CERTIFIED PUBLIC ACCOUNTANT

ADVANCED LEVEL 1 EXAMINATIONS

A1.2: AUDIT PRACTICE AND ASSURANCE SERVICES

DATE: TUESDAY, 24 AUGUST 2021

MARKING GUIDE AND MODEL ANSWERS

SECTION A

QUESTION ONE

Marking guide

	Marks
(a) Main aspects that the auditor should take into account in understanding business	
• Industry, regulatory and other external factors, including the applicable financial reporting framework.	4
• Nature of the entity and its accounting policies	4
• Objectives and strategies and related business risks	4
• Measurement and review of the entity's financial performance	4
• Internal control	4
Maximum Marks	**20**
(b)How audit sampling can be applied in ensuring that the testing kits are distributed	
• Specific audit objectives, population the sample size	0.5
• Sampling risk	0.5
• Tolerable error	0.5
• Expected error	0.5
• Selection Methods,	0.5
• Analyze any errors detected in the sample.	0.5
• Project the errors found in the sample to the population.	0.5
• Reassess the sampling risk.	0.5
• Objective is to ensure that Covid-19 testing Kits are tested in the whole country	1
• Sample be representative of the population	1
• The 30 districts do not have the same population and economic activity	1
• Public & private population need to be established then a suitable criterion	1
Maximum Marks	**8**
(c) Explain the work your audit team should perform in relation to related parties	
• Obtain a list of the Rebelo Ltd current related parties and associated transactions.	1
• Obtain board of directors' meetings, minutes on significant business transactions.	1
• Disclosures from board members, pertaining existing ownership of other entities.	1
• Bank statements and transaction records, comprise of intercompany wires	1
• Viability of related party transactions, and subsequently identifying them to be coded.	1
• Interviews with personnel that is responsible for reported related-party transactions	1
• Critically analyzing presentation of related-party transactions	1

• Recognize fraud risk factors that may lead to material misstatement of the accounts.	1
• Audit Skepticism in Related Party Transactions	1
• Auditors to remain vigilant and alert about any undisclosed related party transactions	1
Maximum Marks	**8**

(d) Factors to consider in evaluating the reliability of using the work of component auditors and experts.

• The nature of the matter to which that other auditor or expert's work relates;	2
• The significance of that expert's work in the context of the audit;	2
• Knowledge of and experience with previous work performed by that expert;	2
• Auditor or expert is subject to the auditor's firm's quality control.	2
• Auditor or expert has the necessary competence, capabilities	2
• Sufficient understanding of the field of expertise of the auditor's expert	2
• The nature, timing and extent of communication	2
• The need for the auditor's expert to observe confidentiality requirements.	2
• Adequacy of the auditor's expert's work for the auditor's purposes,	2
• Relevance and reasonableness of that expert's findings or conclusions,	2
Maximum Marks	**8**

(e) Audit tests for Development costs of the Covid-19 Testing kits

• The technical feasibility of completing the intangible asset	2
• Intention to complete and use or sell the asset	2
• Ability to use or sell the asset	2
• Existence of a market or, if to be used internally, the usefulness of the asset	2
• Adequate technical, financial, and other resources to complete the asset	2
• The cost of the asset can be measured reliably.	2
Maximum Marks	**6**
Total Marks	**50**

Model answers

(a)

Introduction

Gaining an understanding of the business of a client, and the environment in which it operates is a crucial part of the audit planning process. ISA 315 *Identifying and Assessing the Risks of Material Misstatement through understanding the entity and its environment (redrafted)* provides guidance on this matter. The issue is that the auditor must have a thorough understanding of many aspects of the client's business and environment in order to be able to assess risk, decide on an appropriate audit strategy, and be able to design and perform effective audit procedures.

ISA 315 states that there are five main aspects of the client's business and environment which the auditor should understand.

1. **Industry, regulatory and other external factors, including the applicable financial reporting framework**.

This means having an understanding of the industry in which the Rebelo Ltd operates, including the level of competition, the nature of the relationships with suppliers and customers, and the level of technology used in the industry. The industry may have specific laws and regulations which impact on the business. The auditor should also consider wider economic factors such as the level and volatility of interest rates and exchange rates and their potential impact on the client. The importance of these issues is their potential impact on the financial statements and on the planning of the audit. For example, Rebelo Ltd operates in a highly regulated industry, it may be worth considering the inclusion in the audit team of a person with specific experience or knowledge of those regulations. Regulations include the financial reporting framework, for example, whether the company uses local or international financial reporting standards.

2. **Nature of the entity and its accounting policies**

This includes having an understanding of the legal structure of the Rebelo Ltd (and group where relevant), the ownership and governance structure, and the main sources of finance used by the company. Complex ownership structures with multiple subsidiaries and/or locations may increase the risk of material misstatement. Understanding the nature of the Rebelo Ltd also includes an understanding of the accounting policies selected and applied to the financial statements. The auditor must consider whether the accounting policies applied are consistent with the applicable financial reporting framework.

3. **Objectives and strategies and related business risks**

The management of the company should define the objectives of the business, which are the overall plans for the company. Strategies are the operational approaches by which management intend to meet the defined objectives. For example, an objective could be to maximise market share, and the strategy to achieve this could be to launch a new brand or product every year. Business risks are factors which could stop the company achieving its stated objectives, for example, launching a product for which there is limited demand. Most business risks will eventually have financial consequences, and thus an effect on the financial statements. This is why auditors perform a business risk assessment as part of their planning procedures.

4. **Measurement and review of the entity's financial performance**

Here the auditor is looking to gain an understanding of the performance measures which management and others consider to be of importance. Performance measures can create pressure on management to take action to improve the financial statements through deliberate misstatement. For example, a bonus payable to the management based on revenue growth could create pressure for revenue to be overstated. Thus, the auditor must gain an understanding of the company's financial and non-financial key performance indicators, targets, budgets and segmental information.

5. Internal control

The auditor must gain knowledge of internal controls in order to consider how different aspects of internal control could impact on the audit. Internal controls include the control environment, the entity's risk assessment procedures, information systems, control activities, and the monitoring of controls. Put simply, the evaluation of the strength or weakness of internal control is a crucial consideration in the assessment of audit risk, and so will have a significant impact on the audit strategy. The design and implementation of controls should be considered as part of gaining an understanding. The auditor should also understand whether controls are manual or automated. ISA 315 contains a great deal of detailed guidance on the understanding of controls, which these briefing notes do not cover.

(b)

a) When designing an audit sample, the auditor should consider the specific audit objectives, the population from which the auditor wishes to sample and the sample size.

b) Audit objectives relate to tests of control or substantive procedures. The auditor may want to be 90% certain that 95% of the testing kits are fit as per Rebelo Ltd and Rwanda bureau of standards specifications; i.e. that control procedures are being applied.

c) When designing the sample size, the auditors should consider:
   - ✓ Sampling risk
   - ✓ Tolerable error
   - ✓ Expected error

d) Selection Methods, the auditor may use any of the following selection methods; Random Selection, Systematical Selection, Block Selection, Haphazard selection,

e) Evaluation of test results

   Having carried out on each sample item, those audit procedures that are appropriate to the particular audit objective, the auditor should:
   - ✓ Analyze any errors detected in the sample.
   - ✓ Project the errors found in the sample to the population.
   - ✓ Reassess the sampling risk.

f) The audit objective is to ensure that Rebelo Ltd Covid-19 testing kits are tested in the whole country so as to ensure validity in generalization of their reliability. In this case the population will be hospitals and schools across the country.

g) There are 30 districts each having at least two hospitals and at least 8 health centers which makes a population of 300 possible testing centers. Generally, a sample should be representative of the population hence the 300 will be considered as the testing frame.

h) The 30 districts do not have the same population and economic activity hence consideration ought to be made on the distribution of the testing kits. Kigali district together with other districts having major towns are more vulnerable therefore the distribution should consider allocating more testing kits to these districts.

i) In consideration for the schools both public and private the population need to be established then a suitable criterion for distributing the testing kits identified.

(c)

The audit procedures for related party transactions are highly important to be considered because of the fact that there is an underlying potential for undisclosed related party transactions that need to be accounted for by auditors to look for probable incidents of fraud. General examples pertaining to related party transactions can be summarized as follows:

- Firstly, Lowen and Associates is required to obtain a list of the Rebelo Ltd current related parties and associated transactions.
- Subsequently, they also obtain minutes from the board of directors' meetings, especially in the cases when the board discusses significant business transactions.
- It is also useful to consider disclosures from board members, as well as senior executives pertaining to the existing ownership of other entities.
- Bank statements and transaction records, which comprise of intercompany wires are also helpful because they provide certain automated clearing house (ACH) transfers, as well as check payments.

Specific audit procedures that target related-party transactions in this regard include the following specific steps:

- The need to test the overall viability of related party transactions, and subsequently identifying them to be coded.
- Conducting interviews with accounting personnel that is responsible for reported related-party transactions in the company's financial statements
- Critically analyzing presentation of related-party transactions in the financial statements

Objectives to be considered when designing Audit Procedure for Related Party Transactions

When auditing related parties, the fundamental aspects that should be considered by auditors are two-fold. Firstly, they are supposed to recognize fraud risk factors that may lead to material misstatement of the accounts, owing to the act of fraud itself.

Secondly, they are also supposed to conclude if there is fair representation of the related party transactions in the financial statements, and if the disclosures meet applicable financial reporting framework.

Audit Skepticism in Related Party Transactions

Professional skepticism in related party transactions is a very important phenomenon that needs to be withheld when it comes to designing procedures and protocol for related party transactions.

As a matter of fact, it can be seen that it calls for auditors to remain vigilant and alert about any undisclosed related party transactions, as well as maintaining skepticism when it comes to identifying material misstatements in the transactions.

(d)

i) The nature of the matter to which that other auditor or expert's work relates;

(a) The risks of material misstatement in the matter to which that work relates;

(b) The significance of that expert's work in the context of the audit;

(c) The auditor's knowledge of and experience with previous work performed by that expert; and

(d) Whether that other auditor or expert is subject to the auditor's firm's quality control policies and procedures.

ii) The auditor shall evaluate whether the other auditor or expert has the necessary competence, capabilities and objectivity for the auditor's purposes. In the case of an auditor's external expert, the evaluation of objectivity shall include inquiry regarding interests and relationships that may create a threat to that expert's objectivity.

iii)The auditor shall obtain a sufficient understanding of the field of expertise of the auditor's expert to enable the auditor to:

(a) Determine the nature, scope and objectives of that expert's work for the auditor's purposes; and

(b) Evaluate the adequacy of that work for the auditor's purposes.

iv)The nature, scope and objectives of that expert's work;

(a) The respective roles and responsibilities of the auditor and that expert;

(b) The nature, timing and extent of communication between the auditor and that expert, including the form of any report to be provided by that expert; and

(c) The need for the auditor's expert to observe confidentiality requirements.

v) The auditor shall evaluate the adequacy of the auditor's expert's work for the auditor's purposes, including:

(a) The relevance and reasonableness of that expert's findings or conclusions, and their consistency with another audit evidence;

(b) If that expert's work involves use of significant assumptions and methods, the relevance and reasonableness of those assumptions and methods in the circumstances; and

(c) If that expert's work involves the use of source data that is significant to that expert's work, the relevance, completeness, and accuracy of that source data.

(e)

Audit tests for Development costs of the Covid-19 Testing kits

Under IAS 38, an intangible asset arising from development must be capitalized if an entity can demonstrate all of the following criteria:

- the technical feasibility of completing the intangible asset (so that it will be available for use or sale)
- intention to complete and use or sell the asset
- ability to use or sell the asset
- existence of a market or, if to be used internally, the usefulness of the asset
- availability of adequate technical, financial, and other resources to complete the asset
- the cost of the asset can be measured reliably.

If any of the recognition criteria are not met then the expenditure must be charged to the income statement as incurred. Note that if the recognition criteria have been met, capitalization must take place.

Treatment of capitalized development costs

Once development costs have been capitalized, the asset should be amortized in accordance with the accruals concept over its finite life. Amortization must only begin when commercial production has commenced (hence matching the income and expenditure to the period in which it relates).

Each development project must be reviewed at the end of each accounting period to ensure that the recognition criteria are still met. If the criteria are no longer met, then the previously capitalized costs must be written off to the income statement immediately.

SECTION B

QUESTION TWO

Marking guide

a) Responsibilities of Management for the Financial Statements	**Marks**
• Preparation of the financial statement's responsibility	1
• Assessing the entity's ability to continue as a going concern	1
• Responsible for the oversight of the financial reporting process,	1
• Responsibility for fair presentation framework	1
Maximum Marks	**4**
Auditor's Responsibilities for the Audit of the Financial Statements	
• Statement that the objectives of the auditor are to obtain reasonable assurance	1
• Issue an auditor's report that includes the auditor's opinion.	1
• Statement that reasonable assurance is a high level of assurance, but not a guarantee	1
• Statement that misstatements can arise from fraud or error, and either:	1
• Describe that they are considered material if, individually or in the aggregate,	1
• The auditor exercises professional judgment and maintains professional skepticism	1
• To identify and assess the risks of material misstatement	1
• To obtain an understanding of internal control relevant to the audit	1
• To evaluate the appropriateness of accounting policies used and the reasonableness	1
• To conclude on the appropriateness of management's use of the going concern	1
Maximum Marks	**4**
b) From the following table indicate the appropriate audit opinion.	
1. Qualified Opinion	1
2. Disclaimer Opinion	1
3. Qualified Opinion	1
4. Unqualified Opinion	1
5. Unqualified Opinion	1
6. Qualified Opinion	1
7. Unqualified Opinion	1
8. Disclaimer Opinion	1
9. Adverse Opinion	1
Maximum Marks	**6**
c) Forming an Opinion on the Financial Statements.	
• The financial statements adequately disclose the significant accounting policies	1
• The accounting policies selected and applied are consistent	1
• The accounting estimates made by management are reasonable;	1
• Information presented in the financial statements is relevant, reliable,	1
• The financial statements provide adequate disclosures	1
• The overall presentation, structure and content of the financial statements;	1
Maximum Marks	**5**

d) Auditors' consideration on the impact of COVID-19 on financial performance.

• Going concern	1
• Events after the end of the reporting period	1
• Statement of profit or loss	1
• Financial Instruments	1
• Trade receivables	1
• Fair value measurements	1
• Liquidity risk management	1
• Debt modifications	1
• Changes in estimated cash flows	1
• Revenue from contracts with customers	1
• Restructuring plans	1
• Onerous contracts provisions	1
• Insurance recoveries	1
• Lease contracts	1
Maximum Marks	**6**
Total Marks	**25**

Model answers

(a)

What is included under Responsibilities of Management for the Financial Statements.

a) Preparation of the financial statements in accordance with the applicable financial reporting framework, and for such internal control as management determines is necessary to enable the preparation of financial statements that are free from material misstatement, whether due to fraud or error.

b) Assessing the entity's ability to continue as a going concern and whether the use of the going concern basis of accounting is appropriate as well as disclosing, if applicable, matters relating to going concern.

c)This section of the auditor's report shall also identify those responsible for the oversight of the financial reporting process, when those responsible for such oversight are different from those who fulfill the responsibilities. In this case, the heading of this section shall also refer to "Those Charged with Governance" or such term that is appropriate in the context of the legal framework in the particular jurisdiction.

d)When the financial statements are prepared in accordance with a fair presentation framework, the description of responsibilities for the financial statements in the auditor's report shall refer to "the preparation and fair presentation of these financial statements" or "the preparation of financial statements that give a true and fair view," as appropriate in the circumstances.

What is included under Auditor's Responsibilities for the Audit of the Financial Statements

(a) Statement that the objectives of the auditor are to:

(i) Obtain reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error; and

(ii) Issue an auditor's report that includes the auditor's opinion.

(b) Statement that reasonable assurance is a high level of assurance, but is not a guarantee that an audit conducted in accordance with ISAs will always detect a material misstatement when it exists; and

(c) Statement that misstatements can arise from fraud or error, and either:

(i) Describe that they are considered material if, individually or in the aggregate, they could reasonably be expected to influence the economic decisions of users taken on the basis of these financial statements;

(ii)Provide a definition or description of materiality in accordance with the applicable financial reporting framework.

(d) Statement that, as part of an audit in accordance with ISAs, the auditor exercises professional judgment and maintains professional skepticism throughout the audit; and describe an audit by stating that the auditor's responsibilities are:

(i) To identify and assess the risks of material misstatement of the financial statements, whether due to fraud or error; to design and perform audit procedures responsive to those risks; and to obtain audit evidence that is sufficient and appropriate to provide a basis for the auditor's opinion. The risk of not detecting a material misstatement resulting from fraud is higher than for one resulting from error, as fraud may involve collusion, forgery, intentional omissions, misrepresentations, or the override of internal control.

(ii) To obtain an understanding of internal control relevant to the audit in order to design audit procedures that are appropriate in the circumstances, but not for the purpose of expressing an opinion on the effectiveness of the entity's internal control. In circumstances when the auditor also has a responsibility to express an opinion on the effectiveness of internal control in conjunction with the audit of the financial statements, the auditor shall omit the phrase that the auditor's consideration of internal control is not for the purpose of expressing an opinion on the effectiveness of the entity's internal control.

(iii) To evaluate the appropriateness of accounting policies used and the reasonableness of accounting estimates and related disclosures made by management.

(iv) To conclude on the appropriateness of management's use of the going concern basis of accounting and, based on the audit evidence obtained, whether a material uncertainty exists related to events or conditions that may cast significant doubt on the entity's ability to continue as a going concern. If the auditor concludes that a material uncertainty exists, the auditor is required to draw attention in the auditor's report to the related disclosures in the financial statements or, if such disclosures are inadequate, to modify the opinion. The auditor's conclusions are based on the audit evidence obtained up to the date of the auditor's report. However, future events or conditions may cause an entity to cease to continue as a going concern.

(v) When the financial statements are prepared in accordance with a fair presentation framework, to evaluate the overall presentation, structure and content of the financial statements, including the disclosures, and whether the financial statements represent the underlying transactions and events in a manner that achieves fair presentation.

(b)

From the following table indicate the appropriate audit opinion.

S/N	Client circumstances	Appropriate Opinion
1	The business has suffered as a result of low consumer spending and increased competition in the last few years. You have commenced work on the current year audit and discussions with staffs reveal that the inventory stocktake was performed a few days ago at the warehouse without prior notice. No documentation or feedback from that stock take, except for a Frw 70,000,000 stock adjustment in the books, is able to be relayed to the auditors. You have discussed the issue with senior management, and they are aware that audit evidence is missing regarding the Frw 1 billion inventory balance held in the Malika warehouse. No alternative methods to validate the inventory balance are available to the auditors at this time. Total assets of Malika are Frw 3.8 billion.	**Qualified Opinion**
2	The audit of Malenge Ltd has proved extremely difficult, as the client did not maintain appropriate financial records during the year. The financial records were not updated for the first 10 months of the year as Malenge Ltd had no accountant during that period. An accountant was employed in May 2020, and tried to reconstruct records from the details of receipts and payments available. They were unable to reconcile the bank account, and the financial statements. The operating loss recorded by Malenge Ltd in the year is Frw 22,190,000	**Disclaimer Opinion**
3	Malo Dosali Limited is a major management consulting firm in Rwanda and the audit for 30 June 2020 is now complete. You have noticed some disturbing trends, with a 200% increase in revenue since last year despite the economy being relatively flat year-on-year. You have also noticed that management consulting projects are being accounted for differently compared to last year, and include a much more aggressive revenue recognition policy in place. You and the audit partner have spoken to senior management about the inappropriateness of the accounting	**Qualified Opinion**

	treatment; however, they have refused to change the accounting treatment or make any adjustments relating to these accounting policy changes in their financial statements. You estimate that if the accounting policy were to be changed to comply with the appropriate financial reporting framework, a downward (debit) adjustment of Frw 450 million would be required on the current profit of Frw 600 million for the year.	
4	The auditor identified a non-adjusting event which he considers needs disclosure in the financial statements but the directors refuse to include the disclosure?	**Unqualified Opinion**
5	If the use of the going concern assumption is appropriate but a material uncertainty exists "which has been adequately disclosed" which has been disclosed.	**Unqualified Opinion**
6	The directors of an entity are refusing to amend the financial statements to take account of a customer who went bankrupt after the year-end and who owed the entity Frw 9,000,000 at the year-end. This amount is material.	**Qualified Opinion**
7	The auditors have been unable to verify the value of year-end inventory held by an entity due to a fire in one of its premises which destroyed some records. The value of inventory affected is thought to be around Frw 15 million. Materiality is Frw 20 million.	**Unqualified Opinion**
8	Auditor's report when they have been unable to obtain sufficient appropriate audit evidence for an issue that is material and pervasive to the client's financial statements	**Disclaimer Opinion**
9	There is a misstatement arising from the accounting treatment of an item that is material and pervasive to the client's financial statements?	**Adverse Opinion**

(c)

Forming an Opinion on the Financial Statements.

i) The auditor shall form an opinion on whether the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

ii) In order to form that opinion, the auditor shall conclude as to whether the auditor has obtained reasonable assurance about whether the financial statements as a whole are free from material misstatement, whether due to fraud or error. That conclusion shall take into account: (a) The auditor's conclusion, in accordance with ISA 330, whether sufficient appropriate audit evidence has been obtained; (b) The auditor's conclusion, in accordance with ISA 450, whether uncorrected misstatements are material, individually or in aggregate; and (c) The evaluations required by paragraphs.

iii) The auditor shall evaluate whether the financial statements are prepared, in all material respects, in accordance with the requirements of the applicable financial reporting framework. This evaluation shall include consideration of the qualitative aspects of the entity's accounting practices, including indicators of possible bias in management's judgments. (Ref: Para. A1–A3)

iv) In particular, the auditor shall evaluate whether, in view of the requirements of the applicable financial reporting framework:

(a) The financial statements adequately disclose the significant accounting policies selected and applied; (b) The accounting policies selected and applied are consistent with the applicable financial reporting framework and are appropriate;

(c) The accounting estimates made by management are reasonable;

(d) The information presented in the financial statements is relevant, reliable, comparable, and understandable;

(e) The financial statements provide adequate disclosures to enable the intended users to understand the effect of material transactions and events on the information conveyed in the financial statements; and

(f) The terminology used in the financial statements, including the title of each financial statement, is appropriate.

v) When the financial statements are prepared in accordance with a fair presentation framework, the evaluation required by paragraphs shall also include whether the financial statements achieve fair presentation. The auditor's evaluation as to whether the financial statements achieve fair presentation shall include consideration of:

(a) The overall presentation, structure and content of the financial statements; and

(b) Whether the financial statements, including the related notes, represent the underlying transactions and events in a manner that achieves fair presentation.

vi) The auditor shall evaluate whether the financial statements adequately refer to or describe the applicable financial reporting framework.

(d)

Auditors' consideration on the impact of COVID-19 on financial performance.

a**) Going concern:** An entity's current facts and circumstances may challenge the going concern basis of preparation.

b) **Events after the end of the reporting period:** Given the economic environment and the likelihood that events may occur rapidly or unexpectedly, entities should carefully evaluate information that becomes available after the end of the reporting period but before the date of authorization of the financial statements.

c**) Statement of profit or loss:** The impact of COVID-19 may give rise to material expense or income items for many entities, for example restructuring provisions and impairment losses related to non-financial assets.

d) **Financial Instruments**: Allowance for expected credit losses (ECL). COVID-19 can affect the ability of borrowers, whether corporate or individuals, to meet their obligations under loan relationships. Individual and corporate borrowers may have a particular exposure to the economic impacts in their geography and industry sector

e) **Trade receivables:** For entities with certain financial assets such as short-term trade receivables and contract assets the complexity of the estimate of ECL is reduced due to the application of the simplified approach.

f) **Fair value measurements:** Entities will need to pay particular attention to fair value measurements based on unobservable inputs.

g***) Liquidity risk management:*** Disruptions in production and reduced sales can have implications on an entity's working capital and could lead to a breach of a debt covenant resulting in the liability becoming current.

h) **Debt modifications:** In response to liquidity challenges, an entity's debtors may seek to renegotiate the terms of their arrangements with the entity.

i) **Changes in estimated cash flows:** COVID-19 may result in a change in expectations regarding the exercise of prepayment, extension or conversion features in various debt agreements.

j) **Revenue from contracts with customers:** Business disruptions associated with the COVID-19 pandemic may prevent an entity from entering into customer agreements by using its normal business practices, which may make the determination of whether it has enforceable rights and obligations challenging.

l) **Restructuring plans:** In a difficult economic environment and facing difficulties in obtaining financing, an entity may be considering or implementing restructuring plans such as the sale or closure of part of its businesses or the downsizing (temporarily or permanently) of operations.

m) **Onerous contracts provisions:** Because of the impacts of COVID-19, unavoidable costs of meeting the obligations under the contract may exceed the benefits expected to be received, resulting in an onerous contract. IAS 37 Provisions, Contingent Liabilities and Contingent Assets requires recognition of a provision in respect of an onerous contract.

n) **Insurance recoveries:** Entities that incur losses stemming from the COVID-19 pandemic may be entitled to insurance recoveries. For example, losses associated with increased medical claims, asset impairments, or shareholder litigation may be considered insured losses by many entities.

0) **Lease contracts:** As a result of the COVID-19 pandemic, certain entities are experiencing significantly reduced consumer traffic in retail stores and shopping areas, or indefinite closures due to quarantine measures and other government directives.

QUESTION THREE

Marking guide

(a)

	Weakness	Recommendation	Marks
1	Non-executive chairman is also the chair of audit committee	Chairman should resign from two positions to be able to deliver on his/her duties as non-executive chairman.	**3**
2	Chairman and one of the NEDs are former executive directors of **Timau Technology Ltd** and on reaching retirement age, now they took over non-executive roles.	The roles should be occupied by skilled and energetic directors who can contribute setting strategic direction of the company.	**3**
3	All NEDs are members of the audit committee who were previously involved in sales or production related roles.	The company should ensure that the directors who were previously occupied operations positions are not appointed to be audit committee members.	**3**
4	The board is composed of six executives and only three non-executive directors.	At least half of the board should be comprised of non-executive directors.	**3**
5	The Finance director is entrusted to review whether or not Timau Technology Ltd is complying with corporate governance principles in order to its listed status.	There should be a fair and transparent policy in place for external reviews, the finance director should not be involved nor decide on their compliance with corporate governance.	**3**
6	The company has not established a proper internal audit function to monitor internal controls but maintains a small internal audit department.	Should hire qualified and experienced staff to undertake an important role in audit department to help the directors to satisfy their responsibility of accountability with regards to maintaining an appropriate relationship with the company auditor.	**3**

Maximum Marks **12**

(b) Role of the auditor in consideration of laws and regulations as per ISA 250 (Consideration of Laws and regulation in audit of financial statements).	**Marks**
• Auditor not responsible for preventing non-compliance	2
• Auditor is responsible for obtaining reasonable assurance that the financial statements.	2
• Auditor's responsibility is to obtain sufficient appropriate audit evidence	2
• Auditor is required by this ISA to remain alert to the possibility	2
• To obtain sufficient appropriate audit evidence regarding compliance	2
• To perform specified audit procedures to help identify instances of non-compliance	2
• To respond appropriately to identified non-compliance with laws and regulations	2
Maximum Marks	8
(c) Discuss the management responsibilities over laws and regulations governing the entity.	
• To assist in the prevention and detection of noncompliance with laws and regulations:	1
• Monitoring legal requirements and ensuring that operating procedures are designed	1
• Instituting and operating appropriate systems of internal control	1
• Developing, publicizing, and following a code of ethics or code of conduct	1
• Ensuring employees are properly trained and understand the code of ethics	1
• Monitoring compliance with the code of ethics or code of conduct	1
• Engaging legal advisors to assist in monitoring legal requirements	1
• Maintaining a register of significant laws and regulations	1
Maximum Marks	**5**
Total marks	**25**

Model answers

(a) <u>Weaknesses and Recommendations</u>

1. Now, non-executive chairman is also the chair of audit the committee. However, he is supposed to be the independent non-executive directors and hence cannot hold two positions as chair. These roles are both very important and carry significant responsibilities; hence this presents too much power residing in the hands of same individual. Further, the chairman does not have an executive role but he has sole responsibility for liaising with the shareholders and answering any of their questions. This is conflicting with the other roles of being non-executive chairman and chairman of the audit committee.

Recommendation
He should resign from two positions to be able to delivery on his/her duties as non-executive chairman.

2. The chairman and one of the NEDs are former executive directors of **Timau Technology Ltd** and on reaching retirement age, now they took over non-executive roles.

   Recommendation
   The roles should be occupied by skilled and energetic directors who can contribute setting strategic direction of the company.

3. The company has established an audit committee, and all NEDs are members of the audit committee who were previously involved in sales or production related roles. This is an issue as they were in operations, and then can lead to self-review threats.

   Recommendation
   The company should ensure that the directors who were previously occupied operations positions are not appointed to be audit committee members.

4. The board is composed of six executives and only three non-executive directors. There may not be an appropriate balance of executive and non-executives to ensure that the board makes the correct objective decisions, which are in the best interest of the shareholders

   Recommendation

   At least half of the board should be comprised of non-executive directors. Hence the board of **Timau Technology Ltd** should consider recruiting and appointing an additional two to three non-executive directors.

5. The Finance director is entrusted to review whether or not Timau Technology Ltd is complying with corporate governance principles in order to its listed status. However, no director should be involved in reviewing their performance and compliance with corporate governance principles as this may result in excessive levels self-review, conflict of interests and undue influence.

   Recommendation
   There should be a fair and transparent policy in place for external reviews, the finance director should not be involved nor decide on their compliance with corporate governance. They should hire an independent external reviewer who is also licensed.
   Timau Technology Ltd should appoint an audit committee as soon as possible. The committee should be comprised of at least three independent non-executives one of whom should have relevant financial experience.

6. The company has not established a proper internal audit function to monitor internal controls but maintains a small internal audit department.

   Recommendation

   Timau Technology Ltd should hire qualified and experienced staff to undertake an important role in audit department to help the directors to satisfy their responsibility of accountability with regards to maintaining an appropriate relationship with the company auditor. Further, review risk assessments including the adequacy of internal controls of the company.

(b) Responsibility of the Auditor

1. The requirements in this ISA are designed to assist the auditor in identifying material misstatement of the financial statements due to non-compliance with laws and regulations. However, the auditor is not responsible for preventing non-compliance and cannot be expected to detect noncompliance with all laws and regulations.

2. The auditor is responsible for obtaining reasonable assurance that the financial statements, taken as a whole, are free from material misstatement, whether caused by fraud or error.

   In conducting an audit of financial statements, the auditor takes into account the applicable legal and regulatory framework. Owing to the inherent limitations of an audit, there is an unavoidable risk that some material misstatements in the financial statements may not be detected, even though the audit is properly planned and performed in accordance with the ISAs.
   In the context of laws and regulations, the potential effects of inherent limitations on the auditor's ability to detect material misstatements are greater for such reasons as the following:

   - There are many laws and regulations, relating principally to the operating aspects of an entity that typically do not affect the financial statements and are not captured by the entity's information systems relevant to financial reporting.
   - Non-compliance may involve conduct designed to conceal it, such as collusion, forgery, deliberate failure to record transactions, management override of controls or intentional misrepresentations being made to the auditor. • Whether an act constitutes non-compliance is ultimately a matter for legal determination by a court of law. Ordinarily, the further removed non-compliance is from the events and transactions reflected in the financial statements, the less likely the auditor is to become aware of it or to recognize the non-compliance.

3. This ISA distinguishes the auditor's responsibilities in relation to compliance with two different categories of laws and regulations as follows:

   a. The provisions of those laws and regulations generally recognized to have a direct effect on the determination of material amounts and disclosures in the financial statements such as tax and pension laws and regulations; and

   b. Other laws and regulations that do not have a direct effect on the determination of the amounts and disclosures in the financial statements, but compliance with which may be fundamental to the operating aspects of the business, to an entity's ability to continue its business, or to avoid material penalties (for example, compliance with the terms of an operating license, compliance with regulatory solvency requirements, or compliance with environmental regulations); noncompliance with such laws and regulations may therefore have a material effect on the financial statements.

4. In this ISA, differing requirements are specified for each of the above categories of laws and regulations, the auditor's responsibility is to obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations, the auditor's responsibility is limited to undertaking specified audit procedures to help identify non-compliance with those laws and regulations that may have a material effect on the financial statements.

5. The auditor is required by this ISA to remain alert to the possibility that other audit procedures applied for the purpose of forming an opinion on financial statements may bring instances of identified or suspected noncompliance to the auditor's attention. Maintaining professional skepticism throughout the audit, as required by ISA. It is important in this context, given the extent of laws and regulations that affect the entity.
6. To obtain sufficient appropriate audit evidence regarding compliance with the provisions of those laws and regulations generally recognised to have a direct effect on the determination of material amounts and disclosures in the financial statements

7. To perform specified audit procedures to help identify instances of non-compliance with other laws and regulations that may have a material effect on the financial statements
8. To respond appropriately to identified or suspected non-compliance with laws and regulations identified during the audit.

(c) What is management responsibilities over laws and regulation governing the entity (5 marks)

It is the responsibility of management, with the oversight of those charged with governance, to ensure that the entity's operations are conducted in accordance with laws and regulations.

Laws and regulations may affect an entity's financial statements in different ways (for example, most directly, they may affect specific disclosures required of the entity in the financial statements, or they may prescribe the applicable financial reporting framework).

They also may establish certain legal rights and obligations of the entity, some of which will be recognized in the entity's financial statements. In addition, laws and regulations may provide for the imposition of penalties in cases of noncompliance.

The following are examples of the types of policies and procedures an entity may implement

- To assist in the prevention and detection of noncompliance with laws and regulations:
- Monitoring legal requirements and ensuring that operating procedures are designed to meet these requirements
- Instituting and operating appropriate systems of internal control

- Developing, publicizing, and following a code of ethics or code of conduct
- Ensuring employees are properly trained and understand the code of ethics or code of conduct
- Monitoring compliance with the code of ethics or code of conduct and acting appropriately to discipline employees who fail to comply with it
- Engaging legal advisors to assist in monitoring legal requirements
- Maintaining a register of significant laws and regulations with which the entity has to comply within its particular industry and a record of complaints

QUESTION FOUR

Marking guide

(a)Factors that indicate fraud in a company	**Marks**
• Management or other employees have an *incentive* or are under *pressure*,	1
• Circumstances exist, for example, the absence of controls, ineffective controls,	1
• Those involved are able to *rationalize* committing a fraudulent act.	1
• Management has a unique ability to perpetrate fraud	1
• Fraudulent financial reporting often involves management override of controls	1
Maximum Marks	**4**
The audit approach in relation to fraud.	
• ISA 240 prescribes specific audit procedures to detect fraud	1
• The auditor has a responsibility to obtain reasonable assurance	1
• Fraudulent financial reporting often involves management override of controls	1
• Fraud may be concealed by withholding evidence or misrepresenting	1
• Due professional care requires the auditor to exercise professional skepticism.	1
• Professional skepticism is an attitude that includes a questioning mind	1
• The auditor should design and perform audit procedures in a manner that addresses	1
Maximum Marks	**6**
(b) Steps involved in a forensic, including examination procedures that should be used to gather evidence	
• Determination of nature of fraud committed by staff	2
• Examination procedures that should be used to gather evidence	2
• Risk Assessment Procedures	2
• Other risk assessment procedures	2
• Auditor's Responses to the Risk of Material Misstatement due to fraud	2
• Evaluation of Audit Evidence	2
• Management Representation	2
• Communication	2
• Documentation	2
Maximum Marks	**15**
Total Marks	**25**

Model answers

(a) Factors that indicate fraud in a company:

- Three conditions generally are present when fraud occurs. First, the management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud there is in relation to Chelimo Ltd marketing staff.
- However, even otherwise honest individuals can commit fraud in an environment that imposes sufficient pressure on them.
- The greater the incentive or pressure, the more likely an individual will be able to rationalize the acceptability of committing fraud.
- Second, circumstances exist, for example, the absence of controls, ineffective controls, or the ability of management to override controls that provide an *opportunity* for fraud to be perpetrated. This is the case of the payroll fraud that has existed since last year.
- Third, those involved are able to *rationalize* committing a fraudulent act. Some individuals possess an *attitude*, character, or set of ethical values that allow them to knowingly and intentionally commit a dishonest act.

- Management has a unique ability to perpetrate fraud because it frequently is in a position to directly or indirectly manipulate accounting records and present fraudulent financial information.
- Fraudulent financial reporting often involves management override of controls that otherwise may appear to be operating effectively.
- Management can either direct employees to perpetrate fraud or solicit their help in carrying it out.
- In addition, management personnel at a component of the entity may be in a position to manipulate the accounting records of the component in a manner that causes a material misstatement in the consolidated financial statements of the entity.
- Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization.
- Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation.

The audit approach in relation to fraud.

- While audits are not designed to root out every instance of fraud, auditors have a responsibility to detect material misstatements in the company's financial statements caused by either fraud or error.
- Accordingly, ISA 240 prescribes specific audit procedures to detect fraud that must be carried out during each audit.
- The auditor has a responsibility to plan and perform the audit to obtain reasonable assurance about whether the financial statements are free of material misstatement, whether caused by error or fraud.

- Two types of misstatements are relevant to the auditor's consideration of fraud—misstatements arising from fraudulent financial reporting and misstatements arising from misappropriation of assets in the case of Chelimo Ltd we have travel and entertainment expenses, payroll and cash.
- Three conditions generally are present when fraud occurs. First, management or other employees have an *incentive* or are under *pressure*, which provides a reason to commit fraud these is in relation to Chelimo Ltd marketing staff.
- Second, circumstances exist for example, the absence of controls, ineffective controls, or the ability of management to override controls that provide an *opportunity* for a fraud to be perpetrated. This is the case of the payroll fraud that has existed since last year.
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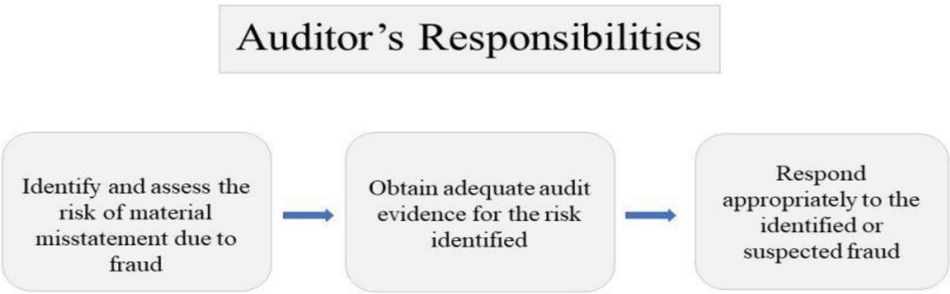
- Management can either direct employees to perpetrate fraud or solicit their help in carrying it out.
- In addition, management personnel at a component of the entity may be in a position to manipulate the accounting records of the component in a manner that causes a material misstatement in the consolidated financial statements of the entity.
- Typically, management and employees engaged in fraud will take steps to conceal the fraud from the auditors and others within and outside the organization.
- Fraud may be concealed by withholding evidence or misrepresenting information in response to inquiries or by falsifying documentation.
- Due professional care requires the auditor to exercise professional skepticism. Because of the characteristics of fraud, the auditor's exercise of professional skepticism is important when considering the fraud risks.
- Professional skepticism is an attitude that includes a questioning mind and a critical assessment of audit evidence.
- The auditor should conduct the engagement with a mindset that recognizes the possibility that a material misstatement due to fraud could be present, regardless of any past experience with the entity and regardless of the auditor's belief about management's honesty and integrity.
- Furthermore, professional skepticism requires an ongoing questioning of whether the information and evidence obtained suggests that a material misstatement due to fraud has occurred.

- ❖ In exercising professional skepticism in gathering and evaluating evidence, the auditor should not be satisfied with less-than-persuasive evidence because of a belief that management is honest.

- ❖ The auditor should design and perform audit procedures in a manner that addresses the assessed risks of material misstatement due to error or fraud for each relevant assertion of each significant account and disclosure "the audit procedures that are necessary to address the assessed fraud risks depend upon the types of risks and the relevant assertions that might be affected.

(b) Explain the steps involved in a forensic, the nature of fraud committed by staff in the marketing and in the payroll in the Chelinoo Ltd case including examination procedures that should be used to gather evidence



Nature of fraud committed

Two types of misstatements are relevant to the auditor's consideration of fraud: misstatements arising from **fraudulent financial reporting** and misstatements arising from **misappropriation of assets**. In the case of Chelimo Ltd, we have b**oth financial reporting and misappropriation of assets**. We have travel and entertainment expenses, payroll that has been inflated by staff to get in turn cash. There are **fictitious journal entries** and **embezzlement of cash**.

Examination procedures that should be used to gather evidence

- Assessment of risk to financials due to fraud
- Process for identifying and responding to the risk of fraud including frauds already identified;

- Communicate to those charged with governance for identifying and responding to the risk of fraud
- Communication to employees regarding its view on business practice and ethical behavior.
- The auditor can suspect or identify but does not make legal determinations of whether the fraud has actually occurred.

❖ **Risk Assessment Procedures**

An auditor attempts to better understand the client and its business environment, including the client's internal controls. The auditor will perform risk assessment procedures to observe and assess the risk of material misstating the financial statements due to either fraud or error. Risk assessment procedures include the following:

1. Inquiries of managers and relevant stakeholders
2. Analytical procedures
3. Observation and investigation
4. Discussing engagement with the team
5. Investigate the inconsistent responses from the management related to the inquiries.
6. SA 315 which covers the Auditor's response to assessed risks, requires discussion among the engagement team members and the engagement partner on those matters which are to be communicated to other team members not involved in the discussion.

❖ **Other risk assessment procedures**

- Auditors to inquire the management, internal audit team, and those charged with governance whether any instance of actual or alleged fraud has occurred in the past and obtain their respective views on the risk of fraud.
- Consider whether any other information obtained indicates the risk of fraud.
- Evaluate any fraud risk factors are present from the information obtained from the assessment.
- Identify Unusual or unexpected relationships while performing the analytical procedures and evaluate them to assess the risk of material misstatement due to fraud

❖ **Auditor's Responses to the Risk of Material Misstatement due to fraud**

Per SA 330, the auditor to determine overall responses to address the assessed risk through:

- Assign and supervise personnel taking significant engagement responsibilities
- Evaluate accounting policies to be indicative of fraudulent financial reporting
- Incorporate audit procedures to be executed to include an element of unpredictability
- Presume fraud risk in revenue recognition and management override of controls

❖ **Audit Procedure Responsive to Risk Related to Management Overrides of Control:**

In order to mitigate the risk of management override of controls, the auditor to design and perform the following Audit procedures:

- Test the appropriateness of the journal entries in the general ledger;
- review and evaluate the accounting estimate for any biases;

- Evaluate business rationale for significant transactions
- Perform any other additional audit procedures

❖ **Evaluation of Audit Evidence**

Auditor to follow these with respect to audit evidence

1. Analytical procedure performed indicates a previously unrecognized risk of material misstatement due to fraud
2. On identification of a misstatement, auditor to evaluate whether it is indicative of fraud
3. In case of fraudulent misstatement where the auditor believes management is involved, then re-evaluate the response to the assessed risk
4. If unable to conclude if the financials are fraudulently misstated, then the auditor to evaluate the implications for the audit

If the fraudulent misstatement encounters the auditor from continuing the audit, then the auditor shall withdraw from the audit if appropriate and report to the person who made the audit appointment.

❖ **Management Representation**

- Responsibility for the design, implementation, and maintenance of internal control to prevent fraud
- Disclosed the result of an assessment of the risk of material misstatement in financial due to fraud.
- Disclosed the fraud occurred or suspected involving management, employees, or others;
- Disclosed allegations of fraud/ suspected fraud informed by employees, regulators or others.

Communication

- On identification of fraud or suspecting of fraud existence, then auditor has to communicate to the appropriate level of management on a timely basis
- Communicate as appropriate to those charged with governance if the suspected fraud involves management, employees performing internal control, or any others.
- Determine if the information about the fraud has to be communicated to a party outside the entity. Here the auditor's legal responsibility overrides the duty of confidentiality.

Documentation

- Significant decisions are taken with respect to the susceptibility of material misstatement in financial due to fraud
- Identified and assessed risk of material misstatement due to fraud at the financial statements level and at the assertion level
- Overall responses to the addressed risk mentioned above
- Audit procedures conclusion including those designed for management override of controls
- To document communications made about the fraud to the management and others

END OF MARKING GUIDE AND MODEL ANSWERS