)} = \frac{5\%}{60\% * 40\%}$$

$$= \frac{0.05}{0.6 * 0.4}$$

Equal to 0.2083*100= **20.8%**

Wrong Option A

$$\text{Detection Risk (DR)} = \frac{\text{Inherent Risk (IR)}}{\text{Audit Risk (AR)} * \text{Control Risk (CR)}}$$

$$\text{Detection Risk (DR)} = \frac{60\%}{5\% * 40\%} \text{ which is equal } 30\%$$

Wrong Option B

$$\text{Detection Risk (DR)} = \frac{\text{Control Risk (CR)}}{\text{Audit Risk (AR)} * \text{Inherent Risk (IR)}}$$

$$\text{Detection Risk (DR)} = \frac{40\%}{60\% * 5\%} \text{ which is Equal to } 13.3\%$$

Wrong Option C

$$\text{Detection Risk (DR)} = \frac{\text{Inherent Risk (IR)} * \text{Control Risk (CR)}}{\text{Audit Risk (AR)}}$$

$$\text{Detection Risk (DR)} = \frac{60\% * 40\%}{5\%} \text{ Equal to } 4.8\%$$

QUESTION TWO

The correct answer is C

ISA 315 states that the auditor shall identify and assess the risks of material misstatement at the financial statements level and assertions level.

The following steps are undertaken by the auditor:

i. Identify risks throughout the process of obtaining an understanding of the entity
ii. Relate the risks to what can go wrong at the assertion level
iii. Consider whether the risks are of a magnitude that could result in material misstatement
iv. Consider a likelihood of the risks causing a material misstatement

QUESTION THREE

The correct answer is D

During the identification and assessment of risks related to the material misstatement, auditors may qualify some risks to be significant risks according to their professional judgement.

All factors presented in the question indicate that a risk might be a significant risk:

i) Risk of fraud
ii) Its relationship with recent developments
iii) The degree of subjectivity in the financial information
iv) It is an unusual transaction

QUESTION FOUR

The correct answer is C

Data given:
Audit risk at 3%
Inherent risk at 85%
Contrrol risk at 70%
Non-sampling risk at 10%

Audit Risk Model
Audit Risk (AR) = Inherent Risk (IR) * Control Risk (CR) * Sampling Risk (SR) * Non-sampling Risk (NSR)

$$\text{Sampling Risk (SR)} = \frac{\text{Audit Risk (AR)}}{\text{Inherent Risk (IR)} * \text{Control Risk (CR)} * \text{Non-sampling Risk (NSR)}}$$

$$\text{Sampling Risk (SR)} = \frac{3\%}{85\% * 70\% * 10\%} \quad \frac{0.03}{0.0595} * 100 = \mathbf{50.4\%}$$

Wrong Option A

$$\text{Sampling Risk (SR)} = \frac{\text{Audit Risk (AR)}}{\text{Inherent Risk (AR)} * \text{Non-sampling Risk (NSR)}}$$

$$\text{Sampling Risk (SR)} = \frac{3\%}{85\% \text{X} 10\%} \text{ Equal to } 35.2\%$$

Wrong Option B

$$\text{Sampling Risk (SR)} = \frac{\text{Audit Risk (CR)}}{\text{Control Risk (CR)} * \text{Non-sampling Risk (NSR)}}$$

$$\text{Sampling Risk (SR)} = \frac{3\%}{70\% \text{ X } 10\%} \text{ Equal to } 42.8\%$$

Wrong Option C

$$\text{Sampling Risk (SR)} = \frac{\text{Non-sampling Risk (NSR)}}{\text{Inherent risk (IR)} * \text{Control Risk (CR)}}$$

$$\text{Sampling Risk (SR)} = \frac{10\%}{85\% \text{X} 70\%} \text{ Equal to } 16.8\%$$

QUESTION FIVE

The correct answer is B

Haphazard Selection Method is defined as a sampling method whereby an auditor himself selects item at random. It may be an alternative to random selection provided auditors are satisfied that the sample is representative of the entire population.

QUESTION SIX

The correct answer is A

The following advantages would be considered by auditors when sampling whether to use statistical sampling method:

- Sample size is objectively determined, having regard to the degree of risk auditors are prepared to accept for each application
- The results of tests can be expressed in precise mathematical terms

QUESTION SEVEN

The correct answer is C

ISA 300 states that auditor should develop an audit plan for the audit in order to reduce audit risk to an acceptably low level and it includes the following:

- o A description of the nature, timing and extent of planned risk assessment procedures sufficient to assess the risks of material misstatement.
- o A description of the nature, timing and extent of planned further audit procedures at the assertion level for each material class of transactions, account balance and disclosure. This will include tests of controls and substantive procedures.
- o Any other audit procedures required for the engagement to comply with ISAs.

Proper communication both within the audit team and with the audited entity is not the primary purpose of the audit plan; though, proper communication between the two (2) parties can contribute to the good conduct of audit exercise.

QUESTION EIGHT

The correct answer is B

Audit strategy is the key planning document looking at the overall approach to be taken in the audit, while Audit plan details the procedures required to put that strategy into effect.

QUESTION NINE

The correct answer is D

(i), (ii), (iii) and (iv) are all benefits for a good audit planning.

QUESTION 10

The correct answer is D

The following are the stages of a structured approach to audit planning:

i) Updating knowledge of the client and assessing risks
ii) Ensuring that ethical requirements are met, including independence
iii) Establishing the overall strategy in terms of the scope, timing a direction of the audit
iv) Preparing the detailed audit approach
v) Making administrative decisions such as staffing and budgets

SECTION B

QUESTION 11

Marking guide

Sub question	Criteria	Marks
(a)	1 mark for each internal control stated on purchase system, Maximum 2 marks	**2**
(b)	1 mark for each internal control stated on sales system, Maximum 2 marks	**2**
(c)	1 mark for each internal control stated on stock system, Maximum 2 marks	**2**
(d)	1 mark for each internal control stated non-current assets and liabilities, Maximum 2 marks	**2**
(e)	1 mark for each internal control stated on Payroll system, Maximum 2 marks	**2**
Total for question 11		**10**

(a) Purchases system

The tests of controls of the **purchases system** will be based around: Buying (authorization), Goods inwards (custody) and Accounting (recording and valuation)

- Orders are only made to authorized suppliers.
- Orders are made at competitive prices.
- Goods and services received are used for the organization's purposes and not private purposes.
- Goods and services are only accepted if they have been ordered, and the order has been authorized.
- All goods and services received are accurately recorded.
- Liabilities are recognized for all goods and services that have been received.
- All credits to which the organization is due are claimed.
- Receipt of goods and services is necessary to establish a liability.

(b) Sales systems

The internal controls of sales system include the following:

- **Ordering and granting of credit:** To ensure that goods and services are only supplied to customers with good credit ratings who pay promptly and orders are recorded properly into the system
- **Dispatch and invoicing:** To ensure that all dispatches of goods are recorded, goods sold and services are correctly invoiced and relate to goods and services that have been supplied by the business
- **Recording, accounting and credit control:** To ensure that all sales have been invoiced and recorded in the general and sales ledgers, all credit notes are recorded in the sales ledgers and potentially irrecoverable debts are identified.

(c) Stocks / Inventory system

The internal controls relating to inventory are:

- **Recording**: To ensure that all inventory movements are authorized and recorded into the system, inventory records only include items that belong to the client, inventory records include inventory that exists and is held by the client, Inventory quantities have been recorded correctly and Cut-off procedures are properly applied to inventory.
- **Protection of inventory:** To ensure that inventory is safeguarded against loss, pilferage or damage.
- **Valuation of inventory:** To ensure that the costing system values inventory correctly and allowance is made for slow-moving, obsolete or damaged inventory.
- **Inventory-holding:** To ensure that levels of inventory held are reasonable.

(d) Non-Current assets and liabilities as balance sheet items

1. Non-current assets

We can describe the internal controls relating to the non-current assets as follows:

- **Segregation** of **duties**; authorization, custody and recording
- **Maintenance** of appropriate accounting records (including distinction between capital and revenue expenditure)
- **Maintenance** of plant and property registers which are regularly reviewed for agreement with general ledger and inspection of assets recorded
- **Inspection** of non-current assets to ensure properly maintained and used
  Acquisition and disposal
- **Authorization** of capital expenditure and authorization of sales, scrapping or transfer of non-current assets
- **Depreciation:** Calculation and confirmation of depreciation rates with arithmetical accuracy and assessment of asset lives.

2. Non-current liabilities

The most important objectives of internal control relating to non-current liabilities are to ensure:

- **Authorization:** that loans and any other long-term borrowings are properly authorized
- **Completeness:** that all non-current liabilities have been recognized and disclosed
- **Accuracy**: that the value of the liability has been correctly recorded, and that interest payable has been calculated correctly and included in the correct accounting period

e) Payroll system

Key controls over payroll cover documentation, authorization of staff changes, Calculation of wages & salaries, payment of wages & salaries and authorization of deductions.

The most important internal controls relating to wages and salaries are:

- **Setting of wages and salaries:** To ensure that employees are only paid for work that they have done, gross pay has been calculated correctly and authorized.

- o **Recording of wages and salaries:** To ensure that gross and net pay and deductions are accurately recorded on the payroll, wages and salaries paid are recorded correctly in the bank and cash records and Wages and salaries are correctly recorded in the general ledger.
- o **Payment of wages and salaries:** To ensure that the correct employees are only paid to valid employees.
- o **Deductions:** To ensure that statutory and non-statutory deductions have been calculated correctly and are authorized and the correct amounts are paid to the taxation authorities.

QUESTION 12

Marking guide

Sub question	**Criteria**	**Marks**
(a)	Award 1.5 marks for audit opinion well stated and explained, Maximum 6 marks	**6**
(b)	2 marks for audit opinion that Uzima CPA Ltd should express in the audit report, Maximum 2 marks	**2**
(c)	2 marks for the reason stated in (b), Maximum 2 marks	**2**
Total for question 12		**10**

Model answers

(a) Four (4) audit opinions that can be expressed in the auditor's report:

1. Qualified opinion

A qualified opinion must be expressed in the auditor's report in the following two situations.

(a) The auditor concludes that misstatements are material, but not pervasive, to the financial statements. Material misstatements could arise in respect of:

- o The appropriateness of selected accounting policies
- o The application of selected accounting policies
- o The appropriateness or adequacy of disclosures in the financial statements

(b) The auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion but concludes that the possible effects of undetected misstatements, if any, could be material but not pervasive.

2. Adverse opinion

An adverse opinion is expressed when the auditor, having obtained sufficient appropriate audit evidence, concludes that misstatements are both material and pervasive to the financial statements. In the house builder example in the table above, the accounts presented would suggest that the company was holding no property for sale but had significant company property that was being utilized by the business. The effects of the misstatement are clearly pervasive.

3. Disclaimers of opinion

An opinion must be disclaimed when the auditor cannot obtain sufficient appropriate audit evidence on which to base the opinion and concludes that the possible effects on the financial statements of undetected misstatements, if any, could be both material and pervasive.

One example of when a disclaimer of opinion is used could be in relation to going concern, where management is unwilling to make or extend its assessment. Another example might be where the auditor is unable to attend the inventory count and unable to request receivables' confirmations, and there is no other realistic means of gathering evidence on these two areas. If these two areas form a significant element of the total assets value, a disclaimer may be appropriate.

4. Unmodified opinion

Unmodified opinion or unqualified opinion is the opinion expressed by the auditor when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

ISA 700 states that the auditor shall express an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

(b) Adverse opinion has been expressed by the auditors of UZIMA CPA Ltd

(c) The reasons of an adverse opinion that is expressed by auditors of UZIMA CPA Ltd include the fact that the auditors have obtained sufficient appropriate audit evidence and conclude that misstatements are both material and pervasive to the financial statements.
Material misstatement is information in the financial statements that is sufficiently incorrect to the extent it may impact the economic decisions of someone relying on those statements
The term **pervasive** is used to describe the effects or possible effects on the financial statements.

SECTION C

QUESTION 13

Marking guide

Sub question	Criteria	Marks
(a)	1 mark for each benefit, Maximum 5 marks	**5**
(b)	1 mark for each information listed, Maximum 5 marks	**5**
(c)	1 mark for each audit procedure stated and 1 mark for explanation, Maximum 10 marks	**10**
Total for question 13		**20**

Model answers

(a) Explain five (5) benefits behind obtaining confirmation from the bank and not from the client.

- Assist in reducing audit risk for the related assertions made by the management in the financial statements e.g.: occurrence, valuation, existence etc…
- External confirmation is likely to provide strong evidence to support the existence, the rights and obligations of items in the financial statements.
- It provides the useful information to be used in the reconciliation to be made,
- It forms reliable information obtained from a source independent from the entity which increases the assurance the auditor obtains from management representations
- It provides information on the clients 'assets held as security and liabilities attached and ownership,
- It provides information on the genuineness of the balances of the balances as at the balance sheet date,
- It is used to test the cut-off procedure of the bank balances as at the balance sheet balances,
- Confirmation also provides evidence regarding the operation of the cut-off procedures.

(b) The information you should request the bank to confirm to auditors about the bank confirmation is as follows:

- The most commonly requested information is in respect of balances due to or from the client entity on current deposits,
- Banks would provide information in terms of loan balances and other accounts at the end of the year,
- Banks are likely to give confirmation of contingent liabilities such as those arising on guarantees, comfort letter, bills etc….
- Banks may also provide information about nil balances on accounts and the ones closed in the 12 months prior to the chosen confirmation date
- Bank may disclose securities and other valuable items in safe custody on behalf of the client.

(c) Verification of accounts receivables is essential as they form a large portion of the assets of the company.

Five (5) audit procedures that auditors of X&Y Partners Ltd would use in the verification of accounts receivables of JAMBO ltd are explained as follows:

1. Completeness

- Agree the balance from the individual sales ledger accounts to the aged receivables listing vice versa,
- Match the total of the aged receivables listing to the sales ledger control account
- Cast and cross cast the aged trial balance before selecting any samples to test
- Trace a sample of shipping documentation to sales invoices and into the sales and receivables ledger
- Complete the disclosure checklist to ensure that all the disclosures relevant to receivables have been made
- Compare the gross profit % by product line with the previous year and industry data,
- Compare the level of prepayments to the previous year to ensure the figure is materially correct and complete

2. Existence

- Perform a receivables circularization on sample of year end trade receivables
- Follow up all balance disagreements and no-replies to the receivable's confirmation.
- Perform alternative procedures for any exceptions and no replies to the receivable's confirmation
- Review after date cash receipts by inspecting bank statements and cash receipts documentation
- Examine the customer's account and correspondences to assess whether the balance outstanding represents specific invoices and confirm their validity
- Examine the underlying documentation (Purchase orders, dispatch documentation, duplicate sales invoices, etc.)
- Inquire from management explanations for invoices remaining unpaid after subsequent ones have been paid.
- Observe whether the balance on the account is growing and if so, find out why by discussing with management.

3. Rights and obligations

- Review bank confirmation for any liens on receivables,
- Make inquiries of management, review loan agreement and review board minutes for any evidence of receivables being sold.

4. Accuracy

- For a sample of sales invoices, compare the prices and terms to the authorized price list and terms of trade documentation
- Test whether discounts have been properly applied by recalculating for a sample of invoices,
- Test the correct calculation of tax on a sample of invoices.

5. Occurrence

- For a sample of sales transactions, recorded in the ledger, vouch sales invoice back to customers' orders and dispatch documentation.

6. Valuation

- Compare receivables turnover and receivables days to the previous year and to the industry data,
- Compare the aged analysis of receivables from the aged trial balance,
- Compare the bad debt expenses as a percentage of sales to previous period,
- Examine large customer accounts individually and compare to the previous year's balances.

7. Cut-off

- For a sample sales invoices around the year end, inspect the dates and compare with the dates of dispatch and the dates recorded in the ledger for application of correct cut-off
- Perform analytical procedures on sales return & comparing the ratio of sales return to sales.

QUESTION 14

Marking guide

Sub question	Criteria	Marks
(a)	1 mark for each risk stated and 1 mark for explanation, Maximum 8 marks	**8**
(b)	2 marks for each important element, Maximum 12 marks. **Note**: consider awarding marks to any valid point not listed in the model answer	**12**
Total for question 14		**20**

Model answers

(a) Four (4) potential risks associated with the audit that financial statements of KEZA Company Ltd may be materially misstated since they do not keep proper books of accounts.

Audit risk is the risk that auditors may give an inappropriate opinion when the financial statements are materially misstated and this risk is potentially associated by the business. Audit risk is the product of below three risks (Inherent risk, Control risk and Detection risk)

i) Inherent risk

It is the likelihood that a specific item in the accounts will be misstated due to characteristics of that item or of the organization as a whole before consideration of related controls. Organizational factors include the nature of its business or whether the directors are under pressure to produce favorable results. Factors affecting individual items include the complexities of the accounting involved, such as whether a significant degree of estimation is involved.

ii) Control risk

Control risk is the risk that an organization's internal controls fail to prevent, or detect and correct material misstatements. Control risk depends on whether the controls that have been designed are appropriate for the business, and whether the controls in place are operating properly.

iii) Detection risk

Detection risk is the risk that audit procedures fail to identify material misstatements. Sampling risk, the risk that the auditors' conclusion differs from what would be the conclusion if the whole population was tested, is a component of detection risk. Other elements of detection risk are the risk that auditors might use inappropriate procedures or fail to recognize a misstatement

(b) Based on the above scenario, clearly explain the important elements that auditors need to understand for audit risk minimization of KEZA Company.

The auditor shall obtain an understanding of the information system, including the related business processes, relevant to financial reporting, including the following areas:

- The classes of transactions in the entity's operations that are significant to the financial statements.
- The procedures, within both information technology (IT) and manual systems, by which those transactions are initiated, recorded, processed, corrected as necessary, transferred to the general ledger and reported in the financial statements.
- The related accounting records, supporting information and specific accounts in the financial statements that are used to initiate, record, process and report transactions; this includes the correction of incorrect information and how information is transferred to the general ledger. The records may be in either manual or electronic form.
- How the information system captures events and conditions, other than classes of transactions, that are significant to the financial statements.
- The financial reporting process used to prepare the entity's financial statements, including significant accounting estimates and disclosures.
- Controls surrounding journal entries, including non-standard journal entries used to record nonrecurring, unusual transactions or adjustments.

QUESTION 15

Marking guide

Sub question	Criteria	Marks
(a)	2 marks for each term between sufficiency and appropriateness, Maximum 4 marks	**4**
(b)	2 marks for each term between audit evidence and audit plan, Maximum 4 marks	**4**
(c)	2 marks for each audit technique, Maximum 12 marks	**12**
Total for question 15		**20**

Model answers

(a) Distinction between sufficiency and appropriateness as both are applied in audit evidence.

"Sufficiency" is the measure of the quantity of audit evidence. The quantity of evidence required will be affected by the level of risk in the area being audited, and the quality of evidence obtained, whereas "**Appropriateness"** is the measure of the quality or relevance and reliability of the audit evidence.

(b) Distinction between "Audit evidence" and "Audit plan" as applied in auditing of the financial statements of organizations.

"Audit evidence" refers to all of the information used by the auditor in arriving at the conclusion on which the auditor's opinion is based. Audit evidence includes the information contained in the accounting records underlying the financial statements and information obtained from other sources, such as confirmations from third parties;

Examples of audit evidence include bank statements, payroll, management accounts, invoices, receipts etc……

whereas "**Audit plan"** refers to the details of the audit procedures required to put the audit strategy into effect in the objective of obtaining audit evidence that will form conclusions to base on the audit opinion.

(c) Different verification / audit techniques at least six (6) that will be used by auditors of GEN Partners ltd during their audit exercise and explain what type of item could be audited by each method.

Verification Techniques	Items
Inspection of assets	Agreeing the accounting records to the physical asset confirms existence, gives evidence of valuation but does not confirm rights and obligations or valuation. E.g: Inspecting physically a machine in the factory proves its existence
Inspection of documentation or records	Confirmation to documentation of items recorded in the accounting records demonstrates that a transaction occurred or an asset or liability exists. E.g: inspecting physically a supplier's invoice posted into ledger account
Observation	It involves watching a procedure being performed (eg post opening, or inventory being counted).

Inquiry	Seeking information from client staff or external sources about operation of controls or how certain items have been treated in the accounting records. E.g: To determine how provisions have been calculated
External confirmation	Seeking confirmation from another source of details in client's accounting records (eg confirmation from bank via a bank audit letter of existence and rights and obligations of bank balances, confirmation from trade receivables in respect of the existence of receivable balances).
Recalculation	Confirming the arithmetic accuracy of a client's records eg adding up a Ledger account
Reperformance	As information generated independently by the audit team itself, reperformance constitutes a strong form of audit evidence.
Analytical procedures	These consist of evaluations of financial information made by studying relationships between both financial and non-financial data. E.g: calculation of various financial ratios.

END OF MARKING GUIDE AND MODEL ANSWERS