# CERTIFIED ACCOUNTING TECHNICIAN (CAT)

# STAGE 3 EXAMINATION

# S3.4 AUDIT AND ASSURANCE

# PILOT PAPER

## ANSWERS

## Section A - Answer Grid

1. B
2. C
3. B
4. B
5. D
6. E
7. A
8. D
9. C
10. D

## Section A - Suggested solutions

### Marking scheme

| | Marks |
|---|---|
| 2 marks for each correct answer | 2 |
| Total marks for this section | 20 |

1. B The auditor's report should be addressed to the shareholders, in line with ISA 700 *Forming an Opinion and Reporting on Financial Statements*. The report is not for individuals or groups of shareholders, but for the shareholders as a body – hence 'principal shareholders' is incorrect. (Although such a consideration may be relevant to the auditor's own determination of the users of the financial statements in line with ISAs, the report is nevertheless addressed to the shareholders as such.) The report is not addressed to those charged with governance; the essence of the audit is that it is a report on what those charged with governance and management have done with the entity, addressed to its owners, the shareholders. The auditor's report is not a report to the stakeholders; these are various, and the auditor's report is addressed solely to one type of stakeholder – the shareholders.

**(LO 1/1.1)**

2. C ISA 720 concerns the auditor's report and is therefore most relevant during the completion phase of the audit, not the planning phase. ISA 560 concerns events after the end of the reporting period. Although it is possible that a subsequent event could be discovered during the planning phase, this ISA is most relevant to the auditor's review of subsequent events, which takes place at the completion phase. ISA 450 has to do with the fieldwork or evidence-gathering phase of the audit, where the auditor applies the audit plan. ISA 330 is most relevant, since the design of responses to the risks assessed during the plan is itself part of the planning process. **(LO 1/1.2)**

3. B A would be haphazard sampling. C would be random sampling. D would be to use block sampling. **(LO 1/3.2)**

4. B Focusing on tests of controls where those controls may contain deficiencies would put audit effectiveness at risk, so (i) is correct. Audit efficiency would be risked if the mistake were the other way around, ie focusing on substantive procedures when controls might have been relied upon; (ii) is therefore incorrect.

   It follows from this that the auditor would be accepting more detection risk than they should, so (iii) is correct. Olive would have assessed control risk as being lower than in fact it is, so (iv) is incorrect. **(LO 1/3.3)**

5. D Option (i) is incorrect as document flowcharts are in fact poorly suited to systems that are not standardised. Option (ii) correctly describes a disadvantage of document flowcharts that is relevant to this audit. Option

(iii) is a valid point in the case of someone without experience, such as Nadine. Option (iv) is a valid advantage of document flowcharts here. **(LO 1/4.1)**

6. E A is incorrect because it treats liabilities, which are not relevant to the receivables balance (the question would have been appropriate to the audit of payables, however). B is incorrect because, although it deals with assets (and receivables are assets), it is only appropriate for non-current assets. C is incorrect because it would relate to management information and general controls, not receivables specifically. D is incorrect because cash payments relate to payables, not receivables. None of these options are therefore correct. **(LO 2/1.1)**

7. A Option B is incorrect because there is no particular evidence of auditor judgment having been used here, and the pattern of the invoice numbers clearly suggests the use of systematic sampling. Similarly, this is not random selection because of the pattern in the invoice numbers. This does not appear to be block selection because the transactions do not appear to have the same characteristics – the customers are of different types. **(LO 2/1.6)**

8. D Tracing sales through to sales invoices is a test of sales occurrence, which is not relevant here and is in any case unusual. Confirming that inventory records have been updated is similarly irrelevant to sales returns. The remaining two options are correct because they deal specifically with management's estimate of the amount to be provided for sales returns. **(LO 2/1.7)**

9. C Options (i) and (iii) are correct – these are specified by ISA 300: para. A8. Option (ii) is incorrect – the timetable for the planned procedures is part of the detailed plan, not the strategy. Option (iv) is incorrect because performance materiality levels should only be specified in the plan, not the strategy. **(LO 2/1.8)**

10. D This is not a breach of integrity as such, as Vedaste has not failed to be straightforward or honest (in a sense he has been too honest). Similarly, Vedaste has not breached objectivity because there is no question here of bias, conflict of interest or undue influence. Finally, Vedaste's professional competence is not in doubt. This is a breach of the audit client's confidentiality. **(LO 2/3.3)**

## Section B - Suggested solutions

11.

### Marking scheme

| | | Marks |
|---|---|---|
| (a) **Materiality definitions and explanations** | | |
| In general, 1 mark for each well-explained point | | |
| • Materiality in line with IFRS | 1 | |
| • Materiality in line with economic decisions of users | 1 | |
| • Need to consider needs of users as a group | 1 | |
| • Materiality used as a basis for risk assessment | 1 | |
| • Reconsider as audit progresses | 1 | |
| • Use of benchmarks (examples) | 1 | |
| • Performance materiality definition | 1 | |
| • Performance materiality explanation | 1 | |
| Max | | 4 |
| (b) **Qualitative factors in determining materiality** | | |
| In general, 1 mark for each well-explained point | | |
| • Depends on needs of users | 1 | |
| • Legal, regulatory and financial reporting framework | 1 | |
| • Importance to the industry being operated in | 1 | |
| • Distinct elements of the business | 1 | |
| Max | | 3 |
| (c) **Benchmarks** | | |
| • Kibungo Hyper Markets Ltd – total assets | 1 | |
| • Nyamata Trading Co – profit before tax | 1 | |
| • Kabuga Capital Ltd – profit before tax | 1 | |
| Max | | 3 |
| **Total marks for this section** | | **10** |

**Detailed suggested answer**

(a) ISA 320 *Materiality in Planning and Performing an Audit* states that the auditor determines materiality in line with discussions present in the financial reporting framework, ie IFRS. ISA 320 does, however, make some points that are generally applicable to auditors in Rwanda who are auditing companies not applying IFRS.

Misstatements or omissions are material if they could reasonably be expected to influence the economic decisions of users taken on the basis of the financial statements (ISA 320: para. 2). Further, materiality includes both quantitative and qualitative elements, ie the size and nature of the misstatement. The auditor also needs to consider the common needs of the users when determining materiality.

The auditor uses the concept of materiality throughout the audit. Judgments about materiality provide them with a basis for:

- Determining risk assessment procedures;
- Identifying risks of material misstatement; and
- Determining the further audit procedures.

(ISA 320: para. 6)

The auditor therefore determines a materiality level at the planning stage of the audit. This level will be subject to reconsideration in the light of the further experience that is afforded in the form of the evidence later obtained.

Materiality may be determined in line with benchmarks, such as 5-10% of profit after tax, ½-1% of revenue, or 1-2% of total assets. The auditor uses their judgment to decide which is the most appropriate benchmark, and at which point in the range materiality should be set.

Performance materiality is defined as:

> […] the amount or amounts set by the auditor at less than materiality for the financial statements as a whole to reduce to an appropriately low level the probability that the aggregate of uncorrected and undetected misstatements exceeds materiality for the financial statements as a whole.
> (ISA 320: para. 9)

The concept of performance materiality is connected to overall materiality – it describes the way in which the auditor uses the concept of materiality in the context of specific areas of the financial statements.

An indication of performance materiality levels can be made at the planning stage in accordance with the auditor's assessment of the risk of material misstatement inhering in the financial statement area in question.

**(LO 1/1.5)**

(b) The central factor in the assessment of materiality is the economic needs of users. The auditor's judgment regarding users' needs allows them to decide which qualitative factors are important to those users.

For example, the legal, regulatory framework present in Rwanda, together with IFRS, affect users' expectations regarding the measurement or disclosure of certain items. Transactions with related parties such as company directors are a good example of this; similarly directors' remuneration.

Some disclosures will be of special importance in the industry in which the audited entity operates. Examples of this would include; research and development costs for a pharmaceutical company; exploration costs for companies operating in extractive industries, or; revenue for retail companies.

Where there are distinct elements of the company's business then these may be of special importance to users; for instance, a newly-acquired subsidiary or expansion into a new area of operations.

(c) Kibungo Hyper Markets Ltd has expanded its asset base, which suggests that materiality ought to be assessed in relation to its statement of financial position. Quick expansion of the asset base may affect the company's cash position, so the audit of its current assets and liabilities is likely to be an area of focus, in addition to the acquired assets themselves (and any associated liabilities).

Materiality ought to be assessed in relation to total assets.

Nyamata Trading Co Ltd has experienced a fraud in relation to its revenue, which could be taken to indicate that materiality should be assessed in relation to revenue. However, the fact that profit is small – and has fallen compared with the prior year – is likely to be of key interest to users. The revenue fraud would likely be a key audit matter, but this does not mean that materiality for the financial statements as a whole should be assessed in relation to it.

Materiality ought to be assessed in relation to profit before tax.

In the case of Kabuga Capital Ltd, we have a clear indication of the focus of users on profit before tax. The company's asset base has been stable and this is unlikely to be the key area of focus.

Materiality ought to be assessed in relation to profit before tax.

12.

**Marking scheme**

| | | | Marks |
|---|---|---|---|
| (a) | **Procedures to identify and assess RoMMs** | | |
| | In general, 1 mark for each well-explained point | | |
| | • Analytical procedures | 1 | |
| | • Observation and inspection | 1 | |
| | • Prior period knowledge | 1 | |
| | • Client acceptance | 1 | |
| | • Discussion by the audit team | 1 | |
| | • Information from other engagements | 1 | |
| | Max | | 4 |
| (b) | **Six areas of which to obtain an understanding** | | |
| | In general, up 1½ marks for each well-explained point | | |
| | • Regulatory environment (as a music retailer) | 1½ | |
| | • Nature of the entity | 1½ | |
| | • Accounting policies | 1½ | |
| | • Objectives and strategies | 1½ | |
| | • Financial performance | 1½ | |
| | • Internal controls | 1½ | |
| | Max | | 6 |
| **Total marks for this section** | | | **10** |

**Detailed suggested answer**

(a) In accordance with ISA 315, the auditor identifies and assesses the risks of material misstatement at the beginning of the audit process, which then enables them to design and perform further audit procedures and gives them a frame of reference for making audit judgments.

The following procedures are relevant:

- 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
- Information from other engagements undertaken for the entity

(ISA 315: paras. 6-10)

(b) The audit firm should obtain information in relation to the following areas of Bugarama Entertainment Ltd's business operations:

**Regulatory factors**

It should be confirmed that Bugarama Entertainment Ltd prepares its financial statements on the basis of IFRS.

It is important to establish the legal framework within which the company operates. As a music retailer it is likely that Bugarama Entertainment Ltd will need to comply with laws relating to copyright and intellectual property and that these laws could have a fundamental bearing on its ability to operate.

**Nature of the entity**

Bugarama Entertainment Ltd is a limited company, which should be confirmed by relevant searches. The structure of its operations should be established – one would expect it to be structured by location but this should be confirmed. The auditor should understand how the operations are financed (eg through debt), as well as any special account balances.

Its corporate governance arrangements should be identified, as this will have a key impact on the auditor's assessment not just of regulatory compliance but of the internal control environment.

**Accounting policies**

The auditor needs to evaluate whether Bugarama Entertainment Ltd's accounting policies are appropriate. Since the company is a retailer, the most important requirements are likely to be its accounting for revenue and for inventory. It should be determined what its policies are and whether these are in accordance with the relevant accounting standards.

Any changes in accounting policies need to be identified, as these are a source of risk, together with the reasons for these changes.

**Objectives and strategies**

The auditor should enquire into Bugarama Entertainment Ltd's objectives and strategies, as these will entail business risks which could give rise to audit risks.

Leoncie has stated that she does not want to focus on finance at the expense of culture; while this may be personally laudable, from the point of view of the auditor it represents a risk. Leoncie's statement casts doubt on the engagement partner's belief that the company has a strong control environment.

**Financial performance**

The way Bugarama Entertainment Ltd measures and reviews its financial performance must be understood. This is because performance measures create pressures on the entity, which may motivate management to take action to improve the business performance or to misstate the financial statements.

If, for example, Bugarama Entertainment Ltd's key performance measure is revenue, then this may create a pressure to improve the revenue figure in the financial statements.

**Internal control**

The auditor must obtain an understanding of the internal controls that are relevant to the audit; these are principally the internal controls that relate to financial reporting.

This means that the auditor must evaluate the design of these controls to determine whether they are likely to be effective. A key consideration is whether the controls do in fact operate as described by management; the auditor should therefore focus their efforts on obtaining detailed knowledge of the actual operation of controls rather than simply making inquiries of management in this area. **(LO 1/3.5)**

## Section C - Suggested solutions

13.

### Marking scheme

| | | | Marks |
|---|---|---|---|
| (a) | **Explanations of fundamental principles** | | |
| | Integrity | 1 | |
| | Objectivity | 1 | |
| | Professional competence and due care | 1 | |
| | Confidentiality | 1 | |
| | Professional behaviour | 1 | |
| | Max | | 5 |
| (b) | **Gitarama Ltd** | | |
| | Self-review threat and explanation | 1 | |
| | Threat of management responsibility | 1 | |
| | Safeguards | 2 | |
| | Need to reduce risk to acceptably low level | 1 | |
| | Max | 5 | |
| | **Rusumo Manufacturing Ltd** | | |
| | Auditor may not be negligent – depends on work done | 1 | |
| | Self-review and advocacy threats and explanations | 2 | |
| | Cannot represent at tribunal or in court | 1 | |
| | Safeguards | 2 | |
| | Max | 5 | |
| | **Bracorwa Ltd** | | |
| | Self-review, familiarity and intimidation threats + explanations | 1½ | |
| | No significant connection and evaluation | 1 | |
| | Factors in level of threat | 1 | |
| | Safeguards | 1 | |
| | Firm policy regarding employment with clients | 1 | |
| | Solange has acted unethically | 1 | |
| | Max | 5 | |
| | Max | | 15 |
| | **Total** | | **20** |

**Detailed solution**

The IESBA *Code of Ethics* explains the five fundamental principles: integrity, objectivity, professional competence and due care, confidentiality, and professional behaviour. Integrity means to be straightforward and honest in all professional and business relationships. Objectivity means not to compromise professional or business judgements because of bias, conflict of interest or undue influence of others. Professional competence and due care means to:

- Attain and maintain professional knowledge or skill at the level required to ensure that a client or employing organisation receives competent professional service, based on current technical and professional standards and relevant legislation; and
- Act diligently and in accordance with applicable technical and professional standards.

Confidentiality means to respect the confidentiality of information acquired as a result of professional and business relationships. Professional behaviour means to comply with relevant laws and regulations and avoid any action that the professional accountant knows or should know might discredit the profession. **(LO 1/1.1)**

(b) **Gitarama Ltd**

Gitarama Ltd is an audit client which is proposing that Manirahi Partners Ltd acts as both internal and external auditor.

Providing internal audit services to an audit client is likely to give rise to a self-review threat to Manirahi Partners Ltd's objectivity as external auditor. This is because Manirahi Partners Ltd would, as part of its external audit, need to evaluate the efficacy of internal controls that it had itself helped to put in place.

There is also a risk of performing services that involve assuming a management responsibility for Gitarama Ltd. The *Code of Ethics* forbids the auditor from taking on such a responsibility, so it will be necessary to assess the proposed engagement in line with the guidance given in the *Code of Ethics*. Manirahi Partners Ltd must not be responsible for designing, implementing or performing internal control activities.

In line with the IESBA *Code of Ethics*, if Gitarama Ltd were a listed entity then it would not be possible to act as both its internal and its external auditor. Similarly, if Manirahi Partners Ltd determines that the threat that would arise from the internal audit services would be only insufficiently mitigated by the application of safeguards, then the internal audit service engagement should not be undertaken.

It may be possible for Manirahi Partners Ltd to apply safeguards to mitigate the self-review threat that could arise. These could include the following:

- Gitarama Ltd should acknowledge its responsibility for the system of internal control.
- Any internal audit service should be performed by a team that is separate from the external audit team.
- Gitarama Ltd could appoint a designated employee with responsibility for internal audit activities.
- Gitarama Ltd itself must approve the scope, risk and frequency of internal audit work.

(c) **Rusumo Manufacturing Ltd**

If Rusumo Manufacturing Ltd is found to have over-declared expenses then it would have fraudulently prepared its taxation records. This is a serious offence. It is possible that the audits conducted in previous years were carried out negligently, but this is not necessarily the case; it is in the nature of fraud that the audit may not necessarily uncover it. The outcome of this issue would depend on whether the auditor's work in this area was sufficient to obtain reasonable assurance, rather than on whether they uncovered the fraud as such.

The proposed engagement to represent Rusumo Manufacturing Ltd with the RRA is what the *Code of Ethics* refers to as a taxation service. This may create a self-review or an advocacy threat to the auditor's independence.

A distinction should be drawn between merely providing assistance in the resolution of a tax dispute, and acting as an advocate before a public tribunal or court. Where former type of service is acceptable in certain circumstances, the latter is never acceptable and must be declined. This is because the advocacy threat so created would be too severe for sufficient mitigating safeguards to be set against it.

Manirahi Partners Ltd should therefore seek clarification from management of the point that the RRA's investigation has reached, and of the nature of the 'help' that it is requesting. It should be made clear to management that the firm cannot represent it at any tribunal or in court, and that if such a need comes to pass then management will need to find a different advocate.

If the services in question do not involve representation at tribunal or in court, then the firm will need to assess the extent of the threats arising. These will depend on factors such as the role management will play in the investigation, and the materiality of the issue's effect on the financial statements.

It is possible that safeguards could be put in place to reduce the threat to an acceptable level. These would include:

- Using two separate teams for the tax dispute assistance service and the audit
- Using an engagement quality control reviewer for either the audit or the taxation service, as appropriate.

**Bracorwa Ltd**

The *Code of Ethics* states that employment with an audit client may create a self-interest, familiarity or intimidation threat, depending on the specific circumstances.

In certain situations it is acceptable for a former member of the audit team to take up employment with their former audit client. Manirahi Partners Ltd must ensure that no significant connection remains between it and Solange. The issue is particularly acute, since the situation here involves two factors that are specifically mentioned by the *Code of Ethics* as giving rise to threats, namely:

- Solange is a member of the audit team
- Solange may join the client as a director or officer – in this case, as finance director

The level of the threats created will depend on the position Solange may take (high threat – finance director); any involvement they will have with the audit team (this is likely as a finance director); the length of time since Solange was on the audit team (the report was issued nine months ago, which is fairly recent); and Solange's position within the audit team (as audit manager she would have been responsible for significant contact with the client).

It should be established at what point Solange applied for the post. The *Code of Ethics* requires any significant judgments that she made to be reviewed, if she knew that she might work at the client while she was working on the last audit. In general terms, the level of threat here is relatively high.

It may be possible for safeguards to be put in place to mitigate this threat, such as the following:

- Ensuring that the audit team will have sufficient experience of Bracorwa Ltd
- Using an engagement quality control reviewer to conduct a post-issuance review of the audit

It should be ensured that Solange has no further contact with Bracorwa Ltd in her capacity as an audit manager and that she is removed from the team for any forthcoming audits. If she has already commenced planning for the next audit then her work will need to be reviewed and, if necessary, done again.

Finally, the *Code of Ethics* requires Manirahi Partners Ltd to have policies and procedures in place to require staff members to notify the firm if they enter into employment negotiations with an audit client. It is encouraging in this respect that Solange has told the firm about the forthcoming interview, but she should have done this at the beginning of her application process. Solange may therefore have breached the requirements of the *Code of Ethics*; there is a case for her receiving a warning from Manirahi Partners Ltd for her conduct in relation to this matter. **(LO 1/1.1)**

14.

**Marking scheme**

| | | | Marks |
|---|---|---|---|
| (a)(i) | **Limitations of internal control** | | |
| | Up to 1½ marks per well-explained point | | |
| | Human factors | 1½ | |
| | Manual override | 1½ | |
| | Cost of controls | 1½ | |
| | Non-routine transactions | 1½ | |
| | Max | | 5 |
| (ii) | **Control environment** | | |
| | 1 mark per point | | |
| | Definition and explanation | 1 | |
| | Examples of factors included | 1 | |
| | Control environment initially weak | 1 | |
| | Control environment improving | 1 | |
| | Max | | 4 |

| | | | Marks |
|---|---|---|---|
| (b) | Purchases system objectives | | |
| | ½ mark for each valid objective | | |
| | Max | 4 | |
| | Purchases system controls | | |
| | ½ mark for each valid control | | |
| | Max | 4 | |
| | Max | | 8 |
| (c) | **Engagement to design internal controls** | | |
| | Discussion of threats – self-review, management responsibility | 1½ | |
| | Possible safeguards | 1½ | |
| | Conclusion | 1 | |
| | Max | | 3 |
| | **Total** | | **20** |

**Detailed solution**

(a) (i) The purpose of internal control at Mutsinzi Associates Ltd will be to provide management with reasonable assurance about its financial reporting. Internal controls can only ever be reasonably reliable (rather than absolutely reliable) because they are subject to inherent limitations. These limitations are manifold, and include the following.

**Human factors**

Human judgment and decision-making is at the core of financial reporting processes and can be faulty. A control may be poorly designed, so that it does not meet its objective, or a well-designed control may be changed because it is not understood. For example, a financial controller may design changes to a company's sales system but without fully understanding the system, with the result that the system may no longer operate effectively.

Even a well-designed control may not operate as intended, eg where information produced for a control is not used effectively (such as an exception report, which must be interpreted correctly and, where appropriate, acted upon).

Finally, the design of controls involves management making judgments about the nature and extent of the controls it needs to meet its financial reporting objectives. These judgments are necessarily subject to the possibility of human error.

**Manual override**

Controls could be circumvented by several people working together (thus neutralising the possible segregation of duties), or by inappropriate management override.

For example, management might disable warnings from a computer program so that transactions that exceed set restrictions can be undertaken.

**Cost of controls**

In smaller entities there may not be enough staff working in a particular area for it to implement a segregation of duties. In this situation, it may be necessary to employ extra staff just to operate a control; this would involve a significant extra cost and would likely be unaffordable for a small entity.

The ISA does note, however, that in the case of some smaller entities close management oversight may be of such benefit – where management provides a good control environment – that this balances out the ill effects of being unable to segregate certain duties.

**Non-routine transactions**

Internal controls tend by nature to focus on recurring, routine transactions; this means that non-routine transactions may fall outside the scope of an entity's system of controls. These transactions therefore present a higher risk of being misreported.

An example of this might be a company engaging in a new line of business that is outside their typical area; a holiday agent could branch out into property sales; a car garage might begin leasing cars to customers as well as simply selling them.

**(LO 2/1.2)**

(ii) The control environment includes the governance and management functions and the attitudes, awareness and actions of those charged with governance and management concerning the entity's internal control and its importance in the entity. The control environment sets the tone of an organisation, influencing the control consciousness of its people.

This includes the communication and enforcement of integrity and ethical values by management; having a commitment to competence; participation by those charged with governance; management's philosophy and operating style; the organisation's structure; the assignment of authority and responsibility; and the company's human resource policies and practices.

The control environment at Mutsinzi Associates Ltd appears to be improving, since Claude Mutsinzi has appointed an ICPAR accountant to run the finance department. However, the fact that several substantial errors have been discovered suggests that the controls in place prior to his arrival were not adequate. The accountant has now introduced regular bank reconciliations, which are welcome, but are only a basic control, the absence of which suggests a lack of proper oversight over the company's financial reporting. This implies that the control environment was weak, since it was only the discovery of errors that caused him to place a sufficient value upon internal control.

For the year ended 30 June 20X0, therefore, the control environment should be assessed as weak, but the situation may be different in future periods.

**(LO 2/1.3)**

(b) The purchases system of Mutsinzi Associates Ltd ought to have the following principal **objectives**.

In relation to ordering, the system must ensure that:

- All orders for, and expenditure on, goods and services are properly authorised, and are for goods and services that are actually received and are for Mutsinzi Associates Ltd.
- Orders are only placed with authorised suppliers.
- Orders are made at competitive prices.

In relation to goods and services, the system must ensure that:

- Goods and services received are used for the company's purposes and not for private purposes.
- Goods and services are only accepted if they have been ordered, and the order has been authorised.
- All goods and services received are recorded accurately.
- Liabilities are recognised for all goods and services that have been received.
- All credits to which Mutsinzi Associates Ltd is due are claimed.
- Receipt of goods and services is necessary to establish a liability.

In relation to accounting, the system must ensure that:

- All expenditure is authorised and is for goods that are actually received by the company.
- All expenditure that is made is recorded correctly in the general (nominal) and payables (purchase) ledgers.
- All credit notes that are received are recorded in the general and payables ledgers.
- All entries in the payables ledger are made to the correct payables ledger accounts.
- Cut-off is applied correctly to the payables ledger.

In order to achieve these objectives, the following purchases system controls may be recommended for Mutsinzi Associates Ltd.

Purchases – suppliers and price

- The new purchases manager could set up an authorised supplier list, to help ensure that purchased goods are of the required quality and to reduce the risk of fraud.
- Records should be kept of suppliers' payment terms, to ensure that any available prompt payments discounts are received.
- Any purchases made from outside of the approved supplier list should be approved by Claude Mutsinzi.

Goods received

- Claude Mutsinzi should authorise all orders above a given threshold, so that goods are ordered for business purposes only.

- The placement of orders by the purchases manager should be segregated from recording by the accountant, and from authorisation by Claude Mutsinzi.
- Goods inwards should be matched to an order authorised by Claude Mutsinzi (where value is above authorisation threshold), to ensure that goods received are for authorised purchases only.

Completeness of recorded purchases

- Purchase invoices should be matched to authorised purchase orders and to goods received notes.
- Supplier statements should be reconciled with the purchases ledger.

Legal liability is established for each purchase

- Purchases invoices should be matched to goods received notes, to ensure that the liability is genuine.

Purchases are recorded accurately

- The accountant should cast purchase invoices to ensure that the cost is accurate, and agree totals to costs anticipated when ordering.
- The purchase ledger should be reconciled with the general ledger.

Purchases are recorded in the appropriate year

- Goods received notes should be sent promptly to the accountant to ensure transactions are processed in the correct year.
- Purchase invoices should be posted daily to the general ledger.
- The accountant should review any goods received notes for which invoices are not available. **(LO 1/2.1)**

(c) Mutsinzi Associates Ltd's request for Umulisa & Partners to give it advice on the establishment of systems of internal control would give rise to a significant self-review threat. This is because Umulisa & Partners would need to evaluate, during the audit, the controls that they had recommended in the first place. They may fail to apply the appropriate level of professional scepticism to these controls, which would represent an audit risk.

Further, there is a threat of Umulisa & Partners taking on a management responsibility which, in line with the IESBA *Code of Ethics*, it must absolutely avoid doing. It is management's responsibility to design and implement a proper system of internal control; Umulisa & Partners may be able to provide advice in general terms, but cannot design the system itself.

It may be possible for Umulisa & Partners to accept the engagement subject to the implementation of safeguards that reduce the above threats to an acceptable level. These could include:

- For the self-review threat, using separate teams for the audit engagement and the review engagement.

- Subjecting the audit of Mutsinzi Associates Ltd to an independent engagement quality control review prior to issuing the auditor's report.
- Regarding the management responsibility, the auditor should ensure that management understands and acknowledges that the design of internal controls is its responsibility alone, and that the purpose of the audit is not the design of internal controls, but rather the provision of reasonable assurance that the financial statements are presented fairly. **(LO 1/1.1)**

15.

## Marking scheme

| | | | Marks |
|---|---|---|---|
| (a) | **Key audit matters** | | |
| | Generally 1 mark per well-explained point | | |
| | Description of KAMs | 1 | |
| | KAMs chosen from matters communicated | 1 | |
| | Factors in selecting KAMs | 2 | |
| | Communicated in auditor's report | 1 | |
| | Description of auditor's report requirements | 1 | |
| | Max | | 6 |
| (b) | **Auditor's report** | | |
| | Generally 1 mark per well-explained point | | |
| | Provision – IAS 37 requirements | 1 | |
| | Report is correct that this is an omission | 1 | |
| | Insufficient detail given in the report | 1 | |
| | Materiality of issue | 1 | |
| | Opinion – likely to be a qualification | 1 | |
| | Inconsistent drafting of opinion (adverse vs qualified) | 1 | |
| | Emphasis of matter 1 – should not refer to matter giving rise to modification | 1 | |
| | Emphasis of matter 1 – should only be for matters included in FS | 1 | |
| | Improper drafting of emphasis of matter paragraph | 1 | |
| | Emphasis of matter 2 – materiality | 1 | |
| | Emphasis of matter 2 – possible aggregate effect of misstatements | 1 | |
| | Emphasis of matter 2 – IAS 38 requires non-recognition of internally-generated brands | 1 | |
| | Drafting of the report – order of sections | 1 | |
| | Drafting of the report – language | 1 | |
| | Other matter paragraph correct | 1 | |
| | Max | | 14 |
| | **Total** | | **20** |

## Detailed solution

(a) A key audit matter (KAM) is one of the matters that was of most significance in the audit of the financial statements. The KAMs are the areas that required the most audit effort, as distinct from areas of complex financial reporting. Disclosing information about KAMs in the auditor's report helps users to understand the audit process better; this is intended to help build trust in the audit, and also to increase users' awareness of the audit's limitations.

(i) The auditor selects the KAMs from the matters communicated with those charged with governance. The KAMs are the most significant matters from among those, ie those that caused the auditor the most difficulty.

In choosing KAMs, the auditor should consider the following:

- Areas of higher risk of material misstatement.
- Significant auditor judgements.
- The effect of significant events or transactions.

(ii) The auditor communicates KAMs in the auditor's report. These are included within a separate section of the report that is headed 'Key Audit Matters'. The section should include an introductory paragraph, and then descriptions of each KAM.

The description of each KAM should include:

- Why the matter was considered to be one of most significance; and
- How the matter was addressed in the audit. **(LO 2/3.1)**

(b) There are two main types of problem with Kevin Kaneza's draft of the auditor's report: there appears to be significant confusion about the formation of the auditor's opinion, and the draft report does not take the form prescribed by the ISAs that deal with auditor reporting.

**Provision**

The matter giving rise to the proposed modified opinion is the omission of a provision for a future liability resulting from a legal case. The relevant accounting guidance here is found in IAS 37 *Provisions, Contingent Liabilities and Contingent Assets*. IAS 37 states that a provision is created where there 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. This is subject to the amount being capable of reliable measurement.

The existence of the obligation is not being disputed by management and audit evidence should have been obtained regarding the legal status of the entity's liability. Management's claim that the liability cannot be measured reliably is also an acceptable reason not to provide for it, in line with IAS 37. However, if this were the case then the obligation would have given rise to a contingent liability, which would need to be disclosed in the notes to the financial statements. The auditor's report would need to refer to this disclosure; it does not, which would suggest that the disclosure does not exist. This would itself constitute a material misstatement.

The auditor's disagreement with management's claim that no reliable estimate can be made of the liability appears reasonable. If this is so, then the report correctly provides an estimate of the amount of the liability. The report would, however, need to provide significantly more detail about the matter; the level of detail should be comparable to the accounting disclosures that should have been made under IAS 37.

**Materiality**

The auditor's estimate of the amount to be provided is RWF 240,000. The report states that the matter has resulted in the overstatement of revenue, but this appears incorrect as a liability would not affect the revenue figure. It also suggests that materiality may have been assessed in relation to revenue, rather than the more appropriate figures of profit before tax or total assets.

The matter represents approximately 7.5% of profit before tax, which would be judged material (it is in the middle of the range of 5–10% of profit before tax). It is not clear, however, whether the matter would be deemed not just material but material and pervasive. Taken in isolation, and in the absence of other qualitative factors, it is likely that the issue would be merely material. The auditor would therefore have expressed a qualified opinion, not an adverse opinion as here.

**Opinion**

This connects to an area of ambivalence in the draft report: the 'Basis for' section is entitled 'Basis for adverse opinion', but this is inconsistent with the 'Opinion section', which goes on to describe a qualified opinion, not an adverse opinion. Given that the matter is likely to be material but not pervasive, a qualified opinion would be most appropriate. This means that the opinion paragraph is drafted correctly.

**Emphasis of matter – 1**

The first of the emphasis of matter paragraphs refers to the matter in respect of which the opinion has been modified. This is not in line with ISAs: an emphasis of matter paragraph can only be included where the auditor would not be required to modify the opinion.

The paragraph states that the matter is highly material but this does not appear to be the case. This is a bald assertion in relation to which the report needs to provide more information.

Further, an emphasis of matter paragraph may only be included to refer to a matter that is appropriately presented or disclosed in the financial statements. This is not the case here and to include the same issue in both the opinion section and an emphasis of matter paragraph would sow confusion amongst users.

**Emphasis of matter – 2**

The second emphasis of matter paragraph is subject to several difficulties. The first of these is that the brand is stated to be valued at RWF 700,000. This is approximately 1.1% of total assets, which is material. If it were correct that the brand should be included in the financial statements then this would be a material omission, in respect of which the opinion should be qualified. There would also be an argument for expressing an adverse opinion, once this misstatement is aggregated with the unprovided-for liability.

The second difficulty is that the report betrays a misunderstanding of the requirements IAS 38 *Intangible assets*. IAS 38 prohibits the recognition of internally-generated brands. The omission of such a brand is therefore not a misstatement.

**Other matter**

The other matter paragraph appears to be appropriately drafted and has been correctly included given that this is the first year for which the firm has acted as auditor.

**Drafting of report**

The order of the sections is not in line with the requirements of ISAs. The 'Opinion' section should have been at the start of the report, with the 'Basis for' section following on immediately below it. It is likely that this should have been entitled 'Basis for Qualified Opinion'.

The language used in the report is frequently not appropriate. The word 'feel' is used, which suggests too great a degree of subjectivity. In two places the report refers to 'the client', which is too vague – it ought to have referred specifically to Kibungo Enterprises Ltd.

The emphasis of matter paragraphs are incorrectly titled; ISA 706 *Emphasis of Matter Paragraphs and Other Matter Paragraphs in the Independent Auditor's Report* requires the paragraph to include an 'appropriate heading' that 'includes the term 'Emphasis of Matter'', but which describes the matter. **(LO 2/3.1)**

**END**