CERTIFIED PUBLIC ACCOUNTANTS

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: FRIDAY 29, NOVEMBER 2024

INSTRUCTIONS:

1. Time Allowed: **3 hours 45 minutes** (15 minutes reading and 3 hours 30 minutes writing).
2. This examination has **two** sections**; A & B.**
3. Section **A** has **one** Compulsory Question while section B has three optional questions to choose any two.
4. In summary attempt **Three** questions.
5. Marks allocated to each question are shown at the end of the question.
6. The question paper should not be taken out of the examination room.

SECTION A

QUESTION ONE

a) You are a manager in Sabiti & Co, a local firm of certified public accountants of Rwanda. On 30 September 2023, your firm was appointed as auditor to Huye Steel & Metals Co (HSM Co). HSM is one of the largest companies that produces iron and steel products with its major customers comprising of construction companies in and outside Rwanda. You are the manager-in-charge of the audit of the financial statements of HSM Co for the year ending 31 December 2023.

HSM operates with both its head office and a large factory located in Huye and has workshops in the large cities of all the provinces of Rwanda. HSM uses the workshops to display its final products for sale to the public. In order to expand the company's storage facilities, HSM has leased a property, which is a privately-owned land in Huye where it has constructed a large-sized stockyard (i.e., an enclosure where the raw materials are kept). The lease commenced on 1 January 2023 for a lease period of 25 years and the construction of the stockyard was completed on 1 July 2023. The senior management team that oversees the daily operations of HSM include the Finance manager, procurement manager, production manager and workshop manager who all report directly to the General manager.

Sales of the iron and steel products are made to the general public through the workshops and the receipts from the sales are received by the receptionist of the workshop. Other than the major customers who are construction companies and whose sales are on credit terms, the other sales made to the public are in cash or through MoMo (mobile money). All MoMo receipts are received through private phone numbers of the workshop managers displayed on at the workshop reception. The finance department at the head office in Huye maintains a monthly cash book with receipts based on the monthly sales report from each workshop which is only reconciled to the cash banked by the workshop cashiers and the declared MoMo receipts from the workshop managers.

The raw materials used by HSM include iron, steel and other metals which are all purchased from the public as scrap and then produced in the HSM factory as refined iron and steel ready for sale. The scrap materials purchased in high volumes from the general public in Huye and are paid on a cash basis based on "scrap" prices determined by the procurement manager. To determine the actual quantity of scrap supplied, a weighbridge at the entrance to the stockyard weighs trucks and vans before and after the scrap metals (raw materials) that they carry are unloaded into the stockyard.

Two heavy-duty boiler machines in the workshop are used to melt down the useable scrap metal raw materials into bundles of finished iron and steel products which are then stored in the workshop (as finished inventory products). Ten (10) years ago, the two boiler-machines had an estimated useful life of twenty-five (25) years and this estimate had not changed by 1 January 2023. Each boiler machine is supported by a motor engine that requires replacement every four (4) years with the last replacement having been done two years ago.

A by-product of the production process by the boiler-machines is the production of a "ash-waste". HSM is unable to recycle the ash-waste or to sell it and therefore this requires appropriate dumping after a formal clearance is received from the environmental regulator of Rwanda. However, due to the need to reduce any non-disruption of the production process, HSM in most times has illegally dumped the ash-waste. The environmental regulations in Rwanda prohibit illegal dumping of waste products like ash-waste and this can result in significant penalties imposed by the regulator including the permanent closure of the company's operations.

HSM's operations are subsidized through a government grant received from the Huye local government. This grant is received on the basis that HSM's purchase of scrap from the public for recycling which results into reduced dumping of scrap metal items in the region. The grant received by HSM is calculated as 15% of the market value of scrap metals purchased which is supported by a quarterly return submitted to the Huye local authority by HSM. The senior management team of HSM receive a direct bonus based on the amount of the grant received on a quarterly basis. HSM plans to submit the return for the quarter ending 31 December 2023 to Huye local government by 15 January 2024.

HSM maintains manual inventory records for each category of the metal and steel produced. The last stock-taking exercise of HSM took place on 30 November 2023 with the intention of "rolling-forward" the procurement manager's valuation as at that date to the year-end 31 December 2023 quantities per the manual records. However, you as the audit manager were not aware of this until you visited HSM on 14 December 2023 to plan your year-end procedures.

During your visit of the HSM's premises on 14 December 2023, you saw that:

- ✓ Sheets of aluminum which are used to produce the steel products were scattered across fields near the stockyard after a storm blew them away;
- ✓ Majority of the quantity of the iron piled up in the stockyard was rusted;
- ✓ Piles of copper and brass, that can be distinguished with a simple acid test, had been mixed up.

The stock-count sheets show that on average, finished metal and steel quantities have increased by one-third (1/3) since last year and the quantity of aluminum as reported in the manual records was three-times as much compared to the previous year figures. There are no suitably qualified experts to value HSM's type of inventory in Rwanda.

The Workshop manager for the largest workshop based in Kigali has not reported for work without any reason or permission since 1 December 2023. HSM's immediate investigations confirm that the workshop manager left the country after withdrawing all the MoMo receipts for sales that had been made for the entire month of November 2023 which he did not hand over to HSM. The finance department last updated the HSM cash book for the month of October 2023. The General manger has made a formal report to the police of a suspected fraud by the workshop manager.

The auditor's report on the financial statements for the year ended 31 December 2022 was unmodified.

Required:

i) **Recommend any FIVE principal audit procedures to be carried out on the opening balances of the financial statements of HSM Co for the year ending 31 December 2023.** (5 Marks)

ii) **Evaluate the risks of material misstatements that should be considered in the planning of the final audit for HSM Co for the year ending 31 December 2023.** (25 Marks)

iii) **Comment on the suitability of the different audit methodologies and justify an audit approach that should be recommended for application by Sabiti & Co in the final audit for HSM Co for the year ending 31 December 2023.** (4 Marks)

iv) **Briefly discuss Sabiti & Co's responsibility for the detection of fraud in its audit clients including HSM.** (3 Marks)

v) **Comment on the matters to be considered in seeking to determine the extent of HSM Co's financial loss resulting from the alleged fraud committed by the workshop manager in Kigali.** (5 Marks)

b) You are an audit manager responsible for the audit of Ebeneza Co, a company that operates in the agricultural industry and whose operations are highly labour intensive. You are currently reviewing the working papers of the audit of Ebeneza Co for the year ended 31 December 2023. In the working papers dealing with the payroll, the audit junior who reviewed Ebeneza Co's payroll for the year ended 31 December 2023 has commented as follows:

"Several new employees have been added to the Ebeneza Co's payroll during the year, with combined payments of FRW 1,125 million being made to the new employees in the year ended 31 December 2023. This figure is equal to 15% of the company's profit before tax figure in the draft financial statements. There does not appear to be an authorization for adding the new employees on company's payroll. When I questioned the payroll supervisor who added these additional employees to the payroll, he responded that no authorization for these additional employees was required since the new employees are only working for Ebeneza Co as temporary casual workers in the farms of the company. However, when discussing staffing levels with management of Ebeneza Co, it was stated that no new employees have been recruited in the year. Other than the tests of controls planned by our audit firm, no other work was performed by the audit team on the employment cost of the company"

Required:

In relation to the audit of Ebeneza Co's payroll, **explain the meaning of the term "professional skepticism" and recommend any further actions that should be taken by the auditor regarding the comment from the audit junior.** (8 marks)

(Total: 50 Marks)

SECTION B

QUESTION TWO

a) You are a manager in Kwizera & Associates, a local firm of professional accountants based in Rwanda providing audit and non-audit services. Your audit client, Prudence Hotel, is an international group of hotels that opened a 5-star hotel in Kigali in January 2021. As part of the strategy, Prudence Hotel plans to implement a 5-year plan aimed at expanding the hotel's operations in Rwanda by opening two (2) other 5-star hotels in two other major cities in Rwanda. You are aware that Prudence Hotel has substantial cash resources which can be used to fund the planned investment in the hotel's expansion in Rwanda. Prudence Hotel's accounting functions are properly managed and, in the past, appropriate accounting policies have been applied by the hotel in the preparation of its financial statements.

In order to implement the planned expansion program, Prudence Hotel is planning to acquire a large construction company in Rwanda with the aim of bringing in-house the construction and refurbishment of the planned hotels in the two major cities of Rwanda. Prudence Hotel's management has recently identified Rurangwa Construction Co (RCC) as a potential target company that can be acquired. The management of Prudence Hotel has urgently requested your firm to conduct a 2-days limited due diligence review on RCC that should commence next week.

If the due diligence review engagement is accepted, you will be the manager on the engagement. Yesterday, you held a preliminary meeting with the management of both RCC and Prudence Hotel and you obtained the following information specifically regarding RCC:

- ✓ The Managing Director, Operations Director and Finance Director of RCC are all family members and they are the major shareholders of RCC. The RCC company name has a well-established reputation in Rwanda for the quality constructions over the past years.
- ✓ Due to the post-COVID-19 implications on the construction industry, RCC has been operating with a large bank overdraft for the past 18 months. In addition, on several occasions, RCC has been close to breaching the terms and conditions of a substantial loan borrowed from the same bank where the bank overdraft is held.
- ✓ RCC's accounting policies are more relaxed than the accounting policies of Prudence hotel. for example, RCC depreciates its assets over longer estimated useful lives compared to Prudence hotel.
- ✓ Contract revenue is recognized on a percentage of completion basis using the "cost method" (i.e., measured by reference to costs incurred to-date). A provision for an onerous contract is made for loss-making contracts.
- ✓ RCC's management team has a qualified and experienced quantity surveyor whose main responsibilities include:
- Supervising quarterly physical counts of materials and the status of the work-in-progress at major construction sites;
- Comparing costs to-date against quarterly rolling budgets; and
- Determining the financial performance (i.e, profits and losses) for each contract at the end of each financial year.

- ✓ Although much of the labor is provided by casual laborers sub-contracted, RCC has its own full-time site managers that supervise the hired casual workers.
- ✓ In the prior year, RCC received a legal claim from the residents of a building constructed by RCC in Remera. The building was constructed three years ago as a residential property with several apartments which RCC sold to the current residents. The residents of the building claim that the building has developed cracks in the walls making it very risky for the safety of the residents and the neighborhood. The residents are demanding that RCC bears the repair costs of the building and in addition, RCC should provide temporary accommodation (at the company's cost) to the affected residents during the repair period.

RCC has referred this matter to its lawyers and refused all claims / liabilities from the residents as RCC alleges that the actual construction of the building that was done by a sub-contracted company called Gasana Services Co. Therefore, RCC did not provide for any liability in respect of the claims from the residents and did not make any disclosures regarding these claims in the financial statements for their mostly recently audited financial statements for the year ended 30 June 2023.

- ✓ The auditor's report on RCC's financial statements for the year ended 30 June 2023 was unmodified and was signed in December 2023.

Required:

- **i) Identify and explain the specific matters that should be clarified within the terms of engagement for the proposed due diligence review of RCC.** (7 Marks)
- **ii) Briefly explain (with reasons), SIX items of principal additional information that you need during the conduct of the due diligence review of RCC.** (12 Marks)

b) Marie bookshop is a new audit client of your firm with a financial year ending at 31 December. Your firm was appointed as an auditor of Marie bookshop on 1 April 2023 after the company registered rapid growth in the year ended 31 December 2022 following a successful launch of an on-line sales Application (the "Marie-App") in October 2022. Prior to the launch of Marie-App, the company operated a small number of retail outlets that were all located in Kigali where customers came in to buy educational books and scholastic materials. The launch of the Marie-App introduced online sales for the company's sales for the first time in October 2022 and this led to an immediate significant increase in the company sales. The Marie-App allowed customers to use their mobile phones to directly access an online catalogue of the company's products along with their displayed prices and other information. This allowed a customer using the Marie-App to place an online order and within 24 hours Marie bookshop delivers the ordered item to the customers located in Kigali at no extra cost. Payments from customers for the online sales are made via mobile money to personal mobile phones of the sales personnel as published on the Marie-App. You have been informed that last month, the Marie-App was upgraded and now Marie bookshop can make purchases from its major suppliers through the same App.

As part of your firm's preparation for the audit of Marie bookshop, you have just completed an interim audit, where you noted that due to the rapid expansion in the volume of sales which are mainly online sales, there is an emerging challenge of ensuring a system reliability of the e-sales system which can potentially expose Marie bookshops to significant financial losses.

Required:

i) Explain any THREE potential 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. (3 Marks)

ii) Recommend THREE appropriate controls that Marie bookshop can implement to prevent the challenges faced by the company in (i) above. (3 Marks)

(Total: 25 Marks)

QUESTION THREE

Today is 15 March 2024. Your audit firm, Kagabo & Partners, a local firm of Certified Public Accountants of Rwanda is the auditor of Vaney Ltd, a local company that is listed on the Rwanda Stock Exchange. Last week, Kagabo & Partners completed the audit of the financial statements of Vaney Ltd for the year ended 31 December 2023 and as a new audit client, this is the first time Vaney Ltd was audited by our firm.

Vaney is a manufacturer of processed food products sold to the general public in Rwanda and a few sales are made outside Rwanda. Vaney is currently seeking to raise finance capital of FRW 9,000 million which is required in three (3) months from today. The finance capital will be raised from two sources that include:

- ✓ Issuing debenture notes of FRW 6,000 million; and
- ✓ Making a formal request to borrow funds from the current / existing shareholders through a shareholders' loan for the remaining FRW 3,000 million.

The debenture notes for FRW 6,000 million will be issued specifically to a commercial bank in Rwanda called Apex Bank, which is also the bank that maintains all Vaney's bank accounts. Currently, Vaney has an existing bank overdraft facility with Apex Bank whose current limit is FRW 6,000 million. The overdraft facility is due to expire on 31 March 2024. The recent audited financial statements of Vaney for the year ended 31 December 2023 reported that the company has a bank overdraft of FRW 5,500 million was raised from Apex Bank.

Management of Vaney have commenced discussions with Apex Bank for a request to change from an overdraft facility whose limit available is FRW 6,000 million to a new facility in form of debenture notes (a long-term loan) for the same amount of FRW 6,000 million. As part of the bank requirements for the application of the debentures, Vaney is required to provide Apex Bank with a cash flow forecast for a 12-months period (January 2024 – December 2024) supported by a forecast profit or loss for the same period and a forecast statement of financial position for the same period as the cash flow forecast.

The management of Vaney has produced the required cash flow forecast. However, Apex Bank requires the Vaney to engage its external auditors to conduct an "examination of Prospective

Financial Information (PFI) engagement" which should be evidenced by a PFI examination report.

It has been proposed that if Kagabo & Partners accepts to take on this additional engagement to examine the PFI of Vaney (i.e., the cash flow forecast), then Claude Ruzidana will be in charge of the additional engagement. Claude Ruzidana is also the audit engagement partner, who last week, signed off the audit of Vaney's financial statements for the year ended 31 December 2023. Vaney Ltd has informed our firm that the engagement fees on the examination of the PFIs shall be attractive.

In a preliminary meeting with the management of Vaney, it has been ascertained that the following information is part of the figures and assumptions used by Vaney in the preparation of the cash flow forecast:

i) The cash flows from sales revenues are based on the assumption of an overall increase of 24% in sales of the forecast period compared to year ended 31 December 2023. The increase in sales is based on an increase in selling prices of 5% and an increase in the volume of sales of 18%. Vaney estimates that 25% of the forecast sales will be made to overseas customers while 75% sales will be made to domestic customers in Rwanda.

ii) The cost of sales in the audited profit or loss in the year ended 31 December 2023 was 80% of the sales revenue, implying the gross profit margin was 20%. The forecasted profit or loss for the year ended 31 December 2024 show that the cost of sales is forecast to fall to 72% of the sales revenue giving a forecast gross profit margin of 28%. The manufacturing costs comprise of equal mixtures (i.e., 33.3%) of materials, labor, and production overheads.

iii) The trade receivable collection period (days) as determined from the cash flow forecast for the 12-month period is estimated to be 61 days compared to the actual period of 93 days (picked from the audited financial statements as at 31 December 2023). In order to reduce the trade receivable collection period in the forecast period, management of Vaney plans to inform all customers the following changes:

✓ A new standard receivable collection period of 60 days to be implemented in the forecast period; and

✓ A discount of 1% shall be given to customers who make an early settlement of their account within 30 days of the credit sale.

iv) The trade payables settlement period is forecast to increase from 45 days (as supported by the audited financial statements as at 31 December 2023) to 90 days in the forecast period.

v) The cash flow forecast showed that the inflow of the debenture amount of FRW 6,000 and the shareholders' loan of FRW 3,000 million are expected to be received on 1 April 2024.

Required:

a) **Explain the matters that Kagabo & Partners should take into consideration before accepting the engagement to report on the cash flow forecast of Vaney Ltd.**

(10 Marks)

b) If Kagabo & Partners accept to take on the engagement to examine the PFI of Vaney, **explain the matters to be considered and the procedures to be undertaken by our**

firm in relation to the cash flow forecast of Vaney for the year ended 31 December 2024. (12 Marks)

c) **Briefly discuss in general, the basis on which a firm of professional accountants should form an opinion when reporting on prospective financial information.**

(3 Marks)

(**Total: 25 marks)**

QUESTION FOUR

a) You are an audit manager in Kamari & sons Associates, a firm of Certified Public Accountants with head office in Kigali, Rwanda. On 1 June 2024, your firm was appointed as new auditors for Global Manufacturer Limited (GM Ltd), a company specialized in steel manufacturing with extended market across East Africa. The company has four subsidiaries and each prepares its financial statements and is audited independently. These subsidiaries are in Kenya-Nairobi, Uganda-Kampala, Tanzania- Dares salaam and Burundi-Bujumbura. The audit scope is the financial statements for the last twelve months ended 31 March 2024.

The audit team leaders for these four audit subsidiaries have submitted to you both draft audit report and working papers for your review and inputs.

Subsidiary in Kenya-Nairobi

The Kenya-Nairobi Ltd subsidiary planned to conduct an inventory physical count on 31 March 2024. An electrical fire caused by installation fault in the inventory destroyed 55% of the total inventory and all the inventory records. The subsidiary could not reliably determine the value of the remaining stock as all cost records were destroyed, only estimate should be made based on selling prices and profit margins on each type.

The audit team leader qualified the audit report with emphasis of matter paragraph under the draft audit report based on the fact that the team was unable to obtain reliable evidence on the value of inventory reported.

Subsidiary in Uganda-Kampala

Before audit finalization, one of the major customers of the subsidiary declared bankruptcy. The court decision was pronounced and the subsidiary lost 70% of owed amount from this customer. With discussion with Uganda-Kampala subsidiary, the subsidiary is not willing to adjust its account receivables balance to reflect the accurate receivables. The audit team leader agreed with the Chief Financial Officer on this practice and given an unmodified audit opinion under the draft audit report.

Subsidiary in Tanzania- Dares salaam

The subsidiary has a big warehouse to avoid any stockout which may occur due to high demand of steel in Tanzania. The subsidiary holds a material inventory kept from the last 2 years and will be sold at less than cost without considering holding cost. The audit team noted that the total inventory was valued at cost instead of net realizable value. The audit team leader recommended the audit opinion to be modified by way of a disclaimer of opinion.

Subsidiary in Burundi-Bujumbura

The steel is produced, kept and reported in bulk. During the audit of non-current assets of the subsidiary, the audit noted that the value of five bulks was reported under non-current assets instead of inventory. The five bulks represent 60% of the total non-current assets reported by the subsidiary. The audit team leader recommended a qualified audit opinion under the draft audit report by stating that the financial statements of Burundi-Bujumbura subsidiary show a true and fair view except for the value of the five bulks.

Required:

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.** (4 marks)

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.** (4 marks)

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.** (4 marks)

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.** (4 marks)

b) Manwhite Ltd is a company primarily involved in the production of cleaning products in Rwanda. The main customers are across the country and mostly involved in supplying reputable companies and other government institutions. The company owns its vehicles used in delivery and may hire some vehicles for assistance in case of high demand received at the same. In coming five years, the company is planning to build production plants in each province.

You're the senior accountant in the Manwhite Ltd and one of your responsibilities is to prepare the financial statements of the company. Today's date is 22nd May 2024 and You are preparing financial statements for year ended 31 March 2024. The financial statements will be approved in the next Annual General Meeting of 31 May 2024. During the preparation, the following comes to your attention from the management side:

i) On 14 April 2024, a major fraud was discovered by your assistant accountant where by the payable's ledger accountant had been diverting funds to his brother's bank account. This practice had been occurring for the last nine (9) months. The payable's ledger accountant was dismissed and legal proceedings initiated immediately and the employee's terminal benefits have been withheld as recovery.

ii) On 20 March 2024, a major customer initiated legal proceedings against the company in relation to failure to supply the agreed quality and in the agreed timeline per the contract signed by both parties. On 29 March 2024, the company's legal advisers informed the head of finance that it was unlikely the company would be found liable and the head of finance advised you to ignore the case and therefore no provision needed in the financial statements and only required to make a related as a contingent liability. On 29 April 2024, the court found the company liable on breach of contract terms and was required to pay a material damage.

iii) On 19 May 2024, another customer with head office in southern province declared bankruptcy. As the financial statements are needed for the board meeting on 24 May 2024, you have decided that because the amount is immaterial, no adjustment is required.

Required:

As senior accountant in the company in line with IAS 10, **you are required to discuss the effects of each case on the financial statements for the year ended 31 March 2024.**

(9 Marks)

(Total: 25 Marks)

End of question paper

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