



ZAMBIA INSTITUTE OF CHARTERED ACCOUNTANTS

CHARTERED ACCOUNTANTS EXAMINATIONS

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PROFESSIONAL LEVEL

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P4: AUDIT AND ASSURANCE

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SERIES: JUNE 2012

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TOTAL MARKS: 100

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TIME ALLOWED: THREE (3) HOURS

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**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 compulsory question.  
Section B: Four Optional Questions. Attempt any three (3).
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. 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.
6. All workings must be done in the answer booklet.
7. Present legible and tidy work.
8. 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.**

EasyEat is a subsidiary of EasyEat of the Republic of South Africa (RSA) and has been operating in Zambia for the past fifteen years. The company is in the food industry and specializes in the manufacture and supply of baby foods which it distributes throughout the country. EasyEat has enjoyed a monopoly in the selling of baby foods due to a government ban on the importation of baby foods.

The company has 52 outlets trading throughout the country trading under its trade name and the outlets are managed by dealers who are accountable to EasyEat head office. The factory is located in Lusaka and all products except for a few selected lines of baby foods are manufactured locally. A small percentage of the baby food is imported from RSA largely because it would not be economical to manufacture the said lines in Zambia.

The manufacture and sale of baby foods is under the control of the Foods and Poisons Board which formulates the legal framework which must be followed by all baby food manufacturers. The board is also responsible for enforcement of the relevant legal requirements.

The relevant act specifies the maximum quantities of food preservatives that may be added to baby foods. Above specified quantities of preservatives, baby foods could be harmful to babies and non-compliance with the legal requirements as regards maximum quantities of the preservatives calls for stiff penalties and in extreme cases could result in the withdrawal of the manufacturing license. It is also a legal requirement that the date of manufacture and the expiry date of the baby foods be clearly indicated on all manufactured goods.

In late 2010 the government lifted the ban on the importation of baby foods. This resulted in the increase in baby foods being imported particularly from China. The imported baby foods are much cheaper than the locally manufactured baby foods including the ones manufactured by EasyEat. This resulted in a drastic decrease in turnover of EastEat Ltd for the year ended 31 December 2011. The company has a policy that all expired baby foods should be returned to head office for disposal. Head office also allows the dealers to reduce prices by as much as 30% when the expiry date is within a period of three months to avoid losses arising from destruction of expired baby foods. The company stocks large quantities of raw materials and also has work in progress at the year end. The company engages an external company to determine the value of the work in progress at the period end and the figures so determined are the ones used as closing work in progress in its financial statements.

Boland and Edwin Chartered Accountants have been the auditors of EasyEat from the time it was established in Zambia. Chris Boland has been the engagement partner during this period and he has gained vast experience in conducting the audit of EasyEat. Chris Boland's son Jones has been working for EasyEat for the past eight years. He joined the company as an accounts clerk and on completing his professional examinations he has risen through the ranks to his current position as Chief Accountant of EasyEat Ltd a position he has held for the past three years.

The management of EasyEat has remained the same except for the position of Human Resources Manager which has been held by three different people during this period. It is group policy that auditors should be changed every five years and EasyEat has been allowed to use the same auditors for longer than allowed because of its performance which has been good over the years.

**Required:**

- (a) Identify and describe the inherent risks in EasyEat Limited clearly explaining where relevant the financial statement assertions affected by such risks. (9 marks)
- (b) Describe the difference between a management expert and an audit expert stating the matters the auditor will consider before relying on the work of an a expert. (6 marks)
- (c) Describe the objectives of Boland & Edwin Chartered Accountants as regards the legal and other requirements that EasyEat Ltd is supposed to follow stating the audit procedures that they will perform in order to identify non compliance by EasyEat Ltd. (7 marks)
- (d) Discuss the risk that the group auditor takes in arriving at the group audit opinion for the EasyEat group accounts for the year ended 31 December 2011 and the action the group auditors may take to reduce the risk. (8 marks)
- (e) Using any information in the scenario, discuss the reasons why it is important that Boland & Edwin Chartered Accountants should be independent of EasyEat Ltd. (10 marks)

**(Total: 40 marks)**

**SECTION B**

**There are four questions in this section. Attempt any three questions only.**

**QUESTION TWO**

You are the audit senior of your firm, Goodluck & Company. The firm has a total workforce of thirty (30) employees based at each of the two offices in Lusaka and Kitwe. The firm has two partners, ten managers, nine audit seniors and the rest are audit assistants and administrative staff. The profile of the clients of your firm is largely that of small to medium size companies run by their owners.

A leading commercial bank with a network of ten branches across the country has advertised in the local press for audit services from reputable firms of auditors.

In the advertisement the bank has specifically stated that the partners of the bidding firms must be members of the Zambia Institute of Chartered Accountants (ZICA).

The outgoing auditors of the bank are Quick Mark and Co Chartered Accountants and they have been the auditors of the bank for the previous ten years. They have vast experience in

auditing banks and have over the years carried out audits of a high quality. Jerry Dickens has been the engagement partner for the bank audit for the last eight years.

You are the audit senior in your firm. Your firm would like to bid for the provision of audit services to the bank. Your partner has requested for information from you which will enable him decide whether to go ahead and submit a bid for this job.

**Required:**

- (a) Describe the ethical and other matters that should be considered by your firm before deciding to bid for the provision of audit services to the bank. (8 marks)
- (b) Discuss why quality control is essential in carrying out of an audit by an audit firm and state how your firm would achieve this. (5 marks)
- (c) Describe the regulation of auditors in Zambia clearly stating why it is necessary that the auditor must be regulated in the performance of his duties. (7 marks)

**(Total: 20 marks)**

**QUESTION THREE**

Mukuba Exploration and Mining Company is involved in the exploration and mining of copper in the North Western Province of Zambia. MEM Company is a subsidiary of an Australian Mining Conglomerate. The company has been operating in Zambia for five years and employs over 500 employees. The company is involved in the open pit mining of copper and has a concentrator which it uses to process copper ore into copper cathodes and copper bars largely for export.

In the process of processing copper ore, there are wastes that are produced some of which are toxic and harmful to humans and any living organisms. In November 2011, there was a spillage of toxic substances at one of the three storage tanks. Before the spill could be contained, there was a heavy downfall of rain which resulted in the spilled substances being swept into the council drains which flow into a nearby Mulonga stream.

Mulonga stream is a tributary of the Kafue River from which many municipalities and local people living along the river draw water for domestic use. The toxic substances that were swept into the Kafue River resulted in fish dying as a result of poisoning and when investigations were carried out by the fisheries department, it was established that the fish died of poisoning from the toxic substances.

A few kilometers downstream from where the spillage occurred there is a commercial crocodile farm run by an investor. Over fifty young crocodiles died from suspected poisoning and a good number of adult crocodiles have shown signs of poisoning and are being treated. The farm owner has taken some dead crocodiles to a veterinary clinic for further investigations to determine the cause of death.

The spillage was traced to Mukuba Exploration and Mining Company and the department in charge of the environment has written to the company informing them of the consequences of the spill and the possible penalties that may arise. The consequences include the cost of

cleaning up the spillage, compensating all parties affected by the spillage and paying the penalties as stipulated in the relevant legislation. The group policy of the mining conglomerate is that the company shall not cause any damage to the environment and when this happens the company shall pay for the cost of rehabilitation of the environment.

You are the audit manager of your firm and your firm is the auditor of Mukuba Exploration and Mining Company. You are about to commence the audit for the year ended 31 December 2011 and the news of the contamination has reached you.

In view of the serious consequences of the spillage, you wish to ensure that your audit team carries out sufficient work to obtain sufficient appropriate audit evidence. You are particularly concerned about accounting estimates that have been included in the draft financial statements produced by Mukuba Exploration and Mining Company.

An extract of the relevant section of the Statement of Financial Position from the draft accounts for the year ended 31 December 2011 is as follows:

<i>Current Liabilities:</i>	(K'million)
Accounts payables	23 460
General Provisions	10 200
Provision for legal suites	9 200

In the process of gaining an understanding of the entity and its environment, you establish that the government department responsible for environmental matters has stipulated in its regulations stiff penalties for water pollution arising from industrial activities. The action that may be taken by the council includes the withdrawal of the operating license in the event that it is proved that an entity negligently polluted the water.

**Required:**

- (a) Discuss why the audit of accounting estimates is a particularly difficult and risky area for statutory auditors. (3 marks)
- (b) Explain how management representations may be of use as audit evidence for the auditor in the audit of accounting estimates and the action that the auditor may take in the event of management refusing to give management representations. (3 marks)
- (c) For each of the figures in the extract of the financial statements of Mukuba Exploration and Mining Company, describe the audit procedures that should be undertaken to obtain audit evidence. (9 marks)
- (d) Discuss the reasons why companies such as Mukuba Exploration should ensure that they observe environmental legislation and why auditors such as your firm carry out environmental audits. (5 marks)

**(Total: 20 marks)**

#### **QUESTION FOUR**

Zambia has seen an unprecedented growth in industry with a great number of small and medium size companies being registered annually. There has also been an increase in the number of medium sized companies graduating and growing wishing to be listed on the Lusaka stock exchange.

Listing on the stock exchange means that there is a change in the ownership of the company. Largescale Plc is a company which has recently been listed on the stock exchange. The listing was successful going by the large number of individual shareholders and institutional shareholders buying shares. The company held its first annual general meeting recently and a number of issues were raised by the shareholders.

It was evident from the deliberations at the Annual General Meeting that a large majority of the shareholders did not understand the operations and management of listed companies. They were particularly not happy that management did not declare any dividend for the year just ended and the fact that management at the same meeting requested the members to vote in favour of a resolution to appoint auditors to hold office from the conclusion of that annual general meeting to the conclusion of the next annual general meeting.

Management proposed an audit fee of \$500 000 per year. The shareholders objected to this and stated that they would not support a resolution that would 'eat' into their profits even more. They stated that as the owners of the company they don't see the need for engaging auditors and that what was important was to employ qualified and competent management.

One of the shareholders stated that he did not see the need for companies to have statutory auditors who just come in for a short period and issue a report without carrying out thorough investigations of the operations of the company. He cited an example of another company in which he holds shares where the auditors gave unmodified audit opinions for three consecutive years and yet there was fraud involving huge sums of money which the auditors failed to detect.

No agreement was reached on the appointment of the auditors and the Board Chairman failed to convince the shareholders to pass the resolution. Efforts by representatives of the institutional shareholders to convince the other shareholders to support the resolution failed.

After the annual general meeting, the Chief Executive of the company called your partner to inform him of the failed bid to appoint your firm as the auditors for the company. The Chief Executive who is not familiar with the corporate governance issues of listed companies stated that they intend to call an extra ordinary general meeting at which they hope to explain and convince the shareholders of the need to have statutory auditors appointed. He has requested your firm to prepare suitable and adequate notes which he wishes to use at the proposed extraordinary general meeting to convince the shareholders on the appointment of auditors.

You have just passed your final examinations of the ZICA program and your partner has asked you to provide him with information requested by the Chief Executive of Largescale Plc.

**Required:**

- (a) Describe what is meant by the 'expectation gap' using the facts in the scenario. (4 marks)
- (b) Draft a report for the attention of your partner clearly stating your arguments in favour of statutory audits for listed companies such as Largescale Plc. (10 marks)
- (c) Describe the duties of statutory auditors as regards fraud as specified by IAS 240 *The auditor's responsibilities relating to fraud in an audit of financial statements*. (6 marks)

**(Total: 20 marks)**

**QUESTION FIVE**

Your firm has been the auditor of Fastgrowing plc for the past three years. You have been assigned to be in charge of the audit for the year ended 30 September 2011. The date now is 12 November 2011 and the audit is almost coming to an end. The work carried out has been reviewed by you, the audit manager, and you wish to present the audit files to the engagement partner for final review in the next few days.

You have called for a post audit review meeting to be attended by all staff that have been on this audit. The purpose of the review meeting is to ensure that all team members are happy with the work that has been carried out and that if there are any matters of concern they should be brought up so that they could be resolved before the audit files are presented to the partner.

You inform the meeting of the final timetable for finalization of the audit which is as follows:

Expected date of signing the audit report	23 November 2011
Date of issue of the financial statements	30 November 2011
Date financial statements will be approved at AGM	20 December 2011

You also inform the meeting that the management of Fastgrowing Plc has carried out a going concern review of the company and is of the view that the company is a going concern. The review carried out covered the period October 2011 to the end of June 2012.

John who recently qualified as a ZICA graduate raises a number of concerns in the meeting. He informs the meeting that in his final year of his studies for the ZICA qualification he learnt that the risk of misstatements of financial statements is high around the period end. He has asked you to explain how you intend to deal with accounting estimates and specifically accruals at the year end. He further asks you to confirm whether once the audit working papers have been sent to the partner and reviewed that will mark the end of the audit work on this assignment. He wants you to clarify what will happen if after the audit report is signed an issue comes up which will require amendments to the financial

statements. He is worried that this may require more audit work to be carried out which might result in him postponing taking his annual leave.

**Required:**

- (a) Discuss the concern of John that the risk of material misstatements is high around the year end and state the responsibility of the auditor as regards the events between 30 September 2011 and 23 November 2011. (7 marks)
- (b) Describe the responsibilities of management and the statutory auditors as regards the going concern assumption of Fastgrowing Plc. (5 marks)
- (c) Describe the action your firm will take in the event that you come across a matter that would be of concern to you and would have affected your audit opinion on the 15<sup>th</sup> December 2011.
  - (i) Management amends the financial statements. (4 marks)
  - (ii) Management refuses to amend the financial statements. (4 marks)

**(Total: 20 marks)**

**END OF PAPER**



**ZAMBIA INSTITUTE OF CHARTERED ACCOUNTANTS**  
**PAPER P4 AUDIT AND ASSURANCE**  
**JUNE 2012 SERIES:            SUGGESTED SOLUTIONS**

**SOLUTION ONE:**

**(a)    Risks in EasyEat Ltd:**

The risks that relate to the situation in EasyEat are the risks that would affect the reliability of the financial statements. Auditors are required to identify the risks in a client and respond appropriately to the risks identified so that the auditor can issue an appropriate audit opinion.

**Risks relating to inventory:**

- In accordance with IAS 2 *Inventories*, inventory should be valued at the lower of cost and net realizable value. Inventory is usually a material figure on the financial statements of manufacturing companies. There is a risk that the inventory of EasyEat may be valued at a figure not in line with the provisions of IAS 2 resulting in a misstatement of the financial statements.
- Inventory that is reaching expiry dates near the period end should be valued at the net realizable value and in this case will be worth nothing as per policy it should be returned to head office for disposal. There is a risk that expired inventory may be included at cost in the inventory value.
- There is also a risk that outlets may still hold on to inventory that is expired and sell to unknowing public and claim to have sold it at discount. This will expose EasyEat to legal suites.
- There is a risk of cut off problems in relation to goods received from RSA whereby goods for one period are recorded and accounted for in the wrong period. The motive could be to improve on the performance of EasyEat especially that revenue has reduced during the current year due to competition which has increased.
- There is a risk of having work in progress being misstated because part of it may be recognized in the current period and part of it in the subsequent period therefore misstating inventory. Reliance is placed on the expert who determines the quantity and value of work in progress.

**Risks pertaining to the going concern assumption of EasyEat:**

- There is a risk that more than allowable levels of food preservatives are used in an effort to lengthen the shelf life of the baby foods. This could result in stiff penalties by the Food and Poisons Board including possible withdrawal of the manufacturing license.
- There is a risk of EasyEat being tempted to falsify the date of manufacture and the date of expiry on some of their lines in an effort to lengthen the period baby foods may be kept and avoid loss through destruction of the baby foods. If found out this would result in penalties.
- The influx of cheap baby foods and the opening of outlets in traditional areas where EasyEat previously monopolized could result in management having

pressure to manipulate revenue to show better performance in a competitive environment.

**(b) Management's expert:**

A management expert is an individual or organization having expertise in a field other than auditing and accounting and whose work is used by management in the preparation of financial statements. In the case of EasyEat the expert they use to quantify and value work in progress in a management expert.

**Auditor's expert:**

An auditor's expert on the other hand is an individual or organization that has expertise in a field other than auditing and accounting. The auditor uses the work of the expert in obtaining appropriate audit evidence. In the case of EasyEat the auditor could engage an expert of their choice to confirm the valuation of work in progress.

**Matters to consider before placing reliance on the work of the auditor's expert:**

If auditors are going to engage their own expert to carry out the valuation of work in progress of EasyEat Ltd they will need to consider the following matters before relying on the work of the expert. ISA 620 *Using the work of an auditor's expert* gives guidance as follows:

- Consider the personal experience of the expert in the field of valuing work in progress for food manufacturing companies.
- Examine any publications that may have been written by the expert in the relevant field.
- Consider the objectivity of the expert by ensuring that he is independent of the EasyEat Ltd, as lack of independence may threaten objectivity.
- Evaluate whether the expert has the necessary competence and capabilities by discussing with the expert. This could be done by having discussions with other organizations for which the expert has carried out work.
- Review the reasonableness of any assumptions that the expert makes in carrying out his work.
- Confirm the expert's membership of any relevant association that may exist for the particular industry.

**(c) The duties of Boland & Edwin Chartered Accountants regarding legal compliance by EasyEat Ltd:**

Generally it is the duty of management, in this case EasyEat, to ensure that they comply with the laws and regulations as formulated by Food and Poisons Board.

Boland & Edwin will have gained an understanding of the legal requirements of EasyEat in accordance with the provisions of ISA 315 *Identifying and assessing the risks of material misstatements through understanding the entity and its environment*.

As regards compliance by EasyEat of the legal provisions, ISA 250 *Consideration of laws and regulations in an audit of financial statements* gives guidance on the role of the auditor as follows:

**Auditor's objectives:**

- Boland & Edwin will want to obtain sufficient appropriate audit evidence that EasyEat has complied with the laws and regulations that have a direct effect on the determination of amounts in the financial statements and the going concern aspects of EasyEat.
- Boland & Edwin will perform specified audit procedures that will help them identify any non compliance with legal requirements.
- The auditors will want to respond to any non compliance that may be observed by them.

**Audit procedures Boland & Edwin will carry out to identify non compliance of legal and regulatory requirements by EasyEat.**

- Boland & Edwin should obtain and review a copy of the laws and regulations to understand the guidance on application in the company.
  - Read through the minutes of the management meetings and board meetings and look out for any possibilities of non compliance with laws and regulations.
  - Make enquiries of management and in-house and external legal advisors regarding any legal suites against the company with a view to determine if they arise as a result of non compliance with laws and regulations.
  - Obtain written representations from management that all known cases of non compliance with laws and regulations which are likely to have an effect on the financial statements have been disclosed to the auditors.
- (d) The EasyEat group comprises a number of subsidiaries located in a number of countries. The Zambian entity is one of the subsidiaries and is currently being audited by Boland & Edwin. The audited financial statements of the Zambian subsidiary will form part of the consolidated financial statements of the EasyEat group.

**Risk of the group auditor:**

The group auditor will be responsible for auditing the consolidated financial statements and forming the group audit opinion.

The question does not specify who the group auditors are but it is most likely that they are not Boland & Edwin as this is a Zambian firm with no international presence. It should be noted that the group auditor will form an opinion on the consolidated accounts which include figures that they did not audit. Where the same firm audits the component financial statements and the group accounts the risk is greatly reduced.

The group auditor is responsible for ensuring that the consolidation process is carried out as per international accounting standards. He runs the risk of giving an inappropriate audit opinion on figures that he did not audit.

**Action that group auditors may take to reduce risk:**

ISA 600 (*revised and redrafted*) *Special considerations – audits of group financial statements (including the work of component auditors)* gives guidance in this area. The group auditor of EasyEat group of companies has the following options to take to enable him give an appropriate audit opinion:

- Enquire from the group management of any information and explanations that the group auditor considers necessary in the performance of his duties.
- Require that group management makes available to him information and explanations from subsidiaries including foreign subsidiaries.
- In principle he will communicate with the component auditors on any matters of concern and the component auditors should be ready to cooperate since they should be aware that the financial statements they have audited will ultimately form part of the group financial statements.
- The group auditor will identify the significant components in the group and may decide to carry out full audits on the financial statements of the significant components.
- The group auditor will need to have a clear understanding of the component auditors and specifically:
  - Whether the component auditors are independent and hence maintain objectivity.
  - Consider the component auditor's professional competence and experience.
  - Whether the component auditors operate in an environment where they are regulated by regulators such as ZICA.
- The group auditor may wish to review the work done by the component auditors and this may be in the form of:
  - Reviewing a report or questionnaire completed by the component auditors which highlight key issues identified during the audit.
  - Evaluate effect of uncorrected misstatements and any situations where component auditor could not obtain sufficient appropriate audit evidence.
  - Based on reviews group auditor will decide whether or not further audit tests should be carried out.

**(e) Importance of independence in a statutory audit:**

The statutory auditors form and issue an audit opinion on the financial statements that are prepared by a client company. The financial statements are used for various purposes by the many stakeholders who may access the financial statements. These stakeholders place reliance on the financial statements to make decisions they may be considering.

One of the fundamental principles of the statutory auditor is that of objectivity. It is a requirement that the auditor should be objective and not be biased or influenced by others in the performance of his duties.

It is observed that unless the auditor is independent of the client whose financial statements they are going to form an opinion, they will not be objective and hence violate this important principle.

Boland & Edwin are supposed to be independent of EastEat Ltd and the following situations may threaten the independence of Boland & Edwin as follows:

- They have been auditors of EasyEat for the past 15 years giving rise to a threat to the independence of Boland & Edwin. EasyEat should consider changing auditors as the period of 15 years is long such that familiarity threat comes in especially that there has been a minimal management change within EasyEat during this period.
- Chris Boland has been engagement partner of EasyEat for the past fifteen years giving rise to a familiarity threat. Guidance states that the engagement partners should be rotated every 5 years so that their independence is maintained. It is recommended that Boland ceases being the engagement partner of this client in line with the guidelines.
- The relationship between Edwin and Jones his son gives rise to a self interest and familiarity threat. The fact that Jones is a high performer does not remove the threat of Edwin not being objective as a result of the father son relationship. To remove this threat, it will be necessary that Edwin should have no dealings with this audit. If this is not possible then the son should consider leaving his job as chief accountant as he has a role to play in the preparation of the financial statements of EasyEat.

## **SOLUTION TWO:**

### **(a) Ethical matters to be considered by Goodluck & company:**

It is a professional requirement that before accepting an appointment as auditors, incoming auditors should ensure that they meet the ethical guidelines that must be followed by professional accountants. These guidelines are meant to protect the interest of auditors and ensure that they are able to meet the independence requirements at all times in order to enable them act objectively. In addition to ethical requirements that are followed, the auditors should ensure that they comply with the legal requirements as stipulated in the company's act of 1994.

Goodluck & Company should consider the following matters before considering bidding for the appointment as auditors of the bank.

- Goodluck & Company will need to ensure that they have a valid practicing certificate to practice as Auditors in the current year. Part IV paragraph 19 requires that to act as auditors, a firm or individual shall have a valid practicing certificate failure to which they will be breaching the act and will be subject to the stipulated fine.
- Goodluck & company should ensure that its partners and other members of staff are duly registered by ZICA as members or students.

- Goodluck & Company should ensure that they are not disqualified to act as auditors by the provisions of the Companies Act 1994 and the Accountants Act 2008
- Goodluck & Company should consider whether it has the necessary resources to be able to undertake an audit of the bank. This would be the first client of the firm in the banking industry. Resources in terms of manpower skills and the financial resources that may be needed to undertake the audit should be considered.
- Goodluck & Company should consider if there are issues pertaining to their independence that may prohibit them from taking up the appointment. This relates to the independence of the firm from the bank as well as the independence of the audit firm members who may be in this assignment. If the threats to the independence of the firm and its staff cannot be reduced to acceptable levels, then the firm may not wish to bid to undertake the audit of the bank.
- In the event that Goodluck & Company goes ahead to bid for the provision of audit services and the bank shortlists them, they will need to communicate to Quick Mark & Co the outgoing auditors. This is for the purpose of establishing whether there are any reasons that the outgoing auditors may have that may cause Goodluck & Company to decline the appointment. The procedure of communication is that Goodluck & Co should seek the permission of the bank to communicate with Quick Mark the outgoing auditors. If permission is granted Goodluck & company will proceed and write to the outgoing auditors. If on the other hand permission to communicate with the outgoing auditors is denied, then Goodluck & Company should decline the appointment as auditors of the bank.
- Goodluck & Company should assess the risk of carrying out the audit of the bank. This is the risk that the financial statements could be materially misstated and that the firm could issue an inappropriate audit opinion. If the risk cannot be reduced to acceptable levels then Goodluck & Company should not accept the appointment.

**(b) Quality control and the importance of quality control:**

The audit opinion that the auditor makes at the end of the audit is based on the audit evidence that is gathered during the audit. An audit team is appointed to carry out the audit and the opinion is based on the findings of the audit team and the opinion is usually made by the partner who may not have been actively involved in the gathering of the audit evidence.

It is therefore important that the evidence that has been gathered is sufficient and reliable enough to form the basis for the audit opinion. Quality is in terms of the working papers that have been prepared and also in terms of the work that has been done and the compliance with the standards set by the firm and with the International Standards on Auditing.

**How the firm might attain a high standard of quality in its audits:**

Quality in an audit can be achieved by ensuring that quality policies are in place at the audit firm level and at the individual audit level.

At the audit firm level, the firm may appoint an individual whose role is to ensure that quality control measures are considered important by all staff in the firm. This will usually be a senior member of the audit firm and their role will be to ensure that quality measures that have been put in place are followed in the carrying out of audits by the firm. This would include measures such as quality peer reviews within the office of the same firm or between different offices of the same firm.

At the individual audit level quality will be the responsibility of the team leader. The team leader will ensure that at all levels of the audit the required level and standard of working papers is achieved. This is achieved largely through reviews of the work carried out whereby the work carried out by an individual is reviewed by their supervisor and this review should be evidenced in writing.

The overall responsibility for the quality of an audit lies in the hands of the engagement partners who ultimately are responsible for the issuance of an appropriate audit opinion.

- (c) In accordance with the provisions of the Companies Act 1994 paragraph 172(2) any registered member of ZICA may be appointed to act as auditor of another. Further, the Accountants Act 2008 provides that ZICA shall issue practicing certificates to individuals and firms wishing to carry out audits of financial statements.

#### **The need for regulation of auditors:**

The reason that the Act requires that auditors should be regulated by ZICA is to protect the interests of shareholders and other stakeholders of a company. An audit is a positive assurance engagement and gives assurance to the users of financial statements that the accounts show a true and fair view. This means that the auditors will have carried out sufficient audit work in arriving at the opinion that the financial statements show a true and fair view. There are many other stakeholders who place reliance on the audited financial statements in making decisions and it therefore important that the auditors are regulated to ensure that they actually carry out sufficient work before forming an opinion.

#### **The regulation of auditors in Zambia:**

In accordance with the Company's Act, ZICA are responsible for regulating accountants in general and auditors in particular.

This is achieved in the following way:

- ZICA is responsible for the issuance and renewal of practicing licenses to audit firms. They will only issue and renew licenses to firms that meet the requirements to carry out quality audits.
- ZICA regulates all accountants and in the event that an accountant commits a grave offence whose penalty could result in disciplinary actions, ZICA will administer the necessary penalties which include expulsion from the institute.

- The Institute is empowered to review the work that is carried out by members and determine whether or not the members comply with laws and regulations such as ISAs in the performance of their work.
- ZICA ensure that auditors meet the continuous professional development of members on an annual basis in order to ensure that auditors are competent and meet the fundamental principle of professional skill and competence at all times.

### **SOLUTION THREE:**

#### **(a) Auditing of accounting estimates:**

It is common that at the period end management makes some accounting estimates for which there is no evidence to support such amounts. This includes matters such as obsolescence provisions, allowances for receivables and estimates of outcomes of legal cases that may not have been concluded by the period date. Usually accounting estimates are made for items for which there is no other available evidence.

The estimates that are made by management are based on management's judgment and therefore there is subjectivity in determining these amounts. Management will make some assumptions upon which basis the amounts will be determined. The auditor will in most cases rely on the figures by management and the audit work that will be conducted is largely that of assessing the assumptions upon which the estimates have been made.

It is also possible that estimates that should have been made and accrued at the period end could in fact not be made by management. The auditor needs to use his professional judgment and his understanding of the entity to make sure that such accounting estimates have been included in the financial statements.

#### **(b) Management representations:**

Management representations are made by the management to the auditors for a number of reasons. These are made in writing to the auditor and they form part of the evidence that the auditor gathers and are part of the current working papers.

##### **Representations for accounting estimates:**

In giving evidence of the amount of K9.2bn being provision for legal suite against Mukuba Exploration, the management will make their representations in writing stating the basis upon which the amount has been arrived at. This way management will take responsibility for the accounting estimate that they have made. Written evidence in form of management representation is more reliable than oral evidence and cannot be refuted at a later stage.

##### **Refusal by management of making management representations:**

In the event that management of Mukuba Exploration refuses to make management representations as requested by the auditors there are two options for the auditor to take as follows:



- In the event that the auditor is able to obtain sufficient and appropriate audit evidence from other sources then he will do so and may take no further action against the refusal by management to provide representations.
- In the event that there is no other source of evidence available to the auditor, the auditor will consider the materiality of the matter at hand and how it affects the reliability of the financial statements. He will then consider the effect of the refusal by management on the audit report. If the auditor considers the matter to be material and pervasive to the financial statements he may consider modifying the audit report.
- Auditor may communicate with those charged with governance like the audit committee

**(c) Audit procedures:**

**Accounts payable:**

- Obtain a schedule of the payables for the period end giving the amount due per accounts payable.
- Cast the schedule of payables and ensure the amount agrees with the balance in the accounts payable control account.
- For a sample of accounts payables agree the balances to the supplier statements for the period end.
- For sample balances that do not agree review the reconciliations for the difference.
- If necessary, for a sample of accounts payables circularize the payables to confirm balances by way of third party evidence.

**General provision:**

Generally IAS 37 provisions and contingencies, prohibits the setting up of general provisions because they have been abused in the past. As regards the balance in the question, the auditor will wish to establish whether all amounts included meet the requirements of the standard for recognition.

- Obtain from management the make up of the general provision and agree to the general ledger account balance.
- Examine evidence available for all components of the provision.
- If necessary obtain management representations for the amount of provision.
- Ensure that all the provisions included in this total meet the conditions set out in IAS 37 for recognition.
- For provisions that do not meet the criteria for recognition, ensure that the provision is reversed as general provisions are not allowed per IAS 37.

**Provision for legal suites:**

- Obtain managements representations on the amount of the provision that has been made.

- Review the assumptions upon which the provision has been made for reasonableness.
- Recalculate the provisions based on the assumptions that have been made.
- With the permission of Mukuba Exploration, communicate with the lawyers of Mukuba Exploration and obtain their view about the outcome of the legal cases and their estimate of the penalties that may arise.
- Examine post year payments relating to the provisions if any. This will help in determining the estimate made at the period end.
- Discuss with management on the possible withdrawal of the mining license and the effect on the going concern assumption of the company.

**(d) Importance of following environmental legislation by Mukuba Exploration:**

- There is an increased awareness on the importance of preserving the environment by industrial activities. There is an increase in customers who will not buy goods from companies that cause damage to the environment.
- There is an increase in legislation to regulate industrial activities and particularly against pollution to the environment.
- There are stiff penalties against companies that violate the environmental regulations.

**Why auditors carry out environmental audits:**

Auditors do carry out environmental audits of the activities of their clients. This is usually for industrial companies such as factories, chemical and oil companies. Environmental effects of companies have an effect on the financial statements.

Arising from increased regulations on environmental matters and penalties that may be levied on companies there could be issues of making accounting estimates by companies which fall short of following the regulations. The auditor needs to understand the regulations and the activities of the company.

Secondly as stated in the case of Mukuba Exploration, serious violations of environmental regulations could result in the withdrawal of the operating license. This has an impact on the going concern of the company and hence the basis upon which the financial statements are prepared. In this regard also environmental breaches could have an impact on the revenue of the company in view of the reaction of customers to such breaches.

## **SOLUTION FOUR:**

### **(a) Expectation gap:**

The expectation gap can be explained as the difference between what the public perception of the responsibilities of the auditor and the reality in terms of legal and professional reality on the other hand. The difference in perception is basically as regards among other matters the following:

- Misunderstandings as regards the nature of audited financial statements for example that the financial statements are stated precisely or that audited financial statements will guarantee that the entity concerned will continue to exist.
- A misunderstanding as regards the type and extent of the work of the auditor.
- A misunderstanding as regards the level of assurance that is provided by the auditors for example that an unmodified report means that no frauds have occurred during the period or that audited financial statements mean that the figures contained in the audited financial statements are correct.

In the case of the facts given in the question, evidence of the expectation gap is seen where one of the shareholders says that he does not see the need to hire auditors who come in for a short period of time to carry out an audit then leave and issue a report. Further, the shareholder is unhappy about the fact that auditors of one of the companies he holds shares did not detect fraud that was being carried on and they continued issuing unmodified audit opinions. These facts show the misunderstanding that exists as to the role of the auditor and specifically their responsibility concerning fraud.

### **(b) Report:**

To: The Partner in Charge

From: Audit Senior

Date: 15 January 2012

Subject: Justification for statutory audits of listed companies.

I refer to your request that I should highlight the need for listed companies to be audited by statutory auditors. I wish to state that statutory auditors are those required to undertake audits by the Companies Act 1994 and any other regulations such as the stock exchange requirements of the Lusaka Stock Exchange.

I give in this report the benefits that accrue to a listed company if its financial statements are audited by external auditors:

1. There is a separation between ownership of most listed companies and their management. The shareholders who own the company do not generally take part in the day to day running of the company. By having the financial statements of listed companies audited by statutory auditors this gives

comfort to the shareholders that management is not abusing the trust that the shareholders have given them to run the company on their behalf.

2. Investors will more likely buy shares in companies whose financial statements are audited. Shares of listed companies are traded on the stock exchange and hence if the financial statements are audited the public will be attracted to invest in shares of such companies.
3. Audited financial statements make negotiations for sale of the entity much easier than for entities that are not audited. The valuation of a company whose financial statements have been audited is much more straight forward.
4. A listed company whose financial statements have been audited stands better chances of borrowing in the capital market when in need of more capital. Lenders will more likely lend to a company whose financial statements have been independently audited.
5. The tax authorities will more often accept audited financial statements and the related tax returns than those of companies that have not been audited.
6. Other stakeholders in a company such as suppliers and customers will be more comfortable to deal with a company that has its financial statements audited. For example the suppliers will be more willing to extend credit to a company whose financial statements are audited.
7. Further, it is a legal and regulatory requirement that financial statements of listed companies be audited every year. The company whose accounts are audited will thus be fulfilling this legal requirement.
8. The mere fact that the financial statements of listed companies are required to be audited by external auditors means that the risk of fraud in a company is reduced. This is because the perpetrators of fraud know that the financial statements will be audited by qualified external auditors and hence they may be found out.

I trust that this information meets your requirements.

### **Audit Senior**

#### **(c) Auditor's responsibility as regards fraud:**

Generally it is not the responsibility of the auditor to detect or prevent fraud in the client undertaking. It is the responsibility management to put in place adequate internal controls in order to ensure that the objectives of the entity are met including the detection and prevention of fraud.

It is important to note, however, that the auditor should conduct his work in a professional manner and apply professional skepticism in the performance of the audit. He must plan his work in such a way that fraud may be detected and must bear in mind the possibility of fraud being perpetuated by the client staff.

*ISA 240 The auditor's responsibilities relating to fraud in an audit of financial statements* gives guidance on the responsibilities of the auditor as regards fraud.

The following guidance is given:

- The primary responsibility for the prevention and detection of fraud lies with management and those charged with governance.
- The responsibility of the auditor is to obtain reasonable assurance that the financial statements are free from material misstatements whether caused by fraud or error.

The auditor will achieve the above objectives by gaining an understanding of the entity in accordance with ISA 315 *Identifying and assessing the risks of material misstatement through understanding the entity and its environment* including the risk due to fraud.

Once he has identified the risk of material misstatements due to fraud the auditor shall respond to this risk in accordance with ISA 330 *The auditor's responses to assessed risks* in any of the following ways:

- The assignment and supervision of staff taking into account their knowledge, skill and ability.
- Incorporating unpredictability in the selection of the nature, timing and extent of audit procedures to be conducted.

### **Management representations:**

In order to reduce misunderstandings as regards the responsibilities of management and the auditors as regards their duty as regards fraud, it is normal practice for the auditors to obtain management representations in order to ensure that:

- Management and those charged with governance acknowledge their responsibility for the design, implementation and maintenance of internal controls to prevent and detect fraud.
- Management has disclosed to the auditors their assessment of the risk of fraud on the financial statements.
- That management has disclosed to the auditors any knowledge of fraud or allegations of fraud involving management, employees and others where fraud could have a material effect on the financial statements.

### **SOLUTION FIVE:**

- (a) The auditor's objective after carrying out an audit is to form an opinion on whether the financial statements show a true and fair view. John's concern that there is a higher risk that financial statements could be misstated around the period end.

This is largely because management may wish to show a better financial position than is really the case and this they may do by deliberately falsifying the financial statements. At the period end, there are a number of accounting estimates that are made in finalizing the financial statements. In most cases the estimation of the values relating to these accounting estimates is subjective and if incorrectly done could result in the misstatement of the financial statements. For example allowances for receivables may need to be estimated and using managements estimates they will decide on how much to provide in the financial statements. The actual allowance however may be different from that estimated by management.

#### **Events between 1/10/2011 and 23/11/2011:**

The events that take place soon after the reporting period end and the date of signing the audit report are known as subsequent events. IAS 10 *Events after the reporting period end* identifies the events after the period end into two categories namely as adjusting and non adjusting events. The standards further gives guidance on the accounting for these events and management is responsible for identifying these events and accounting for them in accordance with the provisions of the IAS.

The auditor's responsibilities as regards events between 1/10/2011 and 23/11/2011 are given in ISA 560 *Subsequent events*. During this period the auditor has an active duty to perform and the following guidance is provided by ISA 560:

- The auditor will perform procedures aimed at obtaining sufficient and appropriate audit evidence that all events up to the date of the auditor's report that may require adjustments or disclosure in the financial statements have been identified.
- Obtain management representation of the procedures they have used to identify events.
- Once such events have been identified the auditor will wish to establish whether management has correctly treated these events in accordance with the requirements of IAS 10.

The ISA states that the auditor will achieve this by making enquiries of management on the procedures that they have put in place to identify such events as well as reviewing subsequent management accounts and reading minutes of board meetings held subsequently and using his knowledge and experience of events that are likely to be misstated.

#### **(b) Responsibility for going concern:**

Historical cost financial statements are prepared on the assumption that the entity is a going concern and in a position to realize the assets at the values they are stated at. It is therefore important that assessments are done at the period end to confirm the going concern assumption.

### **Fastgrowing plc management's responsibility concerning going concern:**

The management of Fastgrowing plc is primarily responsible for the carrying out of the going concern evaluation of the company. This is in accordance with the provisions of IAS 1 *Presentation of financial statements*. The assessment that management undertakes should cover a period of not less than 12 months. In this case it will be observed that the assessment that was carried out was for a period of 9 months only.

### **The statutory auditor's responsibility for going concern:**

The duty of the auditor with regards the going concern assumption is to establish the work carried out by management in arriving at the conclusion that the company is a going concern. The auditor will review the assumptions that management has based its conclusion on and ensure that the period covered in the review is not less than 12 months. In this case management has only covered a period of 9 months and so the auditor should request management to extend their review for another three months so that it meets the minimum 12 month requirement.

### **(c) The duties of the auditor after signing the audit report:**

The duties of the auditor end after signing the audit report. After the date of signing the audit report the auditor has a passive duty to carry out. It is the duty of management to inform the auditor of any events that take place after the signing of the audit report and which they feel should be brought to the attention of the auditor.

### **Event that took place on 15<sup>th</sup> December 2011.**

This event has taken place after the signing of the audit report and the issue of the financial statements. The following actions will be taken in view of the fact that the event is discovered after the issue of the financial statements and the action will depend on management's response and action as regards the said event.

#### **i. Management amends the financial statements:**

Action that will be taken by the auditor will include:

- Carry out the necessary audit procedures on the amendments that have been made by management.
- Review the steps taken by management to make sure that those who received the initial financial statements are informed of the position in terms of amendments made to the financial statements.
- Will issue a new or amended auditor's report with an emphasis of matter paragraph or other matter paragraph.
- Extend the period of review of subsequent events to the date after the first audit report has been issued.

**ii. Management refuses to amend the financial statements:**

The auditor will take the following action:

- Discuss the matter with management and those charged with governance and advise that the auditor will seek to prevent reliance on those financial statements to be made.
- The auditor may seek legal advice on the issue.
- May seek the advice of the regulatory authority such as ZICA.
- As a last resort the auditor may consider resigning if the matter is so serious.
- Consider revising the audit opinion and issue a modified report.

**THE END**