CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P4: AUDIT AND ASSURANCE SERVICES

THURSDAY 17 DECEMBER 2015

TOTAL MARKS: 100; TIME ALLOWED: THREE (3) HOURS

INSTRUCTIONS TO CANDIDATES

1. You have fifteen (15) minutes reading time. Use it to study the examination paper carefully so that you understand what to do in each question. You will be told when to start writing.

2. This paper is divided into TWO sections:

   Section A: One (1) compulsory question.

   Section B: Four (4) Optional Questions. Attempt any three (3) questions.

3. Enter your student number and your National Registration Card number on the front of the answer booklet. Your name must **NOT** appear anywhere on your answer booklet.

4. Do **NOT** write in pencil (except for graphs and diagrams).

5. **Cell Phones** are **NOT** allowed in the Examination Room.

6. The marks shown against the requirement(s) for each question should be taken as an indication of the expected length and depth of the answer.

7. All workings must be done in the answer booklet.

8. Present legible and tidy work.

9. Graph paper (if required) is provided at the end of the answer booklet.

SECTION A

QUESTION ONE:

This question is compulsory and must be attempted.

(a) You were recently appointed as Audit senior in Loftall & Co, a firm of Chartered Accountants with a wide range of clients in the Southern African region. Recently a new client, Gene Mines Ltd, a subsidiary of World Mines Plc registered in the republic of Zambia, has appointed your firm as Group Auditor, taking over from Wangi & Co.

Preliminary discussions with the Director of Finance at Gene Mines a Mr. John Tembo are reproduced below for your attention.

Two weeks later you receive an email from the Audit Manager, Katas Twente, of Loftall & Co:

To: Audit senior.

From: Katas Twente.

Subject: Audit of Gene Mines Ltd.

Good morning,

I would like you to prepare some briefing notes for my use on the following issues:

- Business risks relating to Gene Mines Ltd.
- Specific matters that should have been considered before accepting the appointment as group auditors for Gene mines Ltd.
- Potential financial statement risks caused by the breach of planning regulations.
- Transnational Audit committees in relation to group audits.

Thanks.

Katas.

Comments on Gene Mines from the meeting held with Mr. John Tembo

As the mineral ores begin to deplete, there has been a growing trend by multinational mining companies to invest in other countries. They either acquire foreign interests in other mining firms or merge with already existing companies in order to continue with the mining activities and to increase the wealth of shareholders. Gene Mines Ltd has not been an exception.

Gene Mines Ltd is a company that operates in a neighbouring country to Zambia and is 67% owned by World Mines Plc. At the time the company was acquired, Gene Mines Ltd had remained with a lifespan of two years. Its major operations include the mining of Gold, Platinum and Hituim, a precious metal that is used in the manufacture of mechanical typewriters that have since been discarded as they have been replaced with fast and efficient modern type of computers. The year-end of Gene Mines Ltd is 31 December.

Due to the decline in the use of mechanical typewriters, sales of Hitium have drastically reduced consequently resulting in Gene Mines Ltd.'s failure to settle its loan it obtained from the development bank. The bank has since threatened to proceed with compulsory liquidation if no substantial payments are made towards the loan repayment. Furthermore, most of its revenues are received in advance from its customers mainly from Iraq and Syria. Owing to its reduction in mining activities at one of its Gold Mines, some plant and machinery may not be put to alternative use as it is of a specialized type that is only suitable for conditions at Gene Mines Ltd.

Two years ago, Gene Mines Ltd introduced an online buying system and the call centre is managed in the West Indies perceived to be a low cost region in terms of staff and operational costs. In some cases when customers are not satisfied, warranty provisions are available to deal with any returns and complaints. However the estimations of the warranty provisions are made by the chief executive officer alone and it has been learnt that Gene Mines Ltd awards senior management a bonus incentive based on good results in a particular year.

In the recent past some senior geologists at Gene Mines Ltd resigned, citing the fear of loss of jobs and consequently non-payment of their terminal benefits. One of the directors at Gene Mines Ltd argued that the worsening financial problem was compounded by a lack of accountability coupled with weak controls due to the absence of a transnational audit committee on the board of Gene Mines Ltd. During the year Gene Mines Ltd extended its mineral research and development building but the local authority objected to this development as no planning agreement had been reached.

The local authority contended that the area in question on which the building was to be built is a restricted site which needed approval for any commercial activities to be carried out. In one of the communications to the company, one of the planning officers stated that there was a serious breach of regulations and that it was not the first time that Gene Mines Ltd deliberately ignored planning regulations. The council meeting resolved to take legal action against the company so as to set an example to any other company that would not follow planning regulations in future.

At one of the audit planning meetings, an audit senior regretted the fact that an engagement partner should have carried out a due diligence before Loftall & Co accepted the appointment as principal or group auditor of Gene Mines Ltd.

Required:

(i) Evaluate any seven (7) business risks relating to Gene Mines Ltd. (7 marks)

(ii) State any four (4) specific matters that should have been considered before accepting appointment as group auditors of Gene Mines Ltd. (4 marks)

(iii) Explain any five (5) potential financial statements risks caused by the breach of planning regulations. (5 marks)

(iv) Explain the roles of transnational audit committees. (6 marks)

(b) IAS 36 *Impairment of non-current assets* provides guidance to accountants on how non-current assets are tested for impairment losses.

Required:

Briefly describe four (4) audit procedures relating to the value in use of an asset.

(4 marks)

(c) ISA 560 *Subsequent events* provides guidance on auditor's responsibilities on events after period end. IAS 10 *Events after the reporting period* deals with the treatment in financial statement of events, both favourable and unfavourable, occurring after the period end.

You are the audit partner of Tina Ltd, a listed company, whose year end is 31 October 2014. The audit senior is concerned with the issues and responsibilities of the auditors regarding subsequent events.

The detailed audit work was completed on 8 December 2014 and it is further planned that:

- The audit report will be signed on 22 December 2014.
- The financial statements will be issued on 8 January 2015.
- The company's annual general meeting be held on 31 January 2015.

Required:

State the auditor's responsibilities with regards subsequent events in the following periods:

(i) The end of the accounting period to 8 December the date the audit was completed. (2 marks)

(ii) The end of the audit to 22 December the date the audit report is signed.

(2 marks)

(iii) The signing of the audit report and 8 January 2015 when the financial statements are issued. (4 marks)

(iv) From the issue of the financial statements to 30 January 2015 the date of the Annual General Meeting (AGM). (4 marks)

(v) The period after the AGM and approval of the financial statements. (2 marks)

[Total: 40 Marks]

SECTION B

There are four (4) questions in this section. Attempt any three (3).

QUESTION TWO

(a) Auditors conduct their audit with a view to determine whether or not the financial statements are materially misstated. For this reason auditors usually determine a materiality level to be used in the conduct of the audit and also a performance materiality level may be set at less than the materiality for the financial statements as a whole.

Required:

(i) Explain why it is necessary for the auditor to determine the materiality figure at the planning stage of the audit. (4 marks)

(ii) Distinguish between materiality for the financial statements as a whole and performance materiality. (4 marks)

(b) The following are extracts of matters for your consideration and the related opinions suggested by the audit seniors:

Client one

The client has been making losses for the past four years and it has serious liquidity problems. This has cast doubt on the going concern assumption made by management.

Management has stated that as short term measure the company will get financial assistance from its parent company. They have to this effect obtained a comfort letter from the parent company. Unless this client receives financial support from the parent it will be unable to trade.

The directors have disclosed this in the financial statements in their director's report.

The audit senior has recommended that a modified audit report should be issued and this should be a qualified opinion.

Client two

There is a disagreement between your firm and this client on the valuation of inventory. The inventory figure in the financial statements is K320,000 and the evidence in the working papers shows that inventory has been overstated by K90,000.00. The profit after tax is K540,000 and total assets amount to K760, 000

The audit senior has recommended that a qualified opinion be issued.

Client three

Receivables are a material figure in the financial statements of this client. Included in the figure of receivables is a figure of K500 000.00 due from a mining company which is facing serious liquidity problems. This amounts to 60% of the receivables of this company.

This client sells specialized equipment and 60% of its sales are to the mining company facing liquidity problems. Management is concerned about this and has made the necessary allowances for receivables in the financial statements and also disclosed in the director's report the uncertainty about going concern because of this debt.

The audit senior has suggested that an adverse opinion will be appropriate.

Required:

Discuss the suitability or otherwise of the audit opinions recommended by the audit seniors. (12 marks)

[Total: 20 Marks]

QUESTION THREE

(a) Discuss four (4) ways in which auditor's liability may be restricted. (4 marks)

(b) The following information contained in the draft financial statement is availed to you as audit senior during the planning of the audit work for receivables relating to Hellen Fashions Ltd:

	Draft 2014	Actual 2013
Income statement summary.	**K000**	**K000**
Sales	9,200	6,150
Gross profit	2,680	2,179
Statement of financial position summary.		
Non-current assets	4,300	4,100
Trade receivables	800	670
Other receivables	600	580
Current liabilities	2,100	2,015

Required:

Using analytical procedures, state the observations you can draw from the above extract of draft financial statements and show how they may affect the audit of receivables.

(4 marks)

(c) You are the audit manager responsible for the audit of Pizza World Co. The company was incorporated in Zambia two years ago. The draft consolidated financial statements for the year ended 31 December 2013 show revenue of K195 million (2012-K86.5 million), profit before taxation of K49.7 million (2012-K61.8 million) and total assets of K201.9 million (2012-K183 million).

The following issues have been brought to your attention during the final audit:

1. In December 2013, the board of directors announced that they stopped offering door-to-door deliveries of Pizza for the month end. The revenue amounted to K0.70 million for the year to 30 December 2013(2012-K0.9 million).

2. A provision of K0.4 million had been made as at 31 December 2013 for the compensation of chefs who were made redundant.

3. The vehicles that were used in the delivery of Pizzas been classified as non-current assets held for sale as at 31 December 2013 and measured at fair value less cost to sell at K0.9 million (carrying amount K.6 million).

4. The grills and ovens were undergoing modernization, Pizza World outsourced all its equipment to Pints Size Pizza Ltd. At 31 March 2013, it was not possible to physically inspect Pizza World's inventory held by Pints Size Pizza due to safety and health requirements preventing unauthorized access to the kitchen area at that time. Pizza World Co. has provided written representation that inventory held at 31 December 2013 was valued at K12.4 (2012-K9.1 million) .This amount has been agreed to the costing of Pizza Pints size Ltd.'s monthly returns of quantities held at 31 March 2013.

5. In 2009 Pizza World was awarded a patent right for 20 years of a new type of Pizza known as 'source pizza' whose ingredients were recommended for patients with hypertension. The 'source pizza' was developed at a cost of K11 million which is being amortized over the life of the patent. The patent cost K 14.7 million. In December 2013, a competitor announced the completion of the initial test trials of another Pizza to be known as 'sweet pizza' which will be available in three years' time, with zero fat levels equally recommended for patients with heart conditions.

Required:

Ascertain the materiality of the above matter and state the action your firm will take in each of the above items. (10 marks)

(d) Explain why related party transactions can be a high risk area for auditors. (2 marks)

[Total: 20 Marks]

QUESTION FOUR

(a) Accountants are required to comply with the fundamental ethical principles of the Code of ethics for professional accountants. One of the ethical principles is that of confidentiality.

Required:

Explain the exceptions to the duty of confidentiality by the accountant. (8 marks)

(b) The audit of one of your major audit clients is nearing completion. You are the audit senior in charge of this audit and the current audit file has just been given to you for your review.

The following information is contained in the current audit file.

1. Under the receivables section is an amount of K200,000.00 due from a customer of your client. The age analysis shows that K89,000.00 of this amount has been outstanding for more than two years. The customer is disputing the amount and he claims that he did not receive the goods claimed to have been supplied. This amount is material to the financial statements.

2. There was no physical inventory count at the period end and the company relied on book stock values to arrive at the closing stock figure. A First In First Out basis of inventory valuation is used with closing stock being valued at cost.

   A review of after period end sales shows that there was a general reduction in sales prices of most of the commodities held. The turnover period of inventory is three weeks. Inventory costing K420,000.00 was sold for less than cost. The inventory concerned was sold for K350,000.00 in the subsequent period.

3. A provision of K80,000.00 has been recognized in the current year. This is an estimate made by management arising from a case in which the company has been sued by regulatory authorities for non-compliance with regulations. The case is still active in court and it is not likely that the case will be disposed of in the next six months. Your investigations through reading the relevant legislation shows that a penalty of K150,000.00 shall be imposed for non-compliance with regulations.

   It is the view of your firm that the case meets the conditions in IAS 37 at the period end.

Required:

For each of the above state the audit risk that could arise and describe the audit procedures you expect to have been carried out by the audit assistants.

(12 marks)

[Total: 20 Marks]

QUESTION FIVE

(a) You are audit senior in Agnes & Co a firm of Chartered Accountants and currently carrying out an audit of Glow Lights Ltd a manufacturer of energy saving bulbs. You are not happy with the client's inventory valuation system and have raised the issue several times with the audit manager.

He has dealt with the client for several years and does not see why you are making a big issue about it. He has refused to meet you on site to discuss these issues. The former engagement partner for Agnes resigned two years ago. As the audit manager dealt with Agnes for so many years, the other partner has decided to leave the audit of Glow Light Ltd in his capable hands.

Required:

Evaluate two (2) quality issues in the audit of Glow Lights Limited. (4 marks)

Situation One

Plentforth & Co is an auditor for Lusaka Energy Corporation (LEC) which has considered floating its shares to the public. Recently their practice income has reduced and is considering buying some of the shares in LEC in order to boost their worsening financial position.

Situation Two

Having completed her ZICA professional, Imelda decided to join Limulunga Water & Sewerage Co (LWSC) as an accountant. Seven months later, she resigned and joined Foresight & Co Chartered Accountants a firm managed by the brother of her former lecturer. A year later Foresight & Co was appointed auditor for Limulunga Water & Sewerage Co.

Situation Three

Gene & Co is a firm of Chartered Accountants. Their client has been considering obtaining a listing on the Lusaka Stock Exchange in order to increase its capital and feels uncomfortable about a modified opinion which your firm recently expressed in the audit report. The managing director of your client has expressed her displeasure and requests your firm to replace the modified opinion with an unmodified one or she may propose for your resignation at the next annual general meeting.

Required:

(i) Identify the ethical threats in each of above situations. (3 marks)

(ii) For each threat identified, you are required to provide a suitable safeguard. (3 marks)

(c) IAS 38 *Intangible assets* and IFRS 3 *Business combinations* give guidance for intangible assets.

Required:

State six (6) audit procedures for development costs. (6 marks)

(d) ISRE 2400 *Engagements to review financial statements* gives guidance on review engagements. Auditors are allowed to carry out other services such as review engagements and due diligence reviews.

Required:

Discuss the nature of review and due diligence engagements. (4 marks)

[Total: 20 Marks]

END OF PAPER

P4: AUDIT AND ASSURANCE

SUGGESTED SOLUTIONS

DECEMBER 2015 EXAMINATIONS

SOLUTION ONE:

a) Gene Mines Ltd

i) **Business risks:**

- **Warranties and incentives** -Gene Ltd offers warranties at the discretion of managers, which has the potential for the managers to overstate provisions for warranties in order to post a positive and good balance sheet in so as to obtain bonuses and other related incentives. Furthermore, management at Gene –mines Ltd offers incentives for performance based on financial results that have a potential to misstate company performance and misstate the affairs of the company.
- **Foreign exchange risks** -Gene mine Ltd sales most of its minerals abroad. In this regard it is exposed to foreign exchange losses should prices of its precious metals fall on international markets.
- **Volatile markets**-since some of its customers are in Iraq and Syria. In this case chances of business disruption are very high due to civil wars that can reduce trade with other countries and consequently a fall in the sales revenue at Gene-mines Ltd.
- **E-call centres**-Electronic processing of call centres has the potential to disruption as computer systems can be hacked or system failures can occur. The outsourcing of call Centre to cheap zones has recently come under pressure to increase their pay rise or face consumer boycotts by pressure groups. Customers can also be frustrated when the system fails and are likely to shift their royalty to other efficient suppliers. This can result in loss of revenue that could affect the company's going concern if not properly addressed.
- **Over-valuation of plant and machinery**-the reduction in the purchase of hetium, a metal used in the manufacture of mechanical typewriters, has made the use of specialized equipment to be kept without alternative use. That could result into impairment loss, as a result, the value of this plant and machinery needs an impairment test otherwise noncurrent assets are likely to be overstated which can increase audit risk.
- **Failure to follow health and safety rules**-the company has had a history of being fined and any more noncompliance with the law can result in the

cancellation of the mining license which could send Gene mines into closure leading to huge cost of redundant payments to its workforce.

- **Mines life's span**-Gene mines- lifespan has become too short and in two years' time it should look for other new mines to buy or develop. If that does not happen, Gene mines could present its financial statements on a beak-up basis or non -assets held for resale under IFRS 5 among its current assets instead of non-current asset section of the statement of financial position.
- **Loss of senior geologists**-these are human capital that can be used to maintain quality performance and there resignation can result into loss of productivity and corporate failure leading to weak financial forecast in terms of going concern. Furthermore such valuable expertise can be used against Gene-mines Ltd by its competitors thereby posing business risk as well.
- **E-commerce sales**-the sales are being conducted online, there is a possibility that the system may be overwhelmed with volumes of sales, which could even lead to problems fulfilling orders and potential damage to the credibility of Gene mines Ltd.
- **E-commerce overseas sales**-the countries that trade with Gene mines such as Iraq and Syria are all was prone countries and the cargo risk being hijacked a loss of lives and copper ore as well.

ii) Factors to consider before accepting the offer as group auditors are much similar to those provided for under *IAS 315 understanding the client and its environment*.

Matters to consider

New client.

- Management inquiries from group management
- Communication with group management
- Obtain information from the previous group engagement auditors by getting permission from the client.
- Consider group structure of the client
- Determine whether adequate appropriate audit evidence can be reasonably be obtained to be obtained in relation to the consideration process. If the premises cannot be used as intended then the recoverable should assessed
- Consider the ability of component auditors to perform the audit of a subsidiary.
- Adequate skills and expertise of the audit engagement team.

iii) **Financial statement risks-breach of planning regulations**.

Tangible non-current assets overstated. From the communication, it appears that the local authority aims to close the R & D building before the end of the year. There is therefore a risk that the building is overvalued on the statement of financial

statement position. Under I.A.S 36 impairment of assets, the directors at Gene Mines Ltd should carry out an impairment review if there is any indication of the assets being impaired. If the carrying amount exceeds the recoverable amount (the higher of the fair value less cost to sell and the value in use) the building should be impaired and the impairment loss recognized as an expense.

iv) **The role of the transnational audit committee.**

- Transnational audit means an audit of financial statement which are or may be relied upon outside, the audited entity's home jurisdiction for the purpose of lending, investment or regulatory decisions; this will include audit of all financial statements of companies with listed equity or debt and other public interest entities which attracts particular public attention because of their state, product or service provided.
- They are also involved in setting standards in training and education on behalf of member audit firms who are the Big Four Audit firms.
- They develop audit procedures for member audit firms
- To set quality control procedures for effective international audits
- Impose commitment to perform international audits in accordance with ISAs.

b) Impairment

Audit procedures – value in use:

- Obtain management's calculation of value inuse.
- Perform recalculation to ensure that it is mathematically correct
- Compare the cash flow projection to recent budgets and projections approved by the board to ensure that they are reasonable and realistic
- Calculate /obtain from analysts the long-term average growth rate for the products and ensure that the growth rates assumed in the calculation of value in use do not exceed it
- Refer to competitors 'published information to compare how much similar assets are valued at by companies trading in similar conditions.
- Compare the previous calculations of value in use to ensure that all relevant costs of maintaining the asset have been calculated.
- Ensure that the cost/income from the disposal of asset at the end of the life has been excluded
- Review calculations to ensure that cash flows from financing activities and income tax have been excluded
- Compare the discount rate that has been used to market rates to ensure that it correctly reflects the return expected by the market.

c) Subsequent events:

The auditor's responsibilities in the periods are given in ISA 560 *Subsequent events.*

i. In the period 31st October to 8th October 2014, the auditor should perform procedures designed to obtain sufficient audit evidence so that he/she has reasonable expectations of detecting and quantifying material subsequent events.

ii. In the period 8th December 2014 to 22nd December 2014 the auditors responsibilities are the same as in period a (i) above.

iii. The period from 22nd December 2014 to 8th January is covered in ISA 560.The standard says that the auditor does not have any responsibility to perform procedures or make any enquiries about financial statements in this period. It is director's responsibility to inform the auditor of any material subsequent events detected in this period which may affect the financial statements.

When the auditor becomes aware of material subsequent events in this period, he/she should carry out appropriate audit procedures to determine whether the subsequent event has a material effect on the financial statements. If the directors do not amend the financial statements, and the subsequent event, is material, the auditor should consider how the shareholders can be informed of the subsequent events.

iv. In the period 8th January to 30th January, the auditor has no obligations to make any enquiries about any material subsequent events have occurred in the period. However if the auditor becomes aware of material subsequent event in this period, the auditor may amend the report and carry out the following procedures:
   - Discuss the matter with management and where appropriate, with those charged with governance.
   - Determine whether the financial statement require amendment and if so,
   - Inquire how management intends to address the matter in the financial statement. If management revises the financial statements, then auditors should carry out the following procedures:
   - Carry out procedures necessary in these circumstances
   - Review steps taken by management to inform any member who could have received the report.
   - Extend the audit procedures to the date of the new audit report
   - Issue a new report on the revised financial statement.

v. The auditor's responsibilities in this period are the same as those described in the part (iv) above. As the AGM has passed, there is no longer the option for the director or auditor to make a statement at the meeting.

d) Risk based approach to auditing:

Audit risk approach is an audit strategy in which the concentration of audit procedures is on more risky areas while audit risk is the risk that the auditor may express an opinion which could not have been expressed had other factors been taken into account. The purpose of audit risk is to reduce audit cost by the client and the awakening by the shareholders as most companies have actually collapsed due to risk exposure.

Procedural based approach to auditing:

This approach to auditing uses standard routine. This involves following the approach in the ISAs in auditing specific areas.

SOLUTION TWO:

a) Materiality

i) Need for determining materiality level at planning stage:

Auditors are concerned with material issues during the conduct of an audit. Materiality is an important aspect of auditing and materiality levels are set by auditors at the planning stage of the audit. Material items/amounts are those that if omitted or misstated they could influence the economic decisions of the users of the financial statements.

Further the auditors will wish to ensure that the risk of not detecting any material misstatements is reduced to acceptable levels.

Determination of materiality at the planning stages is essential as it will help auditors know from the start what errors and omissions are considered material to the financial statements. Further, materiality levels will help determine the nature, timing and extent of audit procedures to be conducted.

ii) Distinction between materiality for the financial statements as a whole and performance materiality:

Materiality for the financial statements as a whole:

Before commencement of the audit materiality levels for the financial statements as a whole are set using the recommended criteria.

It is also normal that to set materiality levels for individual classes of transactions or balances such as inventory where misstatements less than the materiality for the financial statements as a whole could be expected to influence the economic decisions of users.

This is the materiality level which if the uncorrected errors/omissions exceed this amount the financial statements are considered to be materially misstated.

Performance materiality:

This is the amount or amounts set by the auditor at less than the materiality at the financial statements as a whole. This is in order to reduce to a low level the probability or chance that the aggregate of uncorrected errors and undetected misstatements exceed the materiality for the financial statements as a whole.

Performance materiality could also be set for any classes of transactions or balances for which specific materiality levels have been set. This way the auditor is playing it safe by taking a lower figure as material.

b) Audit opinions:

Client one:

The parent company has stated that it will give financial support to this company and the letter of comfort is evidence of this. If management gives the necessary representations and other evidence obtained then this would give the auditor some comfort. Further, the directors have made the necessary disclosure in the director's report.

Going by the above the recommendation by the audit senior that a modified report be issued seems inappropriate. Modification could be unsuitable if no letter of comfort had been obtained.

An unmodified opinion is recommended and if necessary the auditor may wish to restate what management has disclosed in their report in an emphasis of matter paragraph.

Client two:

Misstatement of the inventory figure has a direct impact on the reported profit. The disagreed amount of K90 000 is clearly significant to the financial statements at 17% of profit after tax and 11% of the total assets.

Management has refused to amend the financial statements and reduce the value of inventory. Clearly this is a disagreement which will impact on the report of the auditor. Since the amount involved is material the auditor will issue a modified audit opinion. This will be a modified report and an adverse opinion issued.

The recommendation of the audit senior is therefore not appropriate under the circumstance.

Client three:

The amount outstanding is material to the financial statements. Any misstatement of this figure will affect the users of the financial statements and so will have an impact on the auditor report.

Management has made the necessary provision for bad debts in the financial statements. This is reasonable in view of the fact that the whole debt could be irrecoverable. Further, it will be noted that the bulk of the business of this client is with this mining company at 60% of total sales. A going concern aspect therefore arises. Management in their report of directors has stated that the company is a going concern.

It is clear that there is uncertainty regarding the going concern aspect of the company. If management declines to disclose this in the financial statements and the auditor is of the view that the going concern assumption is inappropriate then the auditor must express an adverse opinion. If on the other hand the auditor concludes that the uncertainty to going concern is not fundamental then he may issue a qualified opinion.

The recommended opinion of the audit senior based on the above is appropriate. The auditor will make mention of the uncertainty in the emphasis of matter paragraph.

SOLUTION THREE:

a) The following steps can restrict liabilities to the auditors.

- Agreements concerning the duties of the auditors need to be:
    1) Clear and precise
    2) Should be made in writing
    3) A level of engagement should be confirmed
- Audit work should be:
    1) Relevant to the internal control system which must ascertained and evaluated and tested.
    2) The audit must be planned before the audit commences
    3) Audit work should be reviewed by a senior member of staff in order to ensure quality work is being done.
- Any enquiries arising during the audit should be
    1) Recorded on the current working papers
    2) Cleared and file
- All members of an auditing should be familiar with the standard throughout.

b) The gross profit margin has dropped from 35% the previous year to 29%.

There is a need to have some discussion with management either about their pricing system or business. It could be that a lot of customers have relocated to other competitors. Cost of sales-has increased by 64% while revenue increased by 45%. If this cannot be explained, then there could be some errors of addition and subtraction.

Trade receivables have also increased by 19.4% which is more than the increase in sales. More circularization need to be carried out in case there could some sale that have not been recorded. Trade receivables days have decreased by 8 days from 40 to 32 days. This indicates a positive trend and there is a need to confirm whether credit sales terms have been reviewed and obtain documents for authorization to changes in payment terms if indeed they were any.

Other receivables have increased as well by 3%.There is a need to confirm the values with any amounts on the invoices of prepaid services if any by those charged with governance of the company.

As regards payables there has been a nominal increase on payables by just over 4%.This could not cause much concern but there could be some misclassification of some payables.

c)

i) **Cessation of door- to -door deliveries.**

The revenue from the door-to door delivery is 1.41% (0.7 /49.7 x100=1.42%) which is material to the statement of comprehensive income. If the door-to-door deliveries of pizza can be classified as a major component or division, then there would be a need to provide disclosure notes for discontinuing operations in the financial statements in accordance with IFRS5.

However, for the door-to-door deliveries to be classified as a separate component, its operations need to be distinguished from the rest of pizza world. In this case, it is not separately distinguished and therefore could not be disclosed as discontinued operation.

The provision for redundant loss of K0.4m is material to the statement of comprehensive income at 0.8% (0.4 /49.7x100) on the profit before tax.

Auditors need to take into account IAS 37 in order to ascertain the timing of the provision. If the division is closed then, a liability arising from past events will be reasonable. The provision should be audited for misstatements.

There will be a need to ascertain when the non- current assets for door-to-door deliveries have been classified as held for resale in accordance with IFRS 5.

There is a high probability of an active sale as management has found a market for the assets.

Audit Evidence expected on working papers.

NOTE: The question is not asking for audit procedures but evidence.

ii) The value of inventory is material to the total assets in the statement of financial statement. It represents about 6%. There is a need to obtain sufficient audit evidence regarding its valuation.

- Furthermore, there has been a substantial increase of inventory of K3.3m. There is a need to investigate this increase as it could be that inventory is out of use or obsolete.
- If the value of inventory could not be properly verified, then the report will be modified on the basis of insufficient evidence.
- A written representation from management is not adequate as these incomes be other ways of verifying inventory of K12.4m.
- -Written representation from management referring to the value of year-end inventories.

- Written documentation between pizza world Co and Pint size pizza in respect of inventory it holds (pint size)
- Reconciliation records of inventories between pizza world and pint size Co.
- Documentation or correspondence or written instructions that relate to the health and safety inspections that could have prevented access to the premises of pint size Co.
- Evidence of analytical procedure-that have been carried out so far.

The rate of amortization for a period of 20 years on development cost will be K 0.55m (K11m/20) per year, the cost of development brought forward at the start of the year will be: (0.55x5=11-2.75= K8.25. This represents 9% which is clearly material to total assets.

Pizza world needs to consider whether the new pizza will go on sale given that its competitor has announced taste trials of launching a product with similar health characteristics.

The pronouncement by the competitor would impair the development cost of source pizza. If this happens, then pizza world should consider to record development costs as expense to the statement of comprehensive income for the year.

Lastly in order to be in conformity with 1.A.S 38 intangible assets, management at pizza world should consider and examine the balance of unmortised expenditure for capitalization.

Audit Evidence.

- Patent agreements that duly signed to confirm length, cost and approval.
- Necessary documents to support the development costs of k11m.
- Press announcement/cuttings of competitions new pizza.
- Written representations from pizza world Co on the future prospects of development cost of source pizza.
- Future cash flow projections from management as evidence of useful life of development costs.

d) **Difficulties in identification**

Related parties

Related parties are defined by IAS 24 Related party's disclosures and can be complex, subjective and difficult to identify. It is not immediately obvious to management or the auditor whether a party is related for example. AS 24 states that a party is related to an entity when the party 'controls', is controlled by, or is under common control with, the

entity .control may not always be easy to identity within a complex multinational group or if the controlling party is a trust. It may be difficult to prove who, if any one controls it.

There is little or frequently no documentary evidence of the related party and so the auditor often has to rely on management written representations for their disclosure. If management wish to hide a related party, it may be difficult for the auditor to identify it through normal audit procedures.

Related party transactions

Management systems are not designed to distinguish related parties or to produce a summary of their transactions. Management will generally have to carry out additional work to identify and collate related party transactions .If this work is not completed, it may prove difficult for the auditor to detect all related party transactions.

Management may conceal a related party transaction in full or in part. This could be because they are motivated by more than ordinary business considerations, for example, to enhance the presentation of the financial statements (as part of a fraud or window dressing).If management conceals a related part transaction, it will be very difficult for the auditor to identify.

Conclusion

Related party transactions may be material in substance other than size, so difficult to detect using ordinary audit procedures. It may also be difficult for the auditor to determine whether transactions are material to the related parties who are individuals, such as directors and their families.

SOLUTION FOUR:

a) Disclosure of confidential information by the auditor:

Auditors are subject to the fundamental principles of professional ethics. Among these is that of confidentiality whereby the auditor should not disclose to third parties any information that comes to their attention by virtue of their position.

There are exceptions to this rule and these are voluntary and obligatory disclosures.

Obligatory disclosure:

- If the auditor knows or suspects that the client has committed money laundering, treason is involved in drug trafficking or terrorist offences then he is obliged to disclose

all the information that he has to competent authorities such as the Drug Enforcement Commission.

- Non-disclosure of this would make the auditor an accomplice and could be liable.

Voluntary disclosure:

Voluntary disclosure may apply in the following situation:

- Disclosure is necessary in order to protect the interests of the auditor. For example where there are overdue and outstanding fees and in defence if there is an action against the auditor by the client say for professional negligence.
- In cases where disclosure is authorized by law.
- Disclosure is to non-governmental bodies which have statutory powers to compel disclosure.
- Where it is in the public interest to disclose, say where an offence has been committed which is contrary to the public interest.

The following should be noted , however:

If the auditor is requested by the police or tax authorities or any other authority to provide client information, the auditor should first find out under what statutory authority the information is demanded.

Unless the auditor is satisfied that such authority exists he should decline to give any information unless he gets the authority of the client. If no authority is given then the auditor should not disclose and he may wish to seek legal advise.

It should be remembered that tipping off is an arrestable offence and this is where the auditor without lawful authority or reasonable excuse acts in such a manner as to impede with intent the arrest or prosecution of a client whom he knows or believes to have committed an arrestable offence.

b) Audit procedures:

1. Receivable balance of K200 000.00

A misstatement of the receivables figure could result in the figure of accounts receivables being misstated in the financial statements. This means that current assets and total asset could be misstated.
Since the figure is material in relation to the financial statements then it is a matter that cannot be ignored.

The expected audit procedures expected with regard to receivables and this figure in particular includes the following:

- Examine the invoices relating to the amount disputed and confirm the amount and the fact that it relates to this customer.
- Examine any documentation such as delivery notes to confirm whether goods were delivered and confirmed as received by the customer signing on the delivery note.
- Examine the response, if any, from the circularization and determine the amount confirmed and disputed by the relevant customer. Determine the reasons for disputing the K89 000.00.
- Discuss with management on the recoverability of this debt.
- In view of the length of time the amount has been outstanding, review the list of specific receivables for which provisions have been made and ensure necessary allowance for receivables has been made.

2. Inventory figure of K420 000.00

Any misstatement of any line of inventory will result in the misstatement of the inventory figure in the financial position. The profit for the year will also be misstated and in this case will be overstated by the same amount.

IAS 2 *Inventories* gives guidance on the valuation of inventory.

Audit procedures expected:

- Review the inventory valuation schedules and working too confirm that all inventory is valued at the lower of cost and net realizable value.
- Confirm the cost of the relevant inventory by examining the necessary documentation including invoices.
- Determine that the goods in question have been sold by examining the inventory records and examining the sales invoices to determine the sales price.
- Confirm the selling amount of the inventory and compare with the cost and if lower confirm the inventory valued at the lower figure. If not stated at the lower amount and considered material discuss with management and ensure necessary adjustments to the inventory figure are made.

3. Provision of K80 000.00

Any material misstatement of provisions will result in the provisions and profit for the year being misstated.

IAS 37 *Provisions, contingent liabilities and contingent assets gives guidance on the accounting for provisions.*

Audit procedures expected on the figure for provisions:

- Review the assumptions and workings for arriving at the figure of K80 000.00.
- Obtain the relevant statute and confirm the penalties stated therein for breach of environmental regulations.
- Discuss with management and establish the reasons for providing a lower amount than that stated in the legislation.
- Discuss matter with the legal experts for the client and obtain their views the outcome of the case. May consider seeking own legal opinion on the outcome of the case.
- Ensure that the provision meets the requirements of IAS 37 for making provisions. If it does not then discuss with management so that they de recognize any provision that has been made.

SOLUTION FIVE:

a) Quality control issues regarding the audit of Glow Light Ltd.

Engagement partner an engagement partner is usually appointed to each audit by the firm to take responsibility for the engagement on behalf of the firm. Therefore simply assigning the audit to the experienced auditor is not sufficient enough.
The absence of an engagement partner means several requirements of ISA 220 that relates to independence and directing, supervision and reviewing and conducting a proper audit are not going to be followed. There is a dispute as to the valuation of inventoy.ISA220 requires that the engagement partner takes full responsibility for resolving disputes. Failure to resolve such a dispute indicates a breach of ISQC 1.

b) **Threats to objectivity and safeguards**.

Situation one (i) (ii)

Self-interest threat - This type of threat can exist in many forms, in case of Plenforth & Co, there is a financial interest since the audit firm has acquired shares in CEC. According to IFAC, the parties such as the firm, a member of the audit team and an immediate family

member of the audit team are not allowed to own or have direct financial interest or an indirect material financial interest in a client.

Safe guards

Either Plentforth & Co should dispose of the interest in CEC, keeping the audit committee of CEC informed of the situation to use an independent partner to review work carried out if necessary.

Situation two (i) (ii)

The main threat is self-review - Imelda had previously worked for the LWSC in which she held the position of accountant. In this position she is likely to have prepared financial statements that she could come and audit whilst working at Foresight & Co. It would imply auditing her own work which could compromise her independence and objectivity. Furthermore, there is an issue of familiarity threat as well because one year is not enough to 'cool off' the situation as most of her former colleagues at LWSC could still be working there.

Safeguards:

Imelda should not be allowed to be part of the audit team for LWSC. Other measures include obtain quality assurance review of the individual work on the assignment or have the issue discussed with the audit committee.

Situation three (i) (ii)

The threat in this case is intimidation threat-this is a threat that members of the assurance team may be prevented from actin objectively because of actual or perceived pressure from the client.

Safeguards include the following:

Disclose to the audit team the nature and extent of the threat and litigation or removing specific affected individuals or involve an additional professional accountant on the audit team to conduct review work.

c) **Key audit tests largely follow the criteria as laid down in IAS 38**:

Audit procedure for development costs:

- Check accounting records to confirm that the project is clearly defined, related expenditure can be separately identified, and certified to invoices and time sheets.
- Confirmation for feasibility studies and viability.
  The auditor needs to examine market research exports, feasibility studies, budgets and forecasts as well hold consultations with client's experts.
- Review calculations of future cash flows to ensure that resources exist to complete the project
- Review previous differed expenditure to ensure IAS 38 criteria are still justified.

- Review budget revenues and costs by examining results to date, production forecasts, advance orders and discussion with directors.
- Check amortization from the date of commencement of the project that has been charged on a systematic basis.
- Have written representation from management demonstrating how future economic benefits will be generated from the project.

d) The objective of the **review engagement** is to enable an auditor to state whether on the basis of the procedures which do not provide all the evidence that would be required in an audit, anything has come to the auditors attention that causes the auditor to believe that the financial statements are not prepared, in all material respects, in accordance with an international financial reporting framework. The two types of audit assurance engagement where the accountant declares that a given premise is either correct or not are an attestation and a direct reporting.

In a due diligence is where an advisor often (in an audit firm) engaged by one company planning to take over another to perform an assessment of the material risks associated with a transaction (including validating the assumptions underlying the purchase), to ensure that the acquirer has all the necessary facts and that the perceived business opportunities are in fact real. The common types of due diligence are financial, operational and IT as well as people due diligence for key positions in an organization.

In both case a low level assurance in form of a negative assurance is provided which is an assurance in the absence of any evidence arising to the contrary.

END OF SOLUTIONS