



CERTIFIED ACCOUNTING TECHNICIAN

STAGE 3 EXAMINATIONS

S3.4: AUDIT AND ASSURANCE

DATE: TUESDAY, 29 MARCH 2022

MARKING GUIDE AND MODEL ANSWERS

SECTION A

Marking guide

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

Each question has

2 Marks

Total marks for this section

20 Marks

Model answers

QUESTION ONE

The correct answer is C

As provided for by the Company's Act and International Standards of Auditing (ISAs), auditors have the following rights in regard to the audit of financial statements:

- **Access to records:** A right of access at all times to the books, accounts and vouchers of the company.
- **Information and explanations:** A right to require from the company's officers such information and explanations as the auditors think necessary for the performance of their duties as auditors
- Right to remuneration of audit fee.
- **Attendance at / notices of general meetings:** A right to attend any general meetings of the company and to receive all notices of and communications relating to such meetings which any member of the company is entitled to receive
- **Right to speak at general meetings:** A right to be heard at general meetings which they attend on any part of the business that concerns them as auditors

The client does not have an obligation whatsoever to provide access to the internet connection to auditors. This is because some organizations may not have access to internet themselves, and there are those clients that have policies of not sharing internet access to outsiders to ensure that their networks are not compromised.

QUESTION TWO

The correct answer is B

Auditors should use the Extended External Reporting (EER) Assurance guidance by the International Auditing and Assurance Standards Board (IAASB), which is used to describe engagements and to provide assurance on different forms of non-financial reporting, including integrated reporting, sustainability reporting and non-financial reporting about environmental, social and governance matters.

Auditors should not do nothing or accept any information given by the client without proper review, and they are not required to refuse any client because they prepare integrated financial reporting. Auditors are expected to embrace Integrated reporting as it adds value to clients' stakeholders.

QUESTION THREE

The correct answer is A

ISA 700 (Revised) Forming an opinion and reporting on financial statements provides that among others, the following should be part of the auditor's report for the financial statements: opinion, basis of opinion, key audit matters, responsibilities of management and those charged with governance for the financial statements, auditor's responsibilities for the audit of the financial statements, and report on other legal and regulatory requirements. Audit findings, audit team and auditor's experience are not required to be part of the auditor's report by the standard.

QUESTION FOUR

The correct answer is B

ISA 315: *Identifying and Assessing the Risks of Material Misstatement through Understanding the Entity and Its Environment* (paras. 6–10) state that in order to obtain an understanding of the entity and its environment, inquiries of management and others within the entity should be done through: Analytical procedures, Observation and inspection, Prior period knowledge, Client acceptance or continuance process, Discussion by the audit team of the susceptibility of the financial statements to material misstatement and Information from other engagements undertaken for the entity. Requesting information from the company's competitors is unethical and therefore not provide for by the standard.

QUESTION FIVE

The correct answer is D

All the benchmarks and percentages shown are appropriate and are commonly used to set the materiality for the audit of financial statements as a whole except D: total assets (5-10 %). When total assets are used as a materiality benchmark, the percentage ranges from 1-2 % of the total assets, as their value is expected to be very high; and it can't have the same benchmark as profit after tax.

QUESTION SIX

The correct answer is D

Control (iii) is the only option that actually deals with ensuring that no extra time/hours can be claimed and therefore ensures that staff can only be paid for hours actually worked.

QUESTION SEVEN

The correct answer is A

ISA 315 identifies that internal control is designed, implemented and maintained to address identified business risks that threaten the achievement the entity's objectives with respect to:

- The reliability of its financial reporting
- The effectiveness and efficiency of its operations
- Its compliance with applicable laws and regulations

Leadership and motivation of staff is not the primary purpose of internal control; although, the above could result into good leadership and motivation of employees in an organisation.

QUESTION EIGHT

The correct answer is B

The net realizable value for an inventory is an estimated or actual selling price (net of trade discounts but before settlement discounts) less all further costs to completion and less all costs to be incurred in marketing, selling and distribution. A is not correct because this nature of expense is transport or distribution expense. C is not correct because trade discounts have to be determined before settlement discounts, otherwise it would lead to a miscalculation. D is not correct as it is against the IAS 2 standard.

QUESTION NINE

The correct answer is C

(i), (ii), (iii) and (iv) audit procedures are expected to be part of testing of controls over the non-current assets.

QUESTION 10

The correct answer is A

As the auditors of Uwineza Ltd have concluded that the internal controls of the company are unreliable they cannot rely on them and will have to adopt a substantive procedures approach when conducting the final audit of the company's financial statements. This will involve extensive testing of transactions for the whole accounting period in addition to the verification of the items in the statement of financial position and a review of the financial statements. Options (B), (C) and (D) do not allow the necessary substantive testing to be carried out.

SECTION B

QUESTION 11

Marking guide

a) Auditors should obtain evidence by one or more of the following procedures

Audit procedures

Inspection of assets	1
Inspection of documentation or records	1
Observation	1
Inquiry	1
External confirmation	1
Recalculation	1
Reperformance	1
Analytical procedures	1
Maximum	5

b) The following constitute some of the advantages of using Computer-assisted audit techniques (CAATs) to your audit team and Ahazaza Heza Technology Ltd.

- | | |
|---|---|
| • Audit testing capability is increased – large volumes, up to 100%, | 1 |
| • Tasks which are manually impossible can be carried out – using the computer | 1 |
| • Cost-effectiveness – although up-front costs may be considerable, | 1 |
| • Repetitive work is eliminated – this can increase job satisfaction for auditors | 1 |
| • Knowledge of client systems is improved – | 1 |
| • Results from CAATs can be compared with results from traditional testing | 1 |

Any other valid point 1

Maximum **5**

Model answers

a) Auditors should obtain evidence by one or more of the following procedures (ISA 500: para. A14–A25):

Audit procedures	
Inspection of assets	<p>Agreeing the accounting records of Ahazaza Heza Technology Ltd to the physical asset confirms existence, gives evidence of valuation but does not confirm rights and obligations or valuation. (For example, physically inspecting a lathe machine in a factory proves the machine exists but does not confirm how much it is worth or even that the company owns it – it could be leased under an operating lease.) Auditors may need the aid of experts in valuing assets.</p> <p>Agreeing the physical assets Ahazaza Heza Technology Ltd to the accounting records gives evidence of completeness. (For example,</p>

Audit procedures	
	inspecting the lathe machines at the audit client's premises and matching them to the accounting records identifies whether there are any machines that physically exist, but are not recorded.)
Inspection of documentation or records	Confirmation to documentation of items recorded in the Ahazaza Heza Technology Ltd accounting records demonstrates that a transaction occurred or an asset or liability exists. (For example, inspecting a supplier invoice which has been posted onto the payables ledger confirms that the company owes the supplier for the goods or services shown on the invoice.) Confirmation that items recorded in the supporting documentation are recorded in the accounting records tests completeness. Cut-off can be verified by inspecting the reverse population; that is, agreeing transactions recorded after the reporting period to supporting documentation to confirm that they occurred after the reporting period. Inspection also provides evidence of valuation and measurement, rights and obligations (e.g., that an asset is really owned by the entity), and the nature of items (presentation and disclosure in line with accounting standards). It can also be used to compare documents (and hence test consistency of audit evidence), and to confirm authorization.
Observation	Involves watching a procedure being performed at Ahazaza Heza Technology Ltd (e.g., post opening, or inventory being counted). Observation is particularly useful in gaining an initial understanding of how the client's internal controls work (e.g. a walkthrough). However, it may be of limited use when testing controls, as it only confirms the control procedure took place when the auditor was watching.
Inquiry	Seeking information from Ahazaza Heza Technology Ltd client staff or external sources about operation of controls or how certain items have been treated in the accounting records (e.g., to understand what internal controls have been implemented with regards to the authorization of expenses, or to determine how provisions have been calculated). The strength of evidence depends on the knowledge and integrity of the source of information. It may be necessary to corroborate inquiries, particularly those made of client's staff. Inquiry alone often does not provide sufficient appropriate audit evidence to give the auditor assurance over financial statement assertions. Therefore, other procedures often need to be carried out in order to corroborate the information obtained from inquiry.
External confirmation	Seeking confirmation from another source of details in Ahazaza Heza Technology Ltd accounting records (e.g. confirmation from bank via a

Audit procedures	
	bank audit letter of existence and rights and obligations of bank balances, confirmation from trade receivables in respect of the existence of receivable balances). External confirmations obtained directly by the audit team constitute more reliable audit evidence than confirmations obtained from the client. However, there can be limits to the level of information that they provide: for example, customers will confirm whether trade receivable balances exist, but they may not confirm that receivable balances are complete!
Recalculation	Confirming the arithmetic accuracy of a client's records e.g. adding up a ledger account. If a formula is involved, the auditors should also consider the reasonableness of the formula. Recalculation can sometimes be performed using IT.
Reperformance	This is the auditor's independent execution of procedures of controls that were originally performed as part of the entity's internal control, either manually or through the use of computers. As information generated independently by the audit team itself, reperformance constitutes a strong form of audit evidence.
Analytical procedures	These consist of evaluations of financial information (and fluctuations in financial information) made by studying plausible relationships between both financial and non-financial data. This helps to identify unexpected variances which require the auditor's attention, particularly from large volumes of data. Examples of analytical procedures include comparing the current period gross margin with prior years, comparing the rate of interest on related party loans with the industry average, or reviewing the employment costs of the production department against the number of staff in the production department.

b) The following constitute some of the advantages of using Computer-assisted audit techniques (CAATs) to your audit team and Ahazaza Heza Technology Ltd.

- Audit testing capability is increased – large volumes, up to 100%, of information can be tested, thereby reducing or even eliminating sampling risk.
- Tasks which are manually impossible can be carried out – using the computer to trace key controls and processes where there is no visible audit trail.
- Cost-effectiveness – although up-front costs may be considerable, CAATs can often be used again in subsequent audits.

- Repetitive work is eliminated – this can increase job satisfaction for auditors and frees them up to apply professional judgement to key areas.
- Knowledge of client systems is improved – this is an important by-product that enhances the auditor's knowledge of the client and aids future audit planning.
- Results from CAATs can be compared with results from traditional testing – if the results correlate, overall confidence is increased.

QUESTION 12

Marking guide

a) factors that could affect the size and form of audit working papers to ensure that the audit work documented is sufficient and appropriate to the circumstances of the matter being considered.

- | | |
|--|---|
| • The nature of the procedures to be performed | 1 |
| • Size and complexity of the entity | 1 |
| • The identified risks of material misstatements | 1 |
| • The extent of judgement required in performing the work and evaluating the results | 1 |
| • The significance of the audit evidence obtained | 1 |
| • The nature and extent of exceptions identified | 1 |
| • The need to document a conclusion | 1 |
| • The audit methodology and tools used | 1 |

Any other valid point	1
Maximum	5

b) Please see below the difference between the permanent and current audit files and examples of what documents they may each contain.

The permanent audit file contains information of continuing importance to the audit that is not expected to change from year to year whereas the current audit file contains information which is relevant to the current year's audit only. 1

The following are examples of different documents or information they may each contain:

Permanent audit files contain:

- | | |
|---|-----|
| • Engagement letters | 0.5 |
| • New client questionnaire | 0.5 |
| • The memorandum and articles | 0.5 |
| • Other legal documents such as prospectuses, leases, sales agreement | 0.5 |
| • Details of the history of the client's business | 0.5 |
| • Board minutes of continuing relevance | 0.5 |
| • Previous years' signed accounts, analytical procedures and management letters | 0.5 |
| • Accounting systems notes, previous years' control questionnaires | 0.5 |

Maximum	2
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Current audit files contain:

• Financial statements	0.5
• Accounts checklists	0.5
• Management accounts details	0.5
• Reconciliations of management and financial accounts	0.5
• A summary of unadjusted misstatements	0.5
• Report to partner including details of significant events and misstatements	0.5
• Review notes	0.5
• Audit planning memorandum	0.5
• Time budgets and summaries	0.5
• Representation letter	0.5
• Management letter	0.5
• Notes of board minutes	0.5
• Communications with third parties such as experts or other auditors	0.5
Maximum	2

Model answers

a) factors that could affect the size and form of audit working papers to ensure that the audit work documented is sufficient and appropriate to the circumstances of the matter being considered.

- The nature of the procedures to be performed
- Size and complexity of the entity
- The identified risks of material misstatements
- The extent of judgement required in performing the work and evaluating the results
- The significance of the audit evidence obtained
- The nature and extent of exceptions identified
- The need to document a conclusion or the basis for a conclusion not readily determinable from the documentation of the work performed or audit evidence obtained
- The audit methodology and tools used

b) Please see below the difference between the permanent and current audit files and examples of what documents they may each contain.

The permanent audit file contains information of continuing importance to the audit that is not expected to change from year to year whereas the current audit file contains information which is relevant to the current year's audit only.

The following are examples of different documents or information they may each contain:

Permanent audit files contain:

- Engagement letters
- New client questionnaire
- The memorandum and articles
- Other legal documents such as prospectuses, leases, sales agreement
- Details of the history of the client's business
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- Financial statements
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- Management accounts details
- Reconciliations of management and financial accounts
- A summary of unadjusted misstatements
- Report to partner including details of significant events and misstatements
- Review notes
- Audit planning memorandum
- Time budgets and summaries
- Representation letter
- Management letter
- Notes of board minutes
- Communications with third parties such as experts or other auditors

SECTION C

QUESTION 13

Marking guide

a) The following are some the control objectives and control activities expected at Majyambere Cooperative over the purchase of its non-current assets:

Control objectives	Control activities	
Non-current asset acquisitions are authorized.	<ul style="list-style-type: none"> • Authorization of capital expenditure • Annual capital expenditure budgets should be 	2
Orders are made at competitive prices.	<ul style="list-style-type: none"> • Compliance with procurement rules, procedures • Monitoring of supplier prices in relation to other potential alternative suppliers 	2
All orders for the purchase of non-current assets are properly authorized.	<ul style="list-style-type: none"> • Order forms prepared requisition received • Authorization of order forms (in accordance with pre- defined authority levels at the cooperative) • All orders made on official company documents, 	2
Non-current assets purchased are inspected for quality and standards.	Approval by the user department that the non-current assets purchased match the requirements as per the Terms of Reference.	2
All non-current assets are accurately recorded.	Ensure that all non-current assets are recording in the accounting system and ensure that transport and other related fees are capitalized.	2
Maximum		10

b) The following is the information expected in the non-current assets register for Majyambere Cooperative.

• Cost	0.5
• Additions or alterations to the asset	0.5
• Total depreciation charged over the asset's life	0.5
• The serial number or other means of identification	0.5
• Depreciation of the asset	0.5
• The location of the asset	0.5
• The manufacturer and supplier	0.5
• Insurance details	0.5
• Maintenance record	0.5
• Dates of acquisition/disposal	0.5
Maximum	5

c) common accounting errors in recording non – current assets that can occur at Majyambere Cooperative include:

- Purchase of non-current asset is expensed and not capitalized. 1
 - Applying an erroneous depreciation method or percentage 1
 - Failure to include transport, installation or any other related cost as non-current cost 1
 - Omission to record any additions in accounting records 1
 - Assets recorded in the wrong class of non-current assets. 1
- Maximum 5**

Model Answers

a) The following are some the control objectives and control activities expected at Majyambere Cooperative over the purchase of its non-current assets:

Control objectives	Control activities
Non-current asset acquisitions are authorized.	<ul style="list-style-type: none"> • Authorization of capital expenditure – Applications for capital expenditure should be submitted to the Cooperative board for approval. • Annual capital expenditure budgets should be approved by the board of the Cooperative.
Orders are made at competitive prices.	<ul style="list-style-type: none"> • Compliance with procurement rules and procedures • Monitoring of supplier prices in relation to other potential alternative suppliers
All orders for the purchase of non-current assets are properly authorized.	<ul style="list-style-type: none"> • Order forms prepared only when a purchase requisition has been received • Authorization of order forms (in accordance with pre-defined authority levels at the cooperative) • All orders made on official company documents, and showing suppliers' name, quantity order and price
Non-current assets purchased are inspected for quality and standards.	Approval by the user department that the non-current assets purchased match the requirements as per the Terms of Reference.
All non-current assets are accurately recorded.	Ensure that all non-current assets are recording in the accounting system and ensure that transport and other related fees are capitalized.

b) The following is the information expected in the non-current assets register for Majyambere Cooperative.

- Cost
- Additions or alterations to the asset
- Total depreciation charged over the asset's life
- The serial number or other means of identification
- Depreciation of the asset
- The location of the asset
- The manufacturer and supplier
- Insurance details
- Maintenance record
- Dates of acquisition/disposal

c) common accounting errors in recording non – current assets that can occur at Majyambere Cooperative include:

- Purchase of non-current asset is expensed and not capitalized.
- Applying an erroneous depreciation method or percentage
- Failure to include transport, installation or any other related cost as part of the total non-current cost
- Omission to record any additions in accounting records
- Assets recorded in the wrong class of non-current assets. E.g. Motor vehicle recorded in the plant and machinery.

QUESTION 14

Marking guide

a) i) The following is the auditor's responsibility to conduct physical inventory count:

ISA 501 states that where inventory is material, auditors shall obtain sufficient appropriate audit evidence regarding its existence and condition by attending the physical inventory count. 1

Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress. 1

a) ii) The following are the audit procedures to be conducted before, during and after the physical inventory count of Ubaka Neza Ltd.

Planning inventory count (before) (ISA 501: para. A3)	
Gain understanding	1
Assess key factors	1
Plan procedures	1
Tolerable errors	1
Any other valid point	1
Maximum	4
During the count	
<ul style="list-style-type: none">Observe whether the Ubaka Neza Ltd staff are following instructions	1
<ul style="list-style-type: none">Perform test counts to ensure procedures and internal controls are working properly.	1
<ul style="list-style-type: none">Ensure procedures for identifying damaged, obsolete and slow-moving inventory	1
<ul style="list-style-type: none">Confirm that inventory held on behalf of third parties is separately identified	1
<ul style="list-style-type: none">Ensure proper account is taken of movements in inventory during the inventory count,	1
<ul style="list-style-type: none">Conclude whether the count has been properly carried out and is sufficiently reliable	1
<ul style="list-style-type: none">Consider whether any amendment is necessary to subsequent audit procedures.	1
Maximum	4
After the count	
<ul style="list-style-type: none">Trace items that were test counted to final inventory sheets to confirm the completeness	1
<ul style="list-style-type: none">Verify that all count records have been included in final inventory sheets	1
<ul style="list-style-type: none">Verify that final inventory sheets are supported by count records	1
<ul style="list-style-type: none">Ensure that continuous inventory records have been adjusted to the amounts physically	1
<ul style="list-style-type: none">Trace the invoices relating to the last goods received and goods dispatched notes	1
<ul style="list-style-type: none">Review replies from third parties about inventories held by or for them to confirm that all	1
<ul style="list-style-type: none">Confirm the Ubaka Neza Ltd final valuation of inventory has been calculated correctly	1
<ul style="list-style-type: none">Follow up queries and notify management of any problems.	1
<ul style="list-style-type: none">Consider whether attendance provided sufficient reliable audit evidence	1
Maximum	4

b) The following are the audit procedures to be conducted to ensure the accuracy and completeness of inventory of Ubaka Neza Ltd:

- Review and test system for identifying slow-moving, obsolete or damaged inventory 1
- Follow up any such items that were identified by Kellen at the inventory count, 1
- Examine inventory records to identify slow-moving items 1
- Examine the prices at which finished goods have been sold after the end 1
- Review quantities of goods sold after the year end to determine that inventory 1
- If significant quantities of finished goods inventory remain unsold 1

Maximum 6

Model answers

a) i) The following is the auditor’s responsibility to conduct physical inventory count:

ISA 501 states that where inventory is material, auditors shall obtain sufficient appropriate audit evidence regarding its existence and condition by attending the physical inventory count.

Physical inventory count procedures are vital as they provide evidence which cannot be obtained elsewhere or at any other time about the quantities and conditions of inventories and work-in-progress.

a) ii) The following are the audit procedures to be conducted before, during and after the physical inventory count of Ubaka Neza Ltd.

Planning inventory count (before) (ISA 501: para. A3)	
Gain understanding	<ul style="list-style-type: none"> • Review previous year's arrangements • Perform analytical procedures • Discuss with management inventory count arrangements and significant changes
Assess key factors	<ul style="list-style-type: none"> • The nature and volume of the inventory • Risks relating to inventory • The identification of high value items • Method of accounting for inventory • Location of inventory and how it affects inventory control and recording • Internal control and accounting systems to identify potential areas of difficulty • Possible internal audit involvement

Planning inventory count (before) (ISA 501: para. A3)

Plan procedures	<ul style="list-style-type: none">• Ensure a representative selection of locations, inventory and procedures are covered• Ensure sufficient attention is given to high value items• Arrange to obtain from third parties' confirmation of inventory they hold• Consider the need for expert help if necessary
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During the count

- Observe whether the Ubaka Neza Ltd staff are following instructions (if not, the auditor should immediately draw management's attention to this).
- Perform test counts to ensure procedures and internal controls are working properly.
- Ensure that the procedures for identifying damaged, obsolete and slow-moving inventory operate properly; Kellen should obtain information about the inventories' condition, age, usage and, in the case of work in progress, its stage of completion.
- Confirm that inventory held on behalf of third parties is separately identified and accounted for to ensure that it is not included in the inventory balance.
- Ensure that proper account is taken of movements in inventory during the inventory count, and noting the last numbers of inventory documentation for cut-off purposes (see below).
- Conclude whether the count has been properly carried out and is sufficiently reliable as a basis for determining the existence of inventories.
- Consider whether any amendment is necessary to subsequent audit procedures.

After the count

- Trace items that were test counted to final inventory sheets to confirm the completeness and accuracy of the final inventory sheets.
- Verify that all count records have been included in final inventory sheets to confirm the completeness of the final inventory sheets.
- Verify that final inventory sheets are supported by count records to confirm existence of inventory recorded in final inventory sheets.
- Ensure that continuous inventory records have been adjusted to the amounts physically counted or measured, and that differences have been investigated to ensure that the inventory records are accurate.
- Trace the invoices relating to the last goods received and goods dispatched notes to the accounting records in order to verify that the invoices have been recorded in the correct accounting period and therefore ensure cut-off is accurate.

- Review replies from third parties about inventories held by or for them to confirm that all/only inventory owned by the client is included in the inventory total.
- Confirm the Ubaka Neza Ltd final valuation of inventory has been calculated correctly to confirm accuracy.
- Follow up queries and notify management of any problems.
- Consider whether attendance at the inventory count by Kellen has provided sufficient reliable audit evidence for determining the existence of inventories.

b) The following are the audit procedures to be conducted to ensure the accuracy and completeness of inventory of Ubaka Neza Ltd:

- Review and test Ubaka Neza Ltd system for identifying slow-moving, obsolete or damaged inventory to determine its effectiveness in identifying items which may need to be written down to net realizable value.
- Follow up any such items that were identified by Kellen at the inventory count, ensuring that the client has made adequate provision to write down the items to net realizable value.
- Examine inventory records to identify slow-moving items (it may be possible to incorporate into a computer audit program certain tests and checks such as listing items whose value or quantity has not moved over the previous period).
- Examine the prices at which finished goods have been sold after the end of the financial year to ascertain whether any finished goods items need to be reduced below cost.
- Review quantities of goods sold after the year end to determine that inventory at the year-end has been, or will be, realized.
- If significant quantities of finished goods inventory remain unsold for an unusual time after the end of the financial year, consider the need to make appropriate provision.

QUESTION 15

Marking guide

a) The following are substantive audit procedures to be conducted over ABC Manufacturing Company Ltd Company's acquisition of the loan:

- Obtain/prepare schedule of loans outstanding 1
- Compare opening balances to previous year's papers 1
- Compare balances to the general ledger and investigate any differences. 1
- Agree name of lender etc., to register of debenture holders or equivalent (if kept). 1
- Trace additions and repayments to entries in the cash book 1
- Confirm repayments are in accordance with loan agreement 1
- Examine cancelled cheques and memoranda of satisfaction for loans 1
- Verify that borrowing limits imposed either by the company's constitution 1
- Examine signed Board minutes relating to new borrowings/repayments 1
- Obtain direct confirmation from lenders of the amounts outstanding, accrued interest 1
- Verify interest charged for the period and the adequacy of accrued interest 1
- Review restrictive covenants and provisions relating to default 1
- Review minutes and cash book to confirm that all loans have been recorded. 1
- Review draft financial statements to ensure that disclosures 1

Maximum 5

b) In with IAS 37 Provisions, contingent liabilities and contingent assets, clearly explain the following:

i) Definition of provision and contingent liability

A **provision** is a liability of uncertain timing or amount. 2

A **contingent liability** is:

A possible obligation confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or

ii) The following are the audit procedures to be carried audit provisions and contingent liabilities for ABC Manufacturing Company Ltd:

- Obtain details of all provisions 2
- Obtain a detailed analysis of all provisions 2
- Determine whether it is probable that a transfer of economic benefits 2
- Recalculate all provisions made to confirm accuracy 2
- Compare the amount provided with any payments after the period end 2
- In the event that it is not possible to estimate, confirm disclosure 2
- Consider the nature of the client's business 2
- Consider adequacy of disclosure of provisions 2
- Any other valid point 2

Maximum 10

iii) **Below are examples of accounting provisions and contingent liabilities**

Examples of provisions include:

- accruals, 0.5
- asset impairments, 0.5
- bad debts, 0.5
- depreciation, 0.5
- doubtful debts, 0.5
- guarantees (product warranties), 0.5
- inventory obsolescence, 0.5
- restructuring liabilities and sales allowances 0.5

Examples of contingent liabilities include

- Potential lawsuits (Local community and the client shown in the case study) 0.5
- product warranties 0.5
- pending investigation 0.5

Maximum 3

Model answers

a) The following are substantive audit procedures to be conducted over ABC Manufacturing Company Ltd Company's acquisition of the loan:

- Obtain/prepare schedule of loans outstanding at the period end date showing, for each loan: name of lender, date of loan, maturity date, interest date, interest rate, balance at the end of the period and security.
- Compare opening balances to previous year's papers to confirm that these have been carried forward accurately.
- Compare balances to the general ledger and investigate any differences.
- Agree name of lender etc., to register of debenture holders or equivalent (if kept).
- Trace additions and repayments to entries in the cash book to confirm the accuracy of the closing balance.
- Confirm repayments are in accordance with loan agreement to determine whether there may be any unrecognized penalties.
- Examine cancelled cheques and memoranda of satisfaction for loans repaid to confirm that there are no unrecognized liabilities.
- Verify that borrowing limits imposed either by the company's constitution or by other agreements are not exceeded.
- Examine signed Board minutes relating to new borrowings/repayments to ensure that transactions are authorized.
- Obtain direct confirmation from lenders of the amounts outstanding, accrued interest and what security they hold.

- Verify interest charged for the period and the adequacy of accrued interest to confirm that interest is not misstated.
- Review restrictive covenants and provisions relating to default:
 - Review any correspondence relating to the loan.
 - Review confirmation replies for non-compliance.
 - If a default appears to exist, determine its effect, and schedule findings.
- Review minutes and cash book to confirm that all loans have been recorded.
- Review draft financial statements to ensure that disclosures for non-current liabilities are correct and in accordance with accounting standards. Any elements repayable within one year should be classified as current liabilities.

b) In with IAS 37 Provisions, contingent liabilities and contingent assets, clearly explain the following:

i) Definition of provision and contingent liability

A **provision** is a liability of uncertain timing or amount. A liability is a present obligation of the entity arising from past events, the settlement of which is expected to result in an outflow from the entity of resources embodying economic benefits.

A **contingent liability** is:

- (a) A possible obligation that arises from past events and whose existence will be confirmed only by the occurrence or non-occurrence of one or more uncertain future events not wholly within the control of the entity; or
- (b) A present obligation that arises from past events but is not recognized because:
 - (1) It is not probable that an outflow of resources embodying economic benefits will be required to settle the obligation; or
 - (2) The amount of the obligation cannot be measured with sufficient reliability.

ii) The following are the audit procedures to be carried out for audit provisions and contingent liabilities for ABC Manufacturing Company Ltd:

- Obtain details of all provisions which have been included in the financial statements and all contingencies that have been disclosed.
- Obtain a detailed analysis of all provisions showing opening balances, movements and closing balances.
- Determine for each material provision whether the company has a present obligation as a result of past events by:
 - Review of correspondence relating to the item

- Discussion with the directors. Have they created a valid expectation in other parties that they will discharge the obligation?
 - Determine for each material provision whether it is probable that a transfer of economic benefits will be required to settle the obligation by:
 - Confirming whether any payments have been made after the end of the reporting period in respect of the item, or whether any events occurring up to the date of the auditor's report provide evidence regarding the provision
 - Review of correspondence with lawyers, banks, customers, insurance company and suppliers both pre and post period end
 - Sending a letter to the lawyer to obtain their views (where relevant)
 - Discussing the position of similar past provisions with the directors. Were these provisions eventually settled?
 - Considering the likelihood of reimbursement
 - Recalculate all provisions made to confirm accuracy.
 - Compare the amount provided with any payments after the period end and with any amount paid in the past for similar items to obtain evidence of valuation.
 - In the event that it is not possible to estimate the amount of the provision, confirm that this contingent liability is disclosed in the financial statements.
 - Consider the nature of the client's business to determine whether other provisions may be required e.g. for warranties.
 - Consider adequacy of disclosure of provisions, contingent assets and contingent liabilities in accordance with IAS 37.

iii) Below are examples of accounting provisions and contingent liabilities

Examples of provisions include:

- accruals,
- asset impairments,
- bad debts,
- depreciation,
- doubtful debts,
- guarantees (product warranties),
- inventory obsolescence,
- restructuring liabilities and sales allowances

Examples of contingent liabilities include

- Potential lawsuits (Local community and the client shown in the case study)
- product warranties
- pending investigation
- Etc.

END OF MARKING GUIDE AND MODEL ANSWERS