CERTIFIED PUBLIC ACCOUNTANTS

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: FRIDAY 29, NOVEMBER 2024

MARKING GUIDE AND MODEL ANSWERS

SECTION A

Q1	MARKING GUIDE TO QUESTION ONE: Huye Steel & Metals Co (HSM Co) & Ebeneza Co	Marks
A i)	**Audit procedures for opening balances:** 1 mark for each correct and explained audit procedure for opening balance up to a maximum of 5 marks. *Do not award any mark for general procedure that do not relate to the scenario/opening balance in any way.*	5 Marks
ii)	**Risks of material misstatements (ROMMs) to be considered when planning the final audit for HSM:** Up to 2.5 marks to be awarded for each risk of material misstatement identified and well explained. Award 0.5 marks for each risk of material misstatement identified and 2 marks each correct risk of material misstatement well explained. Maximum marks for this part is 25 marks so on average 10 points are expected from the candidates. *Do not award any mark for general points that do not relate to the scenario in any way.*	25 Marks
iii)	**Different audit methodologies and justify an that should be recommended for application by Sabiti & Co:** Award up to 1 mark for each audit methodology identified and well explained up to a maximum of 3 marks. O5. Marks for identification and 0.5 for correct explanation. Further, 1 mark will be allocated to the correct audit methodology suitable to HSM co.	4 Marks
iv)	**Responsibility for the detection of fraud:** Award 2 marks for clearly explaining the responsibilities of auditors in detection and reporting of fraud. Award 1 mark for identification of who has primary responsibility for the detection and prevention of fraud. *Do not award any mark for general points that do not relate to the scenario.*	3 Marks

v)	**Matters to be considered in seeking to determine the extent of HSM Co's financial loss:** Award 1 mark for each well-developed point explaining a matter to be considered in determining the extent of financial loss suffered by HSM due to the alleged fraud arising from the lost MoMo receipts by the workshop manager (maximum of 5 marks)	5 Marks
B)	**Explain the meaning of the term "skepticism" and recommend any further actions:** Award 2 marks for correct explanation of the term "professional skepticism". Award up to 2 marks for a correct further action that should be taken by auditor to Ebeneza Co payroll costs for the new employees according to the scenario happened up to a maximum of 6 Marks.	**8 Marks**
	Total marks	**50 Marks**

MODEL ANSWER TO QUESTION ONE: Huye Steel & Metals Co (HSM Co)

Part (a) (i) Audit procedures for opening balances:

- Review the appropriateness of the accounting policies applied in the financial statements for the year ended 31 December 2022 to confirm their consistency with those applied in the year ended 31 December 2023.
- Where permitted (e.g., if there is a reciprocal arrangement with the predecessor auditor to share working papers on a change of appointment), a review of the prior period audit working papers to confirm the opening balances.
- Review the collections or settlements made in the current period to confirm the existence, measurement and completeness of rights and obligations of the closing balances on 31 December 2022. For example:
- After-date receipts (in January 2023 and later) confirming the recoverable amount of trade receivables at 31 December 2022;
- Similarly, after-date payments confirming the completeness of trade and other payables;
- After-date value for sales of inventory held at 31 December 2022;
- Review of January 2023 bank reconciliation (confirming clearance of reconciling items at 31 December 2022)
- Analytical procedures on ratios calculated month-by-month from 31 December 2022 to date and further investigation of any distortions identified at the beginning of the current reporting period. For example:
- Inventory turnover (by each category of metal);
- Average collection payment;

- Average payment period;
- Gross profit margin (by each category of metal)
- Examination of historical accounting records for non-current assets and liabilities – for example:
- Agreeing balances on asset registers to the HSM's trial balance as at 31 December 2022;
- Agreeing statements of balances on loan accounts to the financial statements as at 31 December 2022.

Part (a) (ii) Risks of material misstatements

Management bias – grant subsidy

The management of HSM may intentionally provide incorrect information in the quarterly returns submitted to the Huye local government in order to receive a high amount of the government grant subsidy. HSM may overstate the amounts of purchased scrap metals in order to claim a high amount of the government subsidy considering that the subsidy is based on 15% of the amount of scrap metal purchases made in the quarterly return. In addition, the senior management team earn a bonus based on the amount received in the government subsidy which will further motivate the HSM management to provide overstated scrap metal purchases in the quarterly return to the Huye local government in order to gain a high bonus payment to the management team.

Note: *Credit will be awarded accordingly where management bias is indicated in any other relevant point(s) e.g., the non-recognition of wastages in the inventory losses in the stockyard due to theft, poor cash management leading to potential cash theft by the workshop personnel making cash sales etc.*

Lack of sufficient internal controls – cash receipts and payments

HSM operates with a heavy cash environment as the purchases of the scrap materials (which is the major raw material used to produce its products) are mainly settled in cash with the amount of cash purchase determined by the procurement manager. In addition, sales of the finished products are by cash receipts by receptionists in the workshops scattered in major cities across the provinces of Rwanda and mobile money (MoMo) receipts which are all received on a personal MoMo account of the workshop manager. The lack of robust reconciliations by the finance team over these cash sales and purchases in addition to the poor physical / security controls over the cash which is maintained outside the finance office provides potential evidence that some of the cash is lost through misappropriation and yet this cash is reported in the financial statements indicating an overstated cash balance and an understated expense if the cash lost is not recognized in the profit or loss.

Note: *Credit will be awarded accordingly for other valid cases where internal control deficiencies impacting adversely on HSM's financial statements are well explained e.g., non-segregation of duties regarding the decision of prices paid in the purchase of the scrap* *materials, potential internal control gaps exposing HSM to a loss of portable raw materials kept in the stockyard, potential fraud on the valuation of the scrap materials and finished products, potential internal control gaps over the weigh-bridge quantity measurements etc*

New Lease agreement for the stockyard – recognition

On 1 January 2023, HSM has leased a land property for its new large-sized stockyard. In accordance with IFRS 16 *Leases,* a lessee is required to recognize in the statement of financial position, a right-of-use asset as an asset and a lease obligation as a liability at the inception of a lease. The risk is that HSM may not have recognized the leased asset and lease obligation in its financial statements or on a wrong basis that it does not legally own the property and this will result in understated assets and liabilities. On the basis that HSM has used the property to construct a large-sized stockyard, the leased property is likely to be material to the financial statements of HSM.

New Lease agreement for the stockyard – measurement

IFRS 16 *Leases* further requires the initial measure for the right-of-use asset and the lease liability to be determined based on the present value of the future lease payments discounted using an interest rate implicit in the lease contract or the lessee's incremental borrowing rate. If HSM has recognized the right-of-use asset and liability in its financial statements, the risk is that an incorrect initial measure may have been used for example where a wrong present value of the future lease payments has been used for if the number of years used in the calculation is not equal to the 25 years lease period or an incorrect discount rate has been used. This will result in an over / under stated asset and liability.

IFRS 16 requires the lessee to subsequently (at each reporting date) to recognize a depreciation charge based on the economic useful life of the asset and a finance charge based on unwinding the discount on the lease obligation. The risk is that HSM may not have recognized or may have incorrectly measured the depreciation charge on the right-of-use asset and the finance charge at the reporting date (31 December 2023), if these are based on information that is not similar to the terms of the lease contract. This will result in an over / understated expenses in the profit or loss, assets, and liabilities in the statement of financial position.

Note: *Credit will be awarded accordingly where an evaluation of the risk of material misstatement is made on the accounting requirement to present the right-out-use asset separately from property, plant and equipment. In addition, credit will be provided where an explanation of a split in the presented lease liability is made in the non-current liability and current liability.*

Initial and subsequent measurement of the stockyard

HSM constructed a stockyard within the financial year, and this was completed within the financial year (on 1 July 2023). In accordance with IAS 16 *Property, plant and equipment*, a self-constructed asset is recognized as an item of PPE during the construction period and capitalization ends when the asset is ready for its intended use. The risk is that HSM may not have correctly capitalized the cost in the construction of the stockyard as part of the PPE during and after the construction if the cost has incorrectly been recognized in the profit or loss. This will result in an overstated expense and understated assets if the construction costs have been wrongly expensed. The newly constructed stockyard is reported to be a large-sized property making it potentially material to the financial statements

Alternatively, HSM could have capitalized the cost of the Stockyard construction with a risk that the amount capitalized incorrectly includes additional costs incurred in the post-construction period (i.e., after 1 July 2023) such as costs of maintenance which should be charged as expenses in the profit or loss. This results into overstated assets and understated expenses.

Further, IAS 16 requires the entity to charge a depreciation for the asset to reflect the pattern of the consumption of the asset from the date the asset is being used for its intended use. The risk is that HSM may not have appropriately depreciated the stockyard asset based on the correct rate of usage or useful life for the asset which is potentially equivalent to the lease period or the economic useful life if this is shorter which process is highly subjective. In addition, HSM may not have time-apportioned the depreciation charge to only six (6) months (1 July 2023 to 31 December 2023) if in error a full year depreciation charge has been recognized. This will result into an overstated depreciation expense and an understated asset.

Availability and amounts for cash & MoMo receipts for workshop sales made

HSM makes sales of the final products to its customers mainly by cash in hand and mobile-money (MoMo) receipts. There is a risk that HSM has recognized cash and MoMo amounts based on the actual sales made which may agree to the actual cash banked on HSM bank account if the cash receipts have been misused / misplaced or fraudulently used by the workshop receptionists as there appears to be weak internal controls on cash and MoMo sales receipts. This is especially the case where all sales receipts on the MoMo account for November 2023 have been stolen by the workshop manager in Kigali (the largest workshop) and this may be the same case for other sales made by the other workshop managers who may not declare the correct cash sales made as the internal controls on the management of cash are poor. The accounting treatment requires the entity to recognize the cash losses due to theft as an expense in the profit or loss and the loss should be adjusted / removed from the cash balance in the financial statements. The non recognition of the lost cash from the sales will result into an overstated cash asset and understated expenses.

Valuation – purchased inventory

HSM's main inventory includes the scrap metal purchased from public and aluminum used in producing the finished steel products. The quantity of the purchased raw materials is measured using the weighbridge for the trucks bringing in the materials. In accordance with IAS 2 *Inventories*, the cost of purchased raw materials is based on the cost price per unit and the number of units purchased. The risk is that the measurement of the materials on entry by the weighbridge may be incorrect if the price determined for the scrap materials is significantly incorrect as this is subjectively determined by the procurement manager. In addition, there is a risk that the weigh-bridge quantity measurement for the incoming materials is inaccurate if the weigh-bridge machines are not correctly operated or where the recorded quantities are intentionally overstated for fraudulent reasons (e.g., since the purchases are settled in cash, the purchased items directly related to the amount of government subsidy and related bonus to the senior management team etc.). It is also possible that the purchased scrap materials may be over-valued if the quality is not appropriate especially as majority of the quantity of the iron piled up in the stockyard was rusted on the auditor's inspection done on 14 December 2023. This would result to overstated inventory and understated expense for the non-recognized financial loss incurred on the purchased inventory. This is highly material as HSM maintains large quantities of the scrap metal.

Valuation – closing inventory

In accordance with IAS 2 *inventory*, closing inventory (including closing raw materials) is valued at the lower of cost and net realizable value. The risk is that HSM may not have correctly valued the closing inventory at the reporting date on 31 December 2023 if for example this is not written down to a net realizable value as this is potentially lower than the carrying amount as evidenced from the review on 14 December 2023 which indicates that sheets of aluminum used to produce the steel products were lost after a storm blew them away and majority of the quantity of the iron piled up in the stockyard was rusted which all indicate a possible loss in value of the inventory. The non-recognition of the loss in the inventory valuation will result in an overstated inventory and an understated expense in the profit or loss.

In addition, HSM conducted its stock count on 30 November 2023 with plans of making a roll-forward of the inventory valuation to the closing date of 31 December 2023. The risk is that the roll-forward may have been incorrectly done if (say) required adjustments for sales and purchases made in the month of December 2023 are wrongly or subjectively done. This is further compounded by the fact that HSM lacks an expert valuation of its products in the absence of expert valuers in Rwanda for the type of products produced by HSM. This will result in an over / understated inventory and profit.

The closing inventory is potentially a large value and hence material to the financial statements in the year ended 31 December 2023 as the stock-count sheets show that on average, metal quantities have increased by one-third and the quantity of aluminum is reported in the manual records is three-times as much compared to the quantities reported in the prior year ended 31 December 2022.

Note: Credit will be awarded where other supported explanation regarding the risk of incorrect valuations of the inventory is provided e.g., subjective valuation of inventory by the management team that lack the expert skills of inventory valuation in the absence of expert valuers in the locations where HSM operates; different metals being mixed up (e.g., the copper and brass), incorrect roll-forward valuation adjustments for the inventory due to management bias or potential fraudulent reporting incentivized by the bonus earnings etc.

Boiler machines – assets with separate major components

The production of the final iron products requiring the use of two heavy-duty boiler machines with a useful life of 25 years and the boiler-machines are supported by engines whose useful life is 4 years. This is an example of an asset with a major separate component with a different useful life. In accordance with IAS 16 Property, plant and equipment, an item of a PPE with a separate major component having a different useful life must be separated for measurement of the depreciation charge. The risk is that HSM may not have split the computation for the depreciation charge for the boiler machines and therefore may have incorrectly depreciated the engines over a longer useful life (of 25 years) in contrast to their 4-year useful life. This will result in an understated depreciation charge / expense in the profit or loss and an overstated asset. On the basis that the two boiler-machines are heavy-duty, this is an indication that the engines running these machines are of a high cost / value and their value and related depreciation charge is therefore material.

Potential penalties – illegal dumping of ash-waste

HSM's waste-product arising from the production process is the ash-waste which in most cases has been illegally dumped against the requirements of the country's environmental regulations. In accordance with IAS 37 *Provisions, contingent liabilities and assets*, a provision is recognized where there is a present (legal or constructive) obligation, it is highly probable that the entity own economic resources are required to settle the obligation and the obligation can be measured reliably. The illegal dumping of the ash-waste creates an obligating event for HSM as it is highly probable that this will result into legal damages sanctioned by the environmental regulator on HSM. The risk is that HSM may not have recognized the provision for penalties arising from the illegal dumping of the ash-waste especially as the company will want to keep this information away from the public and the government in fear of the legal implications. This will result in understated liabilities and expenses

In addition, where there is only a possible obligation for an outflow of the entity's own economic resources and/or a reliable measure of the obligation cannot be made then a disclosure of the contingent liability such as the nature of the obligation is required in the notes to the financial statements. There is a risk that HSM has not disclosed or has inadequately disclosed a contingent liability related to the illegal dumping of the ash-waste especially if the reason for the non-recognition of a provision is because HSM is unable to reliably determine the value of the obligation. This results into a disclosure risk.

Government subsidy – recognition

HSM receives a government grant from the local government in Huye supported by a quarterly return providing details of the purchases made of the scrap materials every quarter. In accordance with IAS 20 *Government grants and disclosure of government assistance*, the income earned from a "grant related to income" is recognized in the profit or loss in the time period(s) in which the related expense is recognized in the profit or loss. The government subsidy received by HSM is a government grant related to income as this is received in relation to HSM's purchase of scrap from the public that results into reduced dumping of scrap metal items, since HSM recycles this scrap to produce iron used by the public. The risk is that HSM may have wrongly recognized the grant income as deferred income within the liabilities which is in contrast to the fact that HSM receives the grant after submitting a return for purchase of scrap materials made in the prior quarter (for example the return for the quarter ending 31 December 2023 will be submitted to the local government on 15 January 2024 which is after the end of the related quarterly purchases). The 9ncurrect recognition of a deferred income will result in an overstated liability and understated incomes.

Further, in accordance with IAS 20, where the conditions attached to the government grant are not satisfied and consequently a refund of the grant is required, a provision for the government grant received is required in the financial statements. The risk is that HSM may not have recognized a provision for a government grant refund where the refund may have arisen especially if there are potential errors of the costs of purchases for the scrap-materials provided in the quarterly returns submitted to Huye local government due to (say) management bias. In addition, if the assessment for the satisfaction of the grant conditions is linked to HSM's own illegal dumping of the ash-waste (the by-product), the local government may require a refund of the government grants received by HSM. The non-recognition of the government grant refund will result into an understated expense and liability in the financial statements.

Disclosure risk – uncertainties to going concern

There are a number of significant disclosures that are required in the notes to the financial statements of HSM for example the going concern risk arising from the potential closure of HSM due to the illegal dumping of the ash-waste or due to the significant financial losses suffered due to cash thefts in the sales and purchases made in cash without strong / effective internal controls.

In accordance with IAS 1 *Presentation of financial statements*, an entity is required to adequately disclose any material uncertainties regarding going concern in its financial statements including the details of the indicators / risks impacting adversely on the going concern. The risk is that HSM may not have disclosed or have inadequately disclosed material uncertainties to its going concern for example highly probable permanent closure of its operations due to the illegal dumping of the ash-waste or the potential collapse of the entity arising from significant cash thefts due to high volumes of cash used in purchases and sales without adequate internal controls. This will result in a disclosure risk

Part (a) (iii) Suitability of the audit methodologies

The following audit methodologies are being evaluated for their suitability in the audit of HSM's financial statements for the year ended 31 December 2023:

Systems-based / compliance-based approach

A systems-based / compliance approach is not suitable in the audit for HSM because controls are lacking / ineffective at HSM as it is evident that the controls over (say) inventory and cash management at HSM are not effective.

In addition, since the audit appointment was made in September 2023 (3 months to the end of the financial year date of 31 December 2023), there will not have been sufficient time to have conducted an interim audit and hence testing all controls in the final audit will be less efficient compared to a substantive audit approach.

Cyclical approach / directional testing

The cyclical approach / directional testing will not be a suitable approach in the audit of HSM's financial statements as the cycles at HSM are incomplete. This is a case (say) for the purchases cycle for the metals which is currently a "purchase / cash" approach due to the fact that purchases at HSM are made in cash. A purchase cycle requires a "purchase / payable / cash" and therefore in HSM's case, there is absence of an independent third-party evidence to compensate for the evidence such as "suppliers' statements which would be available if there were trade payables.

In addition, the current cycles at HSM are directly inter-related to cash and inventory amounts and yet the cash and inventory items are subject to a high risk of material misstatement arising from potential fraud.

Analytical procedures

The application of substantive analytical procedures at the audit evidence-gathering stage for the audit of HSM may be of limited use due to the following factors:

- There may be significant fluctuating profitability margins – for example fluctuating margins in the gross profitability margin may exist as many factors like subjective pricing decisions made by the purchasing manager for the purchased scrap metal which will influence the price at which scrap is purchased and subsequently the selling prices for the final product. The fluctuation in the prices will not frustrate the use of analytical procedures to a large extent
- In addition, there is lack of reliable historical information on which to make the comparisons if the corresponding / comparative figures for the prior year are not directly accessed from the predecessor auditor.

Risk-based approach

A risk-based approach is the most suitable approach that will apply in the audit of HSM's financial statements for the year ended 31 December 2023 due to the following reasons:

- The inherent risk is high at both the entity and financial assertion levels (an example of the potential fraud arising from the last MoMo receipts due to the missing records and actual receipts from the Workshop manager in Kigali);
- Material errors are likely to arise in inventory where a high degree of subjectivity will be involved (regarding quality of metals, quantities, net realizable value etc.)
- It directs the audit effort to inventory, purchases, income (sales and the grant income from the subsidy) and other risky areas (e.g., contingent liabilities)

Substantive audit approach

In addition to the suitability of the risk-based approach discussed above, applying a detailed substantive / statement of financial statement approach will suitably complement the risk-based approach as this approach will direct audit effort to the appropriate valuation of HSM's assets and liabilities existing at the year-end date of 31 December 2023.

Substantive audit procedures will therefore be suitable in the case of the audit of HSM's financial statements in the following cases:

- The auditor's attendance at the full physical inventory count exercise at the year-end date of 31 December 2023.
- The auditor verifying the cash at bank using a bank confirmation and reconciliations and cash at hand through a physical cash count
- The auditor confirming the accuracy of the quarterly returns to the local authority

Part (a) (iv) Auditor's responsibility in the detection of fraud

In accordance with ISA 240 *The Auditor's responsibility for Fraud and Error*, our audit firm, Sabiti & Co is responsible for the detection of fraud only where it has a material impact on the financial statements. Auditors are responsible for obtaining reasonable assurance that the financial statements are free from material fraud and error.

In the conduct of the audit work, the auditor is expected to always approach the audit with "professional skepticism". In this approach, the auditor applies professional judgement and utilizes his questioning mind over evidence provided to him by the client's management. This implies that the auditor will more likely detect fraud even if it is less than material. Therefore Sabiti & Co is required to plan and perform the audit of HSM Co with professional skepticism in order to detect material misstatements in the financial statements arising from fraud.

There is an expectation, that is part of the “expectation gap”, that auditors have a responsibility to detect any fraud. However, such an expectation denies the role of the auditor in reporting whether or not financial statements are free from material misstatements whether due to fraud or error.

It is unreasonable to expect the auditor will detect fraud on the same scale as detecting an error because due to its nature, there will always an intention by management or the fraudster to conceal the fraud from the auditor.

Part (a) (v) Matters to consider in assessing the extent of the alleged fraud:

- **Details reported to police:** The General manager may have made some estimate of the possible extent of the fraud when reporting the Kigali workshop manager’s disappearance to the police.

- **The minimum loss expected**: There is need to estimate the minimum loss that HSM may suffer assuming there is no insurance cover for the lost cash which in this case may be the MoMo receipts for sales made in the entire month of November 2023 which was not handed over or banked on the HSM bank account by the departed workshop manager. If the minimum loss suffered is not known (say) because the only record for this figure was the information in the cash book, then a simple estimate of the financial loss suffered by HSM might be 30 days (in November 2023) x average MoMo sales per day.

- **The pattern of the MoMo receipts declared / passed over to HSM by the workshop manager**. In this case, the date / month in the current year when a falling trend in the MoMo receipts declared by the Kigali workshop manager will indicate the month / date in the year when the Kigali workshop manager began to misappropriate the company’s cash.

- **Whether the HSM employees have voiced any suspicions** regarding the Kigali workshop manager’s behavior for example, if there has been any spotted change in his lifestyle including what he appeared to spend his money on (say luxurious spendings), the hours he worked (beyond office hours with no requested staff leave) etc.

- **The prior year auditor’s report was unmodified** which implies that the alleged fraud by the workshop manager may have commenced in the current year ended 31 December 2023.

- **The availability of an insurance cover:** It is important to consider whether HSM has any insurance cover for such a financial loss to assess the amount of compensation that the company may receive when computing the estimated net financial loss to be suffered.

- **Any potential likelihood of recovering the misappropriated amounts** – for example, if the workshop manager legally owns any asset like (say) a building that can be used to settle HSM's claims against him in the event that he is arrested and successfully prosecuted.

Part (b): Professional skepticism and further actions – payroll costs of Ebeneza Co

Professional skepticism is an attitude that includes a questioning mind, being alert to conditions which may indicate possible misstatement due to error or fraud, and a critical assessment of audit evidence.

In terms of the information obtained from the audit junior on the audit of Ebeneza Co, the principle of professional skepticism means the audit team should be alert to the actual circumstances of the engagement and the work being done and alert to the possibility that information obtained from the client may not be as it appears to be on first sight e.g., that the evidence supporting the additions for the employees on the payroll may not be reliable or it may be an indicator of fraud.

If the audit team on the audit of Ebeneza Co is not skeptical (with an ongoing questioning mind), they may not realize / spot items that are unusual and therefore, the team may not tailor audit procedures to the actual risk at hand or the team may rush to jump to wrong audit conclusions.

The principle of professional skepticism is core in the audit process both in the sense that it is part of being a competent auditor, and that it is an important part of being ethically independent.

Further actions – regarding additional payroll costs

The audit evidence that has been obtained on the payroll costs for the additional employees is not sufficient as it does not provide evidence supporting the rationale for adding employees on the payroll and is not reliable as it has not been corroborated with other information sources.

The audit team should gather more evidence that confirms / supports the claim by the payroll supervisor that the additional employees were hired on a "temporary basis" by reviewing copies of the contractual terms of these casual workers.

The audit team should corroborate the payroll supervisor's assertion that no authorization is needed for the payment of the additional temporary casual workers for example by reviewing the company's policy on the recruitment and payment of casual workers.

If the payroll supervisor is correct that no authorization is required for new employees, then this is a major deficiency in the internal controls of Ebeneza Co which should have been identified by the audit team during the testing of controls. The deficiency in the internal controls on recruitment of casual workers should be included in the report to management and to those charged with governance (i.e., through the "management letter")

There is a contradiction in the supervisor's claim that additional employees on the payroll were new temporary casual workers and yet the company management claims that there were no new staff recruited during the year. The audit team needs to clarify whether management's reference of staff extends to the "temporary staff" category.

It is possible that there is a fraud taking place at Ebeneza Co, possibly by the payroll supervisor and/or others perpetrating the fraud using a "ghost employees" scheme if the company is paying additional casual workers through the payroll yet the casual workers do not exist. The possibility of a fraud taking place needs to be further reviewed by the audit team on the basis that the additional employee cost of FRW 1,125 million is material to the financial statements for the year ended 31 December 2023.

The audit junior and other members of the audit team should be made aware that when they come across issues that raise the auditor's suspicion of potential errors or fraud in the financial statements of the clients as the case with the uncorroborated evidence of the payments to the new casual workers at Ebenezer Co, this information should promptly be reported to the audit supervisor for further investigations.

QUESTION TWO: Rukungwa Construction Company (RCC) and Marie Bookshop **Marks**

Due diligence review engagement on RCC

(a) (i). Matters to be clarified in the terms of engagement for the due diligence assignment on RCC

Award up to 1 mark for each correct point made representing the "Matters to be clarified in the terms of engagement for the due diligence assignment" (where the 1 mark includes 0.5 marks for correctly identifying a required matter / issue to be included in the terms of the engagement "what" information is needed and 0.5 marks for explaining "why" this is needed) - this may include (but not limited to):

- A reasonable introduction
- Objective of the due diligence review
- Management's responsibility for the final decision to acquire RCC
- The nature and scope of the due diligence review
- The type / level of assurance
- Time budget / deadline for the due-diligence review assignment
- Accessibility to documents and other relevant information
- A disclaimer clause included in the professional accountant's report on the due diligence review

Note: Any other valid matter (other than those included in the model answer) if this is well developed that is relevant to specific due diligence review of RCC

Total marks for Q3 (a) (i) 7

Do Not Award: A reference to a third-party reliance where the third-party is a loan provider as Prudence Hotel is reported to have substantial cash reserves and hence does not need to use the due diligence report to support a borrowing aimed at financing the acquisition of RCC

Part (b) (ii): Principal additional information needed for the due- diligence review engagement on RCC

Award up to 2 marks for each correct point made representing the "additional information needed" (where the 2 marks per point includes 1 mark for identifying "what" information is needed and another 1 mark for correctly explaining "why" this information is needed) - points may include (but are not limited to):

- Employment service contracts and/or any other contracts between RCC and the senior management team
- Prior period financial statements
- The most recent management accounts and cash flow forecasts
- The management accounts
- A signed bank agreement for the overdraft facility
- The standard terms in contracts between RCC and its customers
- Accessibility to documents and other relevant information
- Legal correspondence files dealing with matters such as the legal claims of the residents
-The fee notes from the lawyers
- A copy of RCC’s insurance policy
- The quantity surveyor’s working papers for the last quarterly count
- The quality surveyor’s assessment reports of the financial performance of the construction contracts
- A report on the type and frequency of the construction works undertaken
- A copy of RCC’s non-current assets register

Note: Any other valid matter (other than those included in the model answer) if this is well developed that is relevant to specific due diligence review of RCC

Total marks for Q3 (b) (i) 12

(b) The Marie-App operated by Marie bookshop

(i) Challenges that Marie bookshop may face if its employees are allowed to have unrestricted access to make changes in the information details published on the Marie-App

Award up to 1 mark for each correct / valid challenge posed exposing Marie Bookshop to fraud arising from the employees having unrestricted access to make updates in the information published on the Marie'App - a maximum of 3 marks

Note: Any other valid matter (other than those included in the model answer) if this is well developed that is relevant to specific to case given for Marie Bookshop

Total marks for Q3 (b)(i) 3

(ii)Recommendation to address the challenges in (i) above

Award up to 1 mark for each correct / valid recommendation well-developed to address the specific challenges explained in (c)(i) above
Note: Any other valid matter (other than those included in the model answer) if this is well developed that is relevant to specific to case given for Marie Bookshop

Total marks for Q3 (b)(ii)	3
Total marks for Question Three	**25**

MODEL ANSWER TO QUESTION TWO

DUE DILIGENCE ON RUKUNGWA CONSTRUCTION COMPANY (RCC)

Part (a) (i): Matters to be clarified in the terms of engagement for the due diligence assignment

Introduction: The due diligence review engagement is considered to be a separate engagement from the audit engagement for Prudence hotel. This needs to be clarified with the management of Prudence hotel and therefore a separate engagement letter for the review engagement is required.

The following issues will need to be clarified in the engagement terms for the due diligence assignment:

Objective of the due diligence review: a case here is likely that the objective of the due diligence review is to find and report facts that are relevant to Prudence Hotel's decision making as to whether or not to acquire RCC. The terms of engagement should therefore confirm whether Prudence Hotel's interest is to acquire the shares in RCC or to acquire (say) specific trading assets of RCC as this will impact on the nature and scope of the review engagement.

Responsibility for the final decision to acquire RCC: The terms of the review engagement will clarify that the final decision to acquire RCC and any offer price / payment terms shall solely be the responsibility of the management of Prudence hotel and not for the firm of professional accountancy (Kwizera & Associates).

The nature and scope of the due diligence review: the terms of the engagement must provide details of the nature and scope of the review and any standards / guidelines which shall be followed in the conduct of the due diligence review engagement. The engagement terms should clarify that the due-diligence review will consist of mainly enquiries (e.g., of the directors and the quantity surveyor) and analytical procedures (e.g., on budgeted information and prior period financial statements)

The type / level of assurance: a due diligence review will usually result in a limited assurance of a "negative" opinion type. This limited level of assurance with a negative opinion needs to be clarified in the engagement terms as the management of Prudence Hotel may assume a positive assurance shall be provided considering they are our audit clients where our audit report has always been provided a positive opinion. In the due diligence review assignment, a negative review will state “nothing has come to the attention of the professional accountant, that the subject matter is materially misstated. The engagement terms should also state that a due diligence review is not an audit and that an audit opinion will not be expressed.

Time budget / deadline for the due-diligence review assignment: The engagement terms should clearly indicate the timeframe for conducting the review engagement, which is this case, management of Prudence Hotel is indicating that the assignment should be conducted in a maximum period of two days, and this should be done next week which indicates a deadline for the accountancy firm to report its findings.

Accessibility to documents and other relevant information: The engagement terms should indicate the requirement for the professional accountant to have unrestricted access to the necessary records, documentation, and any other relevant information from RCC. The unrestricted access to records and information from RCC should be subject to an agreement between Prudence hotel and RCC.

A disclaimer clause included in the professional accountant’s report on the due diligence review: the engagement terms should include a responsibility / liability disclaimer that the due-diligence review engagement cannot be relied upon to disclose all errors, illegal acts or other irregularities – for example, due to the limited review procedures applied in a due diligence review engagement, the professional accountant cannot be expected to detect and disclose all the fraudulent financial reporting or misappropriation of (say) RCC’s assets.

Note: Credit will be provided for other well explained points that are valid and relevant to the case in the scenario (e.g., the basis for the fees which may be linked to the tight timeframe and deadlines for the assignment and the likely experts used in line with RCC’s construction industry)

Part (a) (ii): Principal additional information needed for the due- diligence review engagement on RCC

In order to conduct an effective due diligence review, the following additional information will be needed:

- **Employment service contracts and/or any other contracts between RCC and the senior management team** that includes the directors from the family that currently owns RCC and other key employees (e.g., the quality surveyor) will be required. These contracts are needed to evaluate whether they contain any “exit” or other settlement terms that have significant cash flow implications in the event that the services of these personnel are terminated if they are no longer required after the takeover/buyout.

- **Prior period financial statements** (to 30 June 2023) to confirm whether these have disclosed any significant accounting policies and the key assumptions concerning the future of RCC that have a significant risk of causing a material adjustment to the carrying amounts of the assets and liabilities in the year to 30 June 2024. Such may include:

- The outcome the ongoing litigation claim from the residents of a collapsing building in Remera
- Any likelihood of any compensation from Gasana Services Co and/or any other guarantees (e.g., suppliers of the default building materials that were used in the construction of the building in Remera)
- Assumptions made in estimating costs of completion when determining the percentage of completion using the "cost-method" - for example if there are estimated increases in the cost of materials or labor.

- **The most recent management accounts and cash flow forecasts** to assess the quality of management information being used for decision making and control.

- In particular, **the management accounts** will provide information that helps with the assessment of RCC's ability to keep its cash flows within its overdraft limit as this has been done for the past 18 months especially since Prudence hotel has substantial cash flow reserves which may imply that RCC does not need an overdraft after it has been acquired by Prudence hotel.

- **A copy of the signed bank agreement for the overdraft facility** and any other agreements with other finance providers to assess whether there are debt covenants that might result in penalties of contingent liabilities that Prudence Hotel will have to bear if it acquires RCC.

- **The standard terms in contracts between RCC and its customers** for the construction works to confirm if there are:
- guarantees provided – for example for rectification work under a warranty;
- penalty clauses – for example, penalties that can arise in the event of delays in the completion or non-completion of the construction works
- disclaimers against any defaults or negligence from the customers

Prudence Hotel will want to make some allowance for settlement of liabilities arising on contracts already completed / in-progress when offering a price to acquire RCC.

- **Legal correspondence files dealing with matters such as the legal claims of the residents** in the damaged building based in Remera and RCC's counter claim against Gasana Services Co to confirm the status of the legal claims and the likelihood of any compensations from RCC (or Gasana Services Co) to the residents.

- **The fee notes from the lawyers** of RCC to confirm the amount of probable additional legal costs that will have to be settled.

- **A copy of RCC's insurance policy** (if any) to determine RCC's exposure to claims from its customers for claims due to poor construction work done, damages, injuries to employees etc.

- **The quantity surveyor's working papers for the last quarterly count** (e.g., the stock count on 31 December 2023) and the latest rolling budgets to confirm the accuracy of the estimates of the completion stage for ongoing construction works.

- **The quality surveyor's assessment reports of the financial performance of the construction contracts** especially the loss-making contracts to confirm these losses are adequately recognized in full in the financial statements and the impact of the losses on the future of the entity.

- **A report on the type and frequency of the construction works undertaken** as this will help Prudence Hotel to make an assessment whether RCC has the relevant experience in the construction of the buildings similar to the needed 5-star hotels that should be constructed in two major cities in Rwanda.

- **A copy of RCC's non-current assets register** showing the location of plant and equipment so that test checking on the physical existence might be undertaken.

Part (b) (i): The Marie-App operated by Marie bookshop

(i) Challenges that Marie bookshop may face if its employees are allowed to have unrestricted access to make changes in the information details published on the Marie-App

A large number of companies are now providing customers access to online views and purchases of the company's products on the internet for example by use of an online application platform similar to the Marie-App operated by Marie Bookshop. The Marie-App is now upgraded to allow both selling its goods (to customers) and the company itself making purchases from major suppliers via the online platform hence making it possible for an unauthorized access to the Marie-App by its employees.

The following challenges are potentially exposing Marie bookshop if its employees have unauthorized access to make changes in the information maintained on the Marie-App:

- The employees may display and make sales of their own private commodities (similar to the products sold by Marie bookshop like books) especially the sales personnel whose personal mobile phone numbers are published on the Marie-App to receive payments from customers.
- The employees may also sell company assets that are either unauthorized to be sold or even sell the normal books and scholastic materials of Marie bookshop using the Marie-

App and do not declare the receipts as these are received directly on their personal mobile phones

- The employees may make purchase orders for goods of a private nature through the Marie-App which the company goes ahead to pay for based on a wrong assumption that the purchased goods belong to the company
- Employees may make purchases of goods for Marie bookshop when the purchases are not authorized resulting to a financial loss
- Employees may inappropriately use the Marie-App by disseminating confidential information of Marie bookshop e.g., financial data which may damage Marie bookshop's competitiveness if the competitors use this information to their advantage.
- The employees may use the Marie-App to respond to or give advice to customers which may prove to be negligent and therefore, expose Marie bookshop to litigation and/or reputational damage.

(ii) Recommendations of controls that can be introduced to combat unrestricted access to the Marie-App changes by the employees of Marie bookshop

There are a number of controls with Marie Bookshop can use to prevent unauthorized access to the Marie-App including restricting the employees from making unauthorized updates on the online sales and purchases platform. These include:

- **Identity recognition procedures** that can restrict unauthorized access to the Marie-App including the need to use passwords or identity tokens or other security devices. These may need to be encrypted in order to prevent unauthorized use of the password by other persons.
- **Access controls** which may involve the use of a Personal Identification Number (PIN) that expires after a short period of time (requiring regular changes to access the Marie-App)
- **Physical controls** that may include unrestricted access to the IT office where the Marie-App set up and other configurations are being managed from (by shielding and protecting such an office with for example burglar proof protection)
- **Other procedures** including:

- Marie bookshop can set up an internal control system whereby information / transactions to be processed on the Marie-App should only be done by authorized personnel. There should introduce and implement segregation of duties between the user departments (e.g., the sales, purchasing and stores departments) and the data input/output section;
- Marie Bookshop can also set up a formal fraud / error control project where the transactions on the Marie-App are closely scrutinized by (say) the internal audit team as part of a risk-based analysis of transactions that are highly susceptible to fraud.

Note: Credit will be awarded in Q3(c) for other valid points correctly raised as a challenge and/or a recommendation as long as these are specific to the information provided in the scenario

QUESTION THREE: VANEY LTD

Part (a): Matters to consider before accepting the engagement to examine and report on the Prospective Financial Information (PFIs) of Vaney Ltd

Award up to 1 mark for each correct point made representing the "Matters to consider before accepting the engagement to examine and report on the PFIs of Vaney Ltd" (where the 1 mark includes 0.5 marks for correctly identifying a required matter / issue and 0.5 marks for explaining "why" this is needed) - this may include (but not limited to):
- The intended use of the information contained in the PFIs
- The nature of assumptions being applied in the preparation of the PFI
- The “elements” to be included in the information
- The period to be covered by the PFI
- The terms of the engagement to be agreed with management

- Kagabo & Partners should obtain a sufficient level of knowledge of the business of Vaney Ltd
- The expertise and experience of the persons who produced the PFI information
- The documentation supporting the management’s assumptions used
- The techniques used in the preparation of the information
- The level of competence of our firm of professional accountants, Kagabo & Partners
- The time frame (e.g., deadline)
- The level of the client’s integrity
- Professional ethical issues (maximum of 4 marks)
- Award 1 mark for any reasoned conclusion justified by the discussion of matters made

Note: Any other valid matter (other than those included in the model answer) if this is well developed that is relevant to specific due diligence review of RCC

Total marks for Q4 (a) 10

Part (b): Matters to be considered and examination procedures on Vaney's cash flow forecast

Award up to 1 mark for each valid matter / examination procedure based on the model answer and/or any other valid audit procedure(s) provided by the student answers. (Maximum of 12 marks)

12

Part (c): Professional accountant’s basis of reporting on the PFIs

Award 1 mark for each valid point made explaining the basis of reporting and opinion (or level of assurance) provided in the engagement to examine PFI including:
- Any brief explanation of the difference in the level of assurance provided in the report on the PFI examination compared to the assurance provided in an audit engagement (maximum of 1 mark)

- A brief explanation of the rationale for a professional accountant providing a limited level of assurance in a professional accountant report on a PFI examination

- An indication that a limited / moderate level of assurance results into a "negative opinion"
- An example of how a "negative opinion" is worded in the accountant's report on a PFI examination
- Any other point that is well developed to correctly explain the professional accountant's basis of reporting on the PFI examination

Total marks for Q4 (c) 3
Total marks for Question Three **25**

MODEL ANSWER TO QUESTION THREE:

Part (a): Matters to consider before Kagabo & Partners accept the engagement to examine and report on the Prospective Financial Information (PFIs) of Vaney Ltd

Before accepting an engagement to examine and report on the PFIs for Vaney Ltd, our firm of professional accountants should consider:

- **The intended use of the information contained in the PFIs** and whether this information will be provided to the general public (for example any stakeholder that Vaney wishes to make an application for capital finance) or the information is restricted to be used only in the capital finance application to Apex Bank and the current shareholders.

- **The nature of assumptions being applied in the preparation of the PFI**– whether they are “best-estimate” assumptions that are based assumptions that are expected to take place or whether the assumptions used are hypothetical assumptions which are assumptions that are not necessarily expected to occur as these are “what if” assumptions, for example the increase in the gross profit margin forecast (to 28%) may be based on Vaney acquiring a major customer outside Rwanda where such information can only have validity if the major customer has been acquired.

- **The “elements” to be included in the information**: In this case, we need to establish whether Apex Bank and other intended users require the examination of the cash flow forecast to extend to the forecast profit or loss and forecast statement of cash flows as this will increase the volume of work, resources required to conduct the assignment and potentially the engagement fees to charge.

- **The period to be covered by the PFI** – as the volume of work by the professional accountants and the nature of assumptions applied in the preparation of the PFI depends on how long is the period covered by the PFI. Vaney has currently prepared PFI for a 12-months period, but it is possible that Apex Bank and/or the shareholders may require a longer period that is consistent with the duration of the debenture notes and/or the shareholders loan period.

- **The terms of the engagement to be agreed with management**. The terms of the engagement should address the above matters and state that it is management who are responsible for the assumptions and that management will provide the professional accountant with relevant information including access to the source data being used in the forecasts. In this case, a separate engagement letter for the examination of the PFIs has to be in place and not the audit engagement letter that is currently applied in the audit of Vaney's financial statements.

- **Kagabo & Partners should obtain a sufficient level of knowledge of the business of Vaney Ltd** to enable the firm be able to report on the PFI information. This is the first year Kagabo & Partners conducted an audit on the financial statements of Vaney Ltd which implies that Kagabo & Partners may not yet have attained all the required knowledge to perform an examination of the PFIs of Vaney as the learning curve in the first year is always steep. Therefore, in addition, to the type of knowledge referred to in ISA 315 relating to audit matters, the following knowledge should be obtained to conduct an examination of the PFI for Vaney:

- **The internal controls at Vaney** over the system used to produce the prospective information
- **The expertise and experience of the persons who produced the PFI information** at Vaney as different considerations will be applied if (say) the PFI information has been produced by Vaney's own personnel or by external consultants. For example, the engagement will pose significant risks to our firm if the persons involved in the preparation of the PFI are less or non-experienced in the preparation of the PFIs.
- **The documentation supporting the management's assumptions used**. For example, we need to consider whether the communication by Vaney to its customers regarding the change in the credit period to 60 days is validated by the Board's resolution and in addition, there is evidence of documented correspondence with the customers that indicates that the change has been (or likely be) accepted by the customers.
- **The techniques used in the preparation of the information** for example statistical methods, computer generated forecasts etc

- **The level of competence of our firm of professional accountants, Kagabo & Partners**, including the availability of resources especially the skills and competences of the firm's personnel. It is important to ascertain whether the firm has the required (or available) personnel with the competence to conduct the PFI examination engagement within an agreed timeframe.

- **The time frame (e.g., deadline**) for the performance and conclusion of the PFI engagement as it is possible the report on the examination of the PFI may be needed urgently for Vaney to process the application for the capital finance with Apex bank and the shareholders. This is of utmost concern considering that it is only two weeks for Vaney to have received all the required capital finance of FRW 9,000 million (the forecast cash flow indicates the capital finance is planned to be received by 1 April 2024). This indicates a limited timeframe in which the engagement report must be submitted and yet the engagement terms have not yet been agreed upon. If Kagabo & Partners agree to take on the engagement, it may be practical for the firm to request Vaney to extend the deadline for the report to allow the firm to conduct a professional job with high quality.

- **The level of the client's integrity** relating to the preparation of the information in the PFIs needs to be reviewed prior to accepting the engagement to examine the PFIs. It is evident that Vaney Ltd is in need of the capital finance considering that the last audited financial statements report a high overdraft of FRW 5,500 million used and the current overdraft facility with Apex Bank is expiring in a short period (on 31 March 2024). This means that it is highly possible that Vaney will produce PFIs with high optimistic assumptions and figures to impress the potential capital providers (Apex bank and the shareholders). In addition, Vaney is promising an "attractive fee" to Kagabo & Partners if they provide the engagement to examine and report on the PFIs which all indicate a potential bias and lack of integrity by Vaney in the preparation of the PFIs.

- **Professional ethical issues** that impact on the independence and objectivity of Kagabo & Partners as professional accountants need to be considered. For example:

- A self-interest threat can emerge from the total amount of fees received from the same client – in this case Vaney Ltd is a listed client where the cumulative fees received from the same client should not exceed 15% for two consecutive years as this will lead to a self-interest threat as Kagabo & Partners will want to protect this financial interest by providing engagements reports (or opinions) that interest management of Vaney
- A further self-interest threat may arise where the same partner (Claude Ruzidana) who has been the engagement partner on the audit will be same partner on the examination of the PFI implying that Claude will be earning a high amount of fees from the same client, and he may provide a report on either engagement to impress management of Vaney in order to protect his financial interest. As a safeguard, another partner may have to be engaged on the examination of the PFI rather than using the same partner Claude who is the audit engagement partner on the same client.
- A self-interest threat may arise where the fees charged on the engagement to examine PFIs for Vaney is based on the success and/or the amount of the capital finance raised by Vaney Ltd using the professional accountant's report – a contingent fees approach.

Whereas charging fees based on a contingent fee basis may be acceptable for non-audit engagements, this is more likely not acceptable if the client is listed on the Rwanda stock market and in addition to the non-audit engagement, this is also an audit client for the same firm of professional accountants. As a safeguard, Kagabo & Partners should only accept the engagement to examine and report on the PFIs of Vaney if the basis for the fees on this engagement shall be based on professional factors and is commensurate to the risk of the engagement.

- A self-review threat will arise in the subsequent audit of Vaney's financial statements for the year ended 31 December 2024 which will be reviewed against the assumptions used in the forecast financial statements as a comparison and the audit firm will be reviewing the work on which they previously presented a report on the PFIs and hence will not exercise sufficient professional skepticism during the audit. As a safeguard, the firm can utilize different teams with the team used in the examination of the PFIs different from the team that subsequently conducts the audit for the financial statements for the year ended 31 December 2024.
- A familiarity threat will arise where the same audit engagement partner (Claude Ruzidana) is the partner on the engagement to examine and report on the PFIs of Vaney. By conducting both engagements in a quick succession, the partner, Claude Ruzidana, will develop a close relationship with key management personnel (and the systems) of Vaney Co which may imply that he will lose his professional skepticism approach in the subsequent audit of Vaney's financial statements for the year ended 31 December 2024 which will also impact adversely on the quality of the audit engagement.

Conclusion

Where the accountancy accesses that the ethical threats and/or other professional considerations as discussed indicate that this engagement is too risky to accept then Kagabo & Partners should politely decline the engagement and provide a formal reason(s) to those charged with governance of Vaney Co, for the decision not to take on the engagement to examine the PFIs.

Part (b): Vaney's cash flow forecast

Matters to be considered

The intended use of the forecast cash flow is to support Vaney's application to Apex Bank and the existing shareholders for a finance capital totaling to FRW 9,000 million. The purpose for which a cash flow forecast is produced can sometimes influence the assumptions used by management in its preparation, for example the assessment of the time (days) it will take the credit customers to settle their receivable accounts. It is important that the professional accountant tests the cash flow forecast for consistency with other projections that the company will have made such as the profit forecast, capital expenditure budgets and a forecast statement of financial position.

The matters, Kagabo & Partners should enquire of in relation to the cash flow forecast of Vaney Ltd for the 12-months period ended 31 December 2024 include the following:

Matters to be considered and examination procedures based on the profit forecast:

- The projected increase in the future level of sales revenue and gross profit margins needs to be reviewed for its reasonableness by reviewing the evidence to justify these increases. The review team should consider if sales have shown an upturn in the recent past, or if there any new products or any new contracts (with new or existing customers) for the supply of goods that may or have been signed that may have been signed by Vaney.

- A review of the latest trading figures for the period from the end of the last audited financial statements to the current date (two-months: 1 January – 29 February 2024) to confirm that the sales and gross profit margins have indeed increased.

- Obtain an explanation for the reduction in the level of the cost of sales particularly the costs of production (i.e., materials, labor, and production overheads) which should be assessed in light of other factors and its reasonableness.

- Review the consistency for the reduction in the costs of sales with other planned or actual decisions by Vaney including whether the cash flow implications of these have also been considered in the cash flow forecast – for example a restructuring plan to reduce labor costs, or new acquisitions of plant that may support future production efficiencies.

Matters to be considered and examination procedures - Receipts from the credit sales and the trade receivables period:

- Review the reasonableness in the assumptions used to validate the planned reduction in the receivable collection period from 93 days to 61 days.

- Confirm by inquiry and review whether the early settlement discount of 1% expected to be granted to customers making their payments within 30 days of the credit sale has been reflected in the cash flow forecast as this should have a reduction effect on the cash inflows.

- Assess the proportion of the customers who will be able to take advantage of the early settlement discount by (say) reference to the sales that may have been made and settled since the introduction of the discount.

- Review the correspondences between Vaney and the overseas customers to confirm whether it will be practical for the overseas customers to settle their trade receivable credits within the required 30 days to benefit from the early-settlement discount or an alternative policy has been granted to these customers.

- Review the receipts expected from the overseas customers to confirm whether these have appropriately taken into consideration the movement in exchange rates on their receipt in the cash flow forecast (as the dates of the sales receipts will be different from the dates of the sale).

- Review the exchange rates applied in the foreign sale receipts to confirm their consistency with the market expectations e.g., check whether the exchange rates broadly approximate to the appropriate forward contract rates.

Matters to be considered and examination procedures - Payments on purchases and the trade payable period

- On the basis that Vaney expects to increase the trade payable settlement period from 45 days to 90 days (a 100% increase in the payable days), the review team needs to confirm by inquiry and review of the correspondences between Vaney and the suppliers that this increase in the settlement days has formally been agreed upon or the process of agreement is in advanced stages.

- Confirm whether there are implications of the increase payable settlement days (for example an increase in the purchase prices set by the suppliers) and these have correctly been reflected in the cash flow forecast.

- Assuming the increased payable settlement period is an infringement of the supplier's terms, then the review team should consider whether this may have a longer-term effect on Vaney – e.g., review evidence of any recent failures to access credit purchases to confirm possibilities that the suppliers may discontinue the credit terms and only allow to supply to Vaney on cash terms which may have a worse impact on Vaney's cash flow forecast than what is being reported in the cash flow forecast.

- Review the total cash flows in respect to purchases of goods and services to confirm their consistency with the forecast of sales and inventory levels

Matters to be considered and examination procedures - Other figures in the cash flow forecast

- Inquire from management and confirm by review of the details in the cash flow forecast whether they are other forecast inflows of cash from (say) issuance of ordinary share capital (considering that Vaney is a listed client whose shares may be issued in a pre-determined published share issue) or other forms of finance.

- Inquire and review if cash flows relating to taxation/dividends have been included in the cash flow forecast and their basis of amounts reported.

- Review whether the interest cost cash outflows reasonably reflect the possible increase in the interest rates by comparing with the market interest rates and/or the normal interests from Apex bank for similar loans with the same financial structure and risk profile as Vaney.

- Confirm that cash outflows have been correctly included in the cash flow forecast for the repayment of any other outstanding loans (and the last audited bank overdraft of FRW 5,500 million) during the period of the forecast.

- Check the progress of any receivables, payables, and contingencies that were reported in the last audited financial statements and confirm whether these have been correctly reflected in the cash flow forecast or will be crystallized in other forms other than through cash flow transactions and this has been disclosed in the notes to the cash flow forecast.

Vaney's experience with any previous cash flow forecasts:

- Confirm by inquiry of management and a review of any previous cash flow forecasts of Vaney Ltd with the actual results in the period(s) covered by the forecasts to determine whether the actual results were close to the forecast figures in order to confirm management's competence regarding the preparation of PFIs and whether the current cash flow forecast can be relied upon

Part (c): Professional accountant's basis of reporting on the PFIs

When reporting on PFIs, the professional accountant is not attempting to give a high-level assurance that the figures in the statements will be achieved. The level of assurance that is given by the professional accountant in the accountant's report on the PFI is only "moderate" in comparison to the" high" level of assurance given in the audit of historical financial statements.

In providing an assurance on the PFIs, the professional accountant will base their report on the following factors:

- The professional accountant will consider the reasonableness of management's assumptions which have been used as a basis for the preparation of the prospective information. The company's past achievements and an assessment of future economic conditions should support the assumptions.

- The prospective information is properly prepared from, and consistent with, management's assumptions and other information. For example, a forecast level of sales/production activity should not be in excess of the company's existing capacity, unless an expansion is planned. If so, the consequent effects of the expansion must also be included in the prospective information.

- Prospective information must be internally consistent and have clerical accuracy. For example, forecasts which include acquisitions of plant, and the depreciation thereof (profit forecast only) should be consistent with the plant in the statement of financial position and the accounting policy for depreciation. It should also be consistent with the company's historic cost accounts using the same accounting policies unless different policies can be justified.

It is important that the PFIs, or the professional accountant's report on it, should make the following points:

- Reference should be made to applicable International Financial Reporting Standards and International Standards on Auditing (or other appropriate standards).

- Management is responsible for the statement and its underlying assumptions. The assumptions and accounting policies should be disclosed in the statement.

- The purpose for which it is being prepared together with any restrictions on its distribution.

- In this report, the professional accountant normally gives a form of "negative assurance" that nothing has come to his attention which causes him to believe the assumptions, or the figures are unreasonable. If the professional accountant is not satisfied with the reasonableness of the assumptions, he should either withdraw from the engagement or express a qualified or adverse opinion. The professional accountant's report should also state that the actual results are likely to be different to the projected results, and the differences may be material.

MARKING GUIDE AND MODEL ANSWER TO QUESTION FOUR

MARKING GUIDE	Marks
Q4(a) (i) Discuss and comment clearly on the suitability of the audit opinion recommended by audit team leader under Kenya-Nairobi subsidiary draft audit report clearly stating the arguments for or against the recommendation	
Award 3 mark for clearly concerns on the audit opinion recommended by audit team leader under Kenya-Nairobi subsidiary draft audit report by stating the arguments for or against the recommendation. 1 mark for correct conclusion drawn by the student. Max is 4 marks	4
Q4(a) (ii) Discuss and comment clearly on the suitability of the audit opinion recommended by audit team leader under Uganda-Kampala subsidiary draft audit report clearly stating the arguments for or against the recommendation	
Award 3 mark for clearly concerns on the audit opinion recommended by audit team leader under Uganda-Kampala subsidiary draft audit report by stating the arguments for or against the recommendation. 1 mark for correct conclusion drawn by the student. Max is 4 marks	4

Q4(a) (iii) Discuss and comment clearly on the suitability of the audit opinion recommended by audit team leader under Tanzania- Dares salaam subsidiary draft audit report clearly stating the arguments for or against the recommendation

Award 3 mark for clearly concerns on the audit opinion recommended by audit team leader under Tanzania- Dares salaam subsidiary draft audit report by stating the arguments for or against the recommendation. 1 mark for correct conclusion drawn by the student. Max is 4 marks	4

Q4(a) (iv) Discuss and comment clearly on the suitability of the audit opinion recommended by audit team leader under Burundi-Bujumbura subsidiary draft audit report clearly stating the arguments for or against the recommendation

Award 3 mark for concerns suitability on the audit opinion recommended by audit team leader under Burundi-Bujumbura subsidiary draft audit report by stating the arguments for or against the recommendation. 1 mark for correct conclusion drawn by the student. Max is 4 marks	4

Q4 (b) In line with IAS 10, discuss the effects of each case on the financial statements for the year ended 31 March 2024

Award up to 2 marks for important consideration in relation to events after reporting period. The 1 mark for identification and Cleary defining the IAS dealing with event after reporting period.	3
2 marks for each case well elaborated and associated effects clearly stated. Correct effects and clear discussions out of marking guide will also be valid	6
Total marks for Question Two	**25**

MODEL ANSWER

Part (a): Discuss and comment clearly on the suitability of the audit opinion recommended by audit team leader under Kenya-Nairobi subsidiary draft audit report clearly stating the arguments for or against the recommendation

Subsidiary in Kenya-Nairobi

The form of modification that should be given in this case will depend on two factors. The materiality of the matter and whether it is pervasive to the financial statements. The question states that the matter is material but it does not state whether or not the matter is pervasive. In the event that the matter is material and not pervasive, the appropriate opinion would be a qualified report with an except for opinion. If the matter is both material and pervasive then the opinion will be an adverse opinion stating that the financial statements do not show a true and fair view.

Conclusion: The use of a qualified opinion and an emphasis of matter as suggested by the audit team lead is wrong. An emphasis of matter paragraph is not a modification of the audit report.

Subsidiary in Uganda-Kampala

The event of a major customer declared bankruptcy after the year end is an adjusting event subject to the provisions of IAS 10 "*Events after the reporting period*". The fact that the customer has declared bankruptcy and the amount to be settled to creditors determined gives additional information of the conditions that existed at the period end. There is need to make a provision for the amount that may not be collected from this customer. Under ISA 560 the auditor has a responsibility to identify any such events and ensure they are correctly accounted for by management. Management's refusal to make a provision is not correct and the audit team leader should ensure correct treatment of this event.

Conclusion: The auditor team leader is not right in suggesting that an unmodified opinion be issued. If management insist that they cannot amend the provision at the period end, depending on the materiality and pervasiveness of the matter the auditors should consider modifying the audit opinion.

Subsidiary in Tanzania- Dares salaam

IAS 2 "*Inventories*" requires that inventory should be valued at the year end at the lower of cost and net realizable value. The standard recognizes the fact that if inventory is overvalued then this will result in a direct overstatement of profits. Since it is clear that this subsidiary will not be able to sell the clothes at more than cost then the closing items should be valued at the net realizable value. Further, the auditors have gathered sufficient appropriate audit evidence and therefore cannot use a declaimer of opinion which is only used when the auditor has not obtained sufficient appropriate audit evidence.

Conclusion:

The audit team lead is wrong in suggesting a disclaimer of opinion should be used. Depending on the materiality and pervasiveness of the matter, the appropriate opinion will either be qualified or adverse.

Subsidiary in Burundi-Bujumbura

This is an error of principle and will cause misstatements of the financial statements. The five bulks represent 60% of total non-current assets and so the matter is material. The misclassification of inventory as non-current assets is material. The management should be requested to correct the error and once resisted the audit team leader should modify the report.

Conclusion:

The audit team lead is not right by suggesting a qualified audit opinion under the draft audit report. The appropriate form of modification is an adverse opinion that the financial statements do not show a true and fair view.

Part (b): To discuss the effects of cases mentioned under the study on the financial statements for the year ended 31 March 2024

IAS 10 "*Events After the Reporting Period*" stipulates the accounting and disclosure requirements concerning transactions and events that occur between the reporting date and the (expected) date of approval of the financial statements. Among other things, IAS 10 determines when an event that occurs after the reporting date will result in the financial statements being adjusted, or where such events merely require disclosure within the financial statements. Such events are referred to in IAS 10 as 'adjusting' or 'non-adjusting' events.

The important consideration is the timing of the events in relation to the reporting date and to consider whether the events existed at the year-end, or not. If the conditions did exist at the year-end, the event will become an adjusting event. If the event occurred after the year-end, it will become a non-adjusting event and may simply require disclosure within the financial statements.

First scenario on fraud case

Clearly the fraud committed by the payable's ledger accountant has been ongoing during, and beyond the financial year. Fraud, error and other irregularities that occur prior to the year-end date, but which are only discovered after the year-end, are adjusting items, and therefore the financial statements would require amendment to take account of the fraudulent activity up to the year-end.

Second scenario on legal proceedings

At the year-end, the company had made disclosure of a contingent liability. However, subsequent to the year-end (29 April 2024), the court found the company liable for breach of contract. The legal proceedings were issued on 20 March 2024 (some 11 days before the year-end). This is, therefore, evidence of conditions that existed at the year-end. IAS 10 requires the result of a court case after the reporting date to be taken into consideration to determine whether a provision should be recognized in accordance with IAS 37, "*Provisions, Contingent Liabilities and Contingent Assets*" at the year-end. In this case, the financial statements will require adjusting because:

- The conditions existed at the year-end
- The recognition criteria for a provision in accordance with related international standard.

Third scenario on legal proceedings

A customer with head office in southern province was declared bankrupt so soon after the reporting period which indicates non-recoverability of a receivable at the reporting date and therefore represents an adjusting event under IAS 10 "*Events After the Reporting Period*". Assets should not be carried in the statement of financial position at any more than their recoverable amount and, therefore, an allowance for receivables should be made.

End of question paper