

KASNEB REVISION KITS

**ADVANCED
AUDITING AND
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REVISION KIT**

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**ADVANCED AUDITING AND
ASSURANCE**

REVISION KIT

TOPICALLY ARRANGED

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Past Paper with Answers**

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TOPIC 2

AUDIT FRAMEWORK AND REGULATIONS

QUESTION 1

December 2025 Question Five C

Discuss THREE elements of audit quality control within a Certified Public Accountants firm (CPA) as outlined in the International Standard on Quality Control (ISQC 1) or its successor ISQM 1. (6 marks)

QUESTION 2

August 2025 Question Three C

You are the audit manager in the audit of Fresh Start Ltd. a manufacturing firm, for the year ended 31 March 2025. The final audit for the year is almost complete and your team is reviewing the working papers. The audit senior has raised an issue of a major supplier to the company who fraudulently inflated invoices. This led to a Sh. 200 million overstatement in inventory and payables. Fresh Start Ltd. has sued your audit firm for negligence, breach of contract and statutory liability, arguing:

1. Contractual duty breached:

The auditors failed to detect and report material misstatements despite having an obligation to exercise professional skills and due care (established in contract via the engagement letter).

2. Negligence: (Tort):

Their duty extends to the company ("third-party" in tort) and failure to detect fraud constitutes negligence, causing foreseeable financial loss.

3. Statutory Liability under Companies Act:

Civil Liability: Responsible officers (including auditors) risk damages for misuse of position or breach of trust under Section 206.

Criminal Liability: Under Section 46, making a materially false audit statement with intent to deceive attracts up to 7 years' imprisonment.

Required:

Discuss the potential legal liabilities of the auditors in relation to each of the claims by Fresh Start. (6 marks)

QUESTION 3

April 2025 Question Four C

Joan and Jim Associates, a local audit firm, were the auditors of Dhawabu Bank Ltd. that recently went under receivership. Dhawabu Bank Ltd. has been sued for negligence by investors who lost up to Sh.40.3 million through a fake corporate bond issuance programme.

The investors claim that the audit firm failed to verify the bank's claim that it operated a Sh.17.6 million account with the Central Bank. However, it turned out that the non-existent bank account played a major role in inflating the banks financial position, thereby enticing investors to pump Sh.40.3 million into the company through a corporate bond issuance programme. The investors lost their money.

Required:

Evaluate Joan and Jim Associates' legal liability in relation to the above claim.

(10 marks)

QUESTION 4

December 2024 Question Four A

You are the audit engagement partner in the audit of Somesha Ltd. An audit trainee assigned to you is keen to understand how an audit firm can reduce its exposure to claims of negligence and how the auditor can restrict liability by making a liability limitation agreement with an audit client.

Required:

- (i) Discuss THREE negative implications that a liability limitation agreement may have on the auditor or the client. (6 marks)
- (ii) Suggest FOUR strategies that an audit firm may employ in order to reduce exposure to litigation claims. (8 marks)

QUESTION 5

August 2024 Question One A

XYZ Auditors is a medium-sized audit firm that has been operating for over 15 years. The firm has a diverse client base that includes small and micro enterprises, non-profit organisations and publicly listed companies. Recently, XYZ Auditors experienced the following issues that indicate deficiencies in the quality management system:

1. The firm faced regulatory scrutiny and legal action due to a significant audit failure that involved a publicly listed client, Beta Ltd. The regulatory scrutiny revealed material misstatements in the financial statements that were not detected during the audit process.

PART B

SUGGESTED ANSWERS

TOPIC 2

AUDIT FRAMEWORK AND REGULATIONS

QUESTION 1

December 2025 Question Five C

Three Elements of Audit Quality Control in a CPA Firm

1. Leadership Responsibilities for Quality within the Firm:

- The firm's leadership is responsible for promoting a culture that emphasizes quality in all aspects of the audit process. This includes setting a tone at the top that prioritizes professionalism, ethical standards, and the importance of quality control in audit work.
- *Requirement (ISQC 1/ISQM 1):* The firm's leadership must demonstrate a commitment to audit quality by establishing clear policies and guidelines. They should also ensure that the firm's values align with maintaining high standards of professional conduct and quality in audit engagements.

2. Relevant Ethical Requirements

- CPA firms must adhere to ethical standards that promote independence, objectivity, and integrity. The firm must have policies and procedures in place to ensure that all personnel comply with relevant ethical requirements, including those related to conflicts of interest and maintaining professional skepticism.
- *Requirement (ISQC 1/ISQM 1):* The firm must establish mechanisms for identifying and addressing ethical risks, such as conflicts of interest or independence threats. There must be ongoing training and communication on ethical issues, along with a process for monitoring compliance with these standards.

3. Engagement Performance

- Engagement performance refers to the proper execution of audit engagements, including planning, supervision, and review. It ensures that audit work is conducted in accordance with the firm's quality control policies, relevant auditing standards, and legal requirements.
- *Requirement (ISQC 1/ISQM 1):* The firm must establish procedures to ensure that each engagement is appropriately planned and executed. This includes assigning qualified personnel to audits, providing appropriate supervision, and ensuring that all audit work is reviewed at different stages

to guarantee compliance with professional standards and the firm's quality expectations.

4. Acceptance and Continuance of Clients and Engagements

Policies must be in place to evaluate potential and existing clients and specific engagements to minimize association with clients whose management lacks integrity or where the firm cannot perform the engagement with professional competence.

5. Resources

This element ensures the firm has sufficient personnel with the necessary competence, capabilities, and commitment to perform engagements effectively. It covers recruitment, hiring, professional development, training, performance evaluation, compensation, and the assignment of personnel to engagements. Under newer standards (SQMS 1), this is expanded to include technological and intellectual resources.

6. Information and Communication

A system must be established for internal and external communication regarding the quality management system. This includes communicating policies to personnel, training programs, and the results of monitoring activities.

7. Monitoring and Remediation Process

The firm must design and implement procedures to monitor the ongoing effectiveness and relevance of its quality control system. This includes periodic inspection of completed engagements and the identification and remediation of deficiencies.

8. Risk Assessment Process

A key component, especially under newer quality management standards (SQMS 1), is a firm-level process to establish quality objectives, identify and assess quality risks (e.g., risk of failing to comply with standards), and design and implement responses to address those risks.

QUESTION 2

August 2025 Question Three C

Potential legal liabilities of the auditors in relation to each of the claims by Fresh Start

1. Contractual Duty

Fresh Start Ltd. can claim that the audit firm breached its contractual duty by failing to detect the material misstatement of Sh. 200 million in inventory and payables. The **engagement letter** defines the scope of the audit and the duties of the auditor. The contract obligates the auditor to exercise **reasonable skill and care** in accordance with professional standards (ISAs).

2. Negligence (Tort)

Fresh Start Ltd. claims the audit firm was negligent and failed in its duty of care. For a negligence claim to succeed, the plaintiff must prove three things:

1. **Duty of Care:** The auditor owed a duty of care to the plaintiff (Fresh Start Ltd.). This is generally established in an audit engagement, where the auditor has a duty to the client.
2. **Breach of Duty:** The auditor breached that duty by failing to act with the required level of professional skill and care. The Sh. 200 million overstatement is material, and the failure to detect it could be seen as a prima facie breach.
3. **Causation and Loss:** The breach of duty directly caused the plaintiff to suffer a foreseeable financial loss. Fresh Start can argue that the failure to detect the fraud caused them to continue operating with a distorted view of their financial position, leading to the loss.

3. Statutory Liability

- **Civil Liability (Section 206):** Responsible officers, including auditors, may be held liable for damages if they misuse their positions or breach trust. If the auditors are found to have failed in their duties or engaged in misconduct, they could be liable for civil damages, especially if their actions or omissions contributed to the misstatement.
- **Criminal Liability (Section 46):** Making a materially false audit statement with intent to deceive can attract criminal sanctions, including up to 7 years' imprisonment. If auditors knowingly or recklessly issued false or misleading audit reports, they could face criminal prosecution. However, if the misconduct was due to negligence without fraudulent intent, criminal liability may not be established.

QUESTION 3

April 2025 Question Four C

Evaluation of Joan and Jim Associates' Legal Liability

Joan and Jim Associates, as the auditors of Dhawabu Bank Ltd., may face significant legal liability in relation to the claim of negligence raised by the investors. The evaluation of their legal liability hinges on several key legal principles, including the auditor's **duty of care, negligence, and causation**. Below is a breakdown of the issues involved in determining their liability.

1. Duty of Care

- **Auditor's Duty of Care to Third Parties:**
 - Auditors owe a duty of care to their **clients** (in this case, Dhawabu Bank Ltd.) and, in some instances, to **third parties** (such as investors) who may rely on the audited financial statements. The duty of care extends to the **reasonable**

accuracy of the financial statements and ensuring that they **do not mislead investors**.

- In this case, the investors relied on the audited financial statements, which purportedly contained a non-existent account with the Central Bank. If the auditors failed to detect or verify the existence of the account, they might have breached their duty of care towards third parties (investors) who relied on these statements to make their investment decision.
- **Scope of Duty:**
 - The extent of the auditor's duty can depend on whether it was **foreseeable** that investors would rely on the audited financial statements when deciding to invest in the bank's bonds. Given that the investors suffered losses of Sh.40.3 million, it could be argued that the auditors should have anticipated the risk of harm to investors arising from reliance on materially misstated financial statements.

2. Negligence

- **Failure to Detect the Fraud:**
 - **Negligence** arises if the auditors failed to exercise **reasonable care and skill** in performing their audit. The primary question is whether Joan and Jim Associates were negligent in verifying the **existence** of the Sh.17.6 million account with the Central Bank.
 - The audit process includes procedures such as **confirmations** from third parties (e.g., the Central Bank) to verify the existence of material accounts. If Joan and Jim Associates did not perform such verification or **failed to detect fraudulent transactions** that inflated the bank's financial position, they might be considered negligent.
- **Standard of Care for Auditors:**
 - Auditors are expected to follow **International Standards on Auditing (ISA)**, which outline the procedures and steps auditors must take to obtain sufficient and appropriate audit evidence. If the auditors neglected procedures that would have revealed the non-existence of the account, this could be seen as negligence. For example, failure to:
 - Confirm the account directly with the Central Bank.
 - Inspect related documents supporting the existence of the account (e.g., account statements).
 - Investigate any discrepancies or red flags raised during the audit.
- **Causation of Loss:**
 - In order for negligence to result in liability, the investors must show that **the auditors' failure directly caused their losses**. In this case, the non-existent account played a major role in inflating the bank's financial position, which led investors to believe in the bank's solvency and potential. The investors subsequently invested Sh.40.3 million in the corporate bond program.