CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P4: AUDIT AND ASSURANCE

SERIES: JUNE 2013

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 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

This question is COMPULSORY and MUST be attempted.

QUESTION ONE

Hardtimber Ltd is a company that is in the timber industry. The company's head office is in Luanshya on the Copperbelt. The company has large timber plantations located in an area that covers 30 km^2 and on two sides the plantation shares boundaries with two shanty compounds which have a population of over 5 000 generally unemployed people. Most of the casual workers that are employed reside within these two compounds.

The company has a nursery of timber trees situated not far from its head office at which small plants are grown before they are transplanted. It takes five years for a plant to grow into a tree that can be used as timber.

The company also deals in timber made out of a special natural tree that is commonly found just beyond the plantation of Hardtimber Ltd. Under strict regulations of forests, the company can only cut a limited quantity of trees per annum as the cutting of these trees is regulated by the organization responsible for the environment. One of the regulations stipulated by the regulator is that any company that cuts these natural trees should plant two trees for each tree that it cuts.

Your firm is considering bidding for audit services of Hardtimber Limited. Your firm has been in existence for many years in Zambia and has offices in three provinces including the Copperbelt. It is the view of your firm that it has the necessary resources in terms of skill and time to undertake the audit of Hardtimber Ltd. Your firm has not audited any company in this industry but is of the view that they would not have any problems auditing this company especially that Dick Jones who has been Chief Financial Officer for Hardtimber Ltd has shown great interest in joining your firm as a partner. The Managing Partner has assured you that they will recruit Dick Jones and as such there is no need for concern. Your partner further says they will advertise for audit seniors and audit assistants and is sure that most of the staff of the outgoing auditors may wish to join your firm and as such experienced staff will be available to carry out the audit.

At a staff meeting at which the intention to bid for audit services of Hardtimber Ltd was tabled for the information of all staff, Chanda an audit senior reminded the meeting that if your firm is shortlisted and considered for the assignment, it would be necessary to carry out a risk assessment before finalizing the deal with Hardtimber Ltd. He stated that International Standards on Auditing require that audit risk should be within acceptable levels before an assignment is accepted. Tembo an audit assistant added and said that your firm needed to follow a risk based approach in auditing the financial statements of Hardtimber Ltd rather than follow a procedural approach.

The Managing Partner informed the meeting that he has got information to the effect that the previous auditors were replaced because for two consecutive years they issued what the client considered to be inappropriate audit opinions. He has emphasized that all staff should use professional skepticism in carrying out their work and any material misstatement should be investigated fully. This way he hopes the firm will only modify audit reports if it is proved beyond doubt that there are material misstatements in the financial statements. He explained that any other minor concerns would be reported in the other matter paragraph

and it is only in this way that your firm will not risk being replaced just like the previous auditors were.

Required:

a) Discuss the statement made by Tembo that your firm should follow a risk based approach rather than a procedural approach in the audit of the financial statements of its clients. (6 marks)

b) Compare and contrast business risk and audit risk of Hardtimber Ltd (4 marks) and describe the action your firm will take in the event that audit risk is considered to be:

   i. High (3 marks)

   ii. Low (2 marks)

c) Describe what is meant by materiality in an audit stating how materiality will depend on level of risk identified in a client such as Hardtimber Ltd (5 marks)

d) Describe the ethical matters that your firm should consider before bidding and accepting appointment as auditors of Hardtimber Ltd. (10 marks)

e) In relation to the audit report:

   i. Describe the forms of modifications of the audit report that are open for your firm to use. (6 marks)

   ii. One of the elements of the audit report is the *other matter paragraph*. Explain what the use of this paragraph is giving an example of the situation under which it may be used by the statutory auditor. (4 marks)

(Total: 40 marks)

SECTION B

Attempt any THREE questions in this section.

QUESTION TWO

There is increased concern about the role of statutory auditors in commerce and industry globally. The concern arises largely because of large corporate collapses despite the fact that the financial statements of these organizations are audited by professional auditors. At its annual conference held in Mfuwe in 2011, the Zambia Institute of Chartered accountants invited the Minister of Finance to open the conference.

In his opening remarks, the minister raised a number of concerns about the effectiveness of accountants in general and the benefits of statutory audits in particular. He challenged the participants to come up with resolutions that will help increase the effectiveness of the profession so that there can be a marked decrease in entities that collapse even after their financial statements have been audited by professional accountants and declared to show a true and fair view. He stated that, in his opinion, there are indicators before a company goes into financial distress and he wonders why these are not noticed in good time to enable measures be put in place.

The Chief Executive of ZICA assured the Minister that statutory auditors carry out their duties in a professional manner and they are strictly regulated by ZICA to ensure that their work is of the highest standard and meets the auditing requirements as stated in the International Statements on Auditing and apply International Accounting Standards in the preparation of the financial statements. He further stated that all accountants whether in industry or practice are required to meet the mandatory number of hours in terms of continuing professional development.

During the plenary session, it was agreed that ZICA should conduct more seminars for accountants covering specific matters of concern to the profession. The ZICA Chief Executive informed the gathering that they will see an increase in these seminars which are free of charge for members. He further stated that the time spent in attending these seminars goes towards meeting the mandatory Continuous Professional Development (CPD) Hours for those members who attend.

The Institute has approached your firm, which is one of the leading firms of auditors in the country, to lead the discussion at one of the monthly seminars it organizes for its members.

Your Partner has requested you to make the presentation to be held at one of the leading hotels in Lusaka. He informs you that the Institute in their letter to your firm would like the following matters to be included in the four hour discussion:

- The importance of International Accounting Standards and the International Statements on Auditing and their relevance in this age of increased globalization.
- The debate that is going on as regards the offering of non audit services by statutory auditors to their assurance engagement clients.

Required:

a) Discuss how the International Accounting Standards and International Statements on Auditing increase the credibility of published financial statements. (6 marks)

b) Discuss why ZICA organizes seminars such as the ones referred to in the scenario for its members and why members should meet the minimum Continuous Professional Development (CPD) hours. (4 marks)

c) Briefly discuss how the Zambia Institute of Accountants (ZICA) regulates firms of auditors in Zambia. (4 marks)

d) Discuss arguments for and against statutory auditors offering non audit services to their audit assurance clients. (6 marks)

(Total: 20 marks)

QUESTION THREE

Chemicalclean Ltd is a chemical company involved in the manufacture of a chemical used in cleaning services by laundry companies. The company has a fleet of motor vehicles used in the delivery of bulk products it delivers to its customers and also has plant and equipment including a boiler.

You have been appointed the auditors of Chemicalclean Ltd and this will be the first year that your firm will audit the financial statements of Chemicalclean Ltd. The year end of Chemicalclean is 31 March and the date today is 3 April 2011. You are the audit manager for this assignment and you have been requested by your partner to constitute an audit team to carry out this assignment. The reporting timetable of Chemicalclean is rather tight with the audited financial statements expected to be submitted within one and half months after the period end.

At a pre audit meeting with the members of the audit team, John a newly qualified ZICA graduate observes that there is need for the team to conduct an audit which meets the requirements of International Statements on Auditing (ISAs) and goes on to say that through the draft financial statements, management are making a number of assertions and a period of one and half months will not be sufficient to complete the audit.

Mutinta who is still pursuing her accountancy studies suggests that in view of the fact that there is limited time, the team should rely on the internal controls set up by management and carry out tests of control only and issue an audit report thereafter. She states that if the internal controls are found to be effective, then there is no need to carry out substantive audit tests and in this way the tight schedule can be met.

An extract of the income statement of Chemicalclean Ltd for the year ended 31 March 2011 shows the following:

	Km
Sales revenue	5 800
Opening Inventory	2 300
Purchases of materials	3 200
	5 500
Closing Inventory	3 100
Cost of sales	2 400
Gross margin	3 400
Government grant	400
	3 800
Interest cost	90
Taxation	1 200
Depreciation of plant and equipment	150
Loss on disposal of motor vehicles	20
Net profit	2 340

Required:

a) Discuss the suggestion by Mutinta that your firm should only carry out tests of control in the audit of the financial statements of Chemicalclean Ltd for the year ended 31 March 2011. (6 marks)

b) Describe what is meant by financial statement assertions and their relevance to the audit of the financial statements of Chemicalclean Ltd. (4 marks)

c) Describe one (1) financial statement assertion pertaining to each of any three (3) of the figures in the draft income statement of Chemicalclean Ltd and for each assertion describe the audit procedures you will undertake. (10 marks)

(Total: 20 marks)

QUESTION FOUR

Hung Kong Ltd is a company that has just obtained a listing on the Lusaka Stock Exchange. The company is in the mining industry and operates two mines on the Copperbelt of Zambia.

In order to meet the listing requirements, a new board of directors has just been constituted and put in place. King Hu, the majority shareholder, has put together what he considers a formidable team of experienced industrialists to sit on the board. Below are the profiles of the proposed board members:

Chang Li is the current Chief Executive Officer of the company. Chang has wide experience spanning over a period of twenty years in this industry. Chang is posed to be board chairman, in addition to his current position as chief executive officer of Hung Kong. He is considered suitable for the position as he has a very strong personality and will be able to direct the board effectively.

Andrew Nyirenda is currently the Human Resources Director of Hung Kong Ltd and brings with him many years of experience in industrial relations issues. He is a member of the Zambia Institute of Human Resources Managers and is a key person in wage negotiations with the workers.

John King is the Finance Director of Hung Kong and has been with the company for the past five years. He is a Chartered Accountant with many years experience in the industry in the Bahamas the country of his origin. He is poised to be the Chairman of the Audit Committee of the board.

Bruce Jung is the production director of Hung Kong Ltd. He is new in this position and his command of English is poor and relies on an interpreter in the performance of his duties.

Prince Kadoli is a successful businessman in an industry not related to the mining industry. He has the right connections in government circles and it is thought that he will be very useful to the board and through the public relations manager will ensure a sound relationship with the government is always maintained.

The company has an internal audit department under the supervision of James Phiri a holder of the ZICA Technician Certificate. He has worked for various companies and has risen to this position because of the experience he gained when he worked for a firm of auditors for five years. James reports to John and all reports that he makes are released only after clearance by John. The total number of staff in internal audit is five none of whom is a qualified accountant.

Your firm is the auditor of Hung Kong Ltd and you are the audit senior of this assignment and your firm is considering relying on the work of internal audit department.

Required:

a) Discuss the proposed composition of the board of Hung Kong Ltd and make any recommendations you consider necessary. (8 marks)

b) Describe the matters that your firm will consider before placing reliance on the work of the internal audit department of Hung Kong Ltd clearly stating how reliance on internal audit would be applied by your firm. (8 marks)

c) Describe what is meant by independent non-executive directors and state why they are important to companies such as Hung Kong Ltd. (4 marks)

(Total: 20 marks)

QUESTION FIVE

You are a qualified accountant with more than ten years experience in practice having worked for a leading firm of auditors. You have just been employed by CML Chartered Accountants as an audit manager at their Lusaka Office. Before joining CML Chartered Accountants you worked as Finance Manager for Precious Stones Ltd.

The following information relates to CML Chartered Accountants:

The firm has three offices located in Lusaka, Ndola and Kitwe.

1. There is a managing partner in charge of the Zambian practice based in Lusaka and each branch is under the supervision of a senior partner.
2. Each firm has three other partners to whom assignments are given.
3. The following are the staffing levels for other members of staff:

	Lusaka	Kitwe	Ndola
Audit Managers	5	3	3
Audit Seniors	7	5	4
Senior Audit Assistants	4	3	2
Junior Audit Assistants	6	5	3

On reporting for work, your partner informs you that the Lusaka Office has just won tenders for three new assignments. The new clients are Oxygen Chemicals, Precious Stones Ltd and Kafue Fisheries Ltd. He informs you that two of these assignments have the same year end as other existing assignments and all the other audit managers are busy on existing jobs. He has assigned you to be the audit manager of Precious Stones Ltd.

Precious Stones Ltd deals in cutting of precious stones for the export market to Europe. Other than yourself, no other existing members of staff have experience in the audit of companies in this industry. The partner is sure that you will execute your duties diligently and you should not face any challenges due to the experience you gained whilst working for Precious Stones Ltd.

The partner has requested you to quickly put in place a suitable audit team to be assigned on this job and he has informed you that you may contact the Human Resource Officer for any information you may wish as regards experience of staff in the office.

Required:

a) Other than when the auditor is obtaining written evidence to support oral evidence obtained from a client, describe other situations when the auditor may obtain management representation as guided by ISA 580 *Written representations.*

(5 marks)

b) Regarding the request by your partner that you should put in place an audit team for the audit of the financial statements of Precious Stones Ltd:

i. Comment on your appointment as audit manager and state the factors you will consider in appointing audit team members for the audit of Precious Stones Ltd.

(5 marks)

ii. Describe the composition of the audit team for submission to the audit partner.

(2 marks)

c) Describe the quality control measures you would expect to find in the audit of Precious Stones Ltd by your firm:

i. At the firm level. (4 marks)

ii. At the individual audit level for the audit of Precious Stones Ltd. (4 marks)

(Total: 20 marks)

END OF PAPER

P4 AUDIT AND ASSURANCE

JUNE 2013 EXAMINATIONS

SUGGESTED SOLUTIONS

SOLUTION ONE

a) The objective of a statutory assurance engagement is for the audit firm to form an opinion on the financial statements audited. The statement made by Tembo indicates that there are two possible approaches to carrying out an audit namely the risk based approach and the procedural approach to an audit. The meaning of each of these approaches is given below:

Risk based approach to auditing:

Under this approach, the auditor will assess the risk of material misstatements of the financial statements of the client. The auditor will wish to establish that the risk of material misstatements is within acceptable levels otherwise the auditor should not undertake the audit. The auditor will analyze the risks associated with the client's business, transactions and systems.

Once the risk has been assessed and risky areas identified, the auditor will plan his work bearing in mind the risks inherent in the relevant client business or transactions or account balances.

Under this method the auditor will attach more importance to areas that are riskier and will develop audit procedures which are likely to detect any material misstatements of the financial statements. The auditor will thus direct their testing to the riskier areas.

Procedural approach to auditing:

Under this approach the auditor will carry out audit procedures that have been set up regardless of the risk of the various balances and transactions. Under this method the auditor does not consider any risk in deciding on the audit procedures and audit work to be carried out.

Following this method, the risk of giving an inappropriate opinion is higher compared to the risk using the risk based approach.

Conclusion:

In order to reduce the risk of giving an inappropriate audit opinion the statutory auditors follow a risk based approach just like Tembo has stated which is in line with International Standards on Auditing. Specifically ISA 315 *Identifying and assessing the risks of material misstatements through understanding the entity and its environment* requires that auditors use a risk based approach.

b) Business risk:

Business risk is the risk that is inherent in certain types of businesses compared to others. Some businesses are by nature more risky than others and most organizations identify the business risks so that they can take action to prevent the risks from crystallizing.

Business risk relates to the business unlike audit risk which is related to the financial statements. In the case scenario an example of the business risk of Hardtimber Ltd could be the risk of a fire sweeping through the plantation and destroying all the tress before they are harvested.

Audit risk:

Is the risk that the auditor will give an inappropriate audit opinion. For example instead of giving a modified audit opinion the auditor gives an unmodified audit opinion and vice versa.

Audit risk comprises three elements as follows:

Audit risk = Inherent risk x Control risk x Detection risk.

The objective of the auditor is that overall audit risk should be at an acceptable level otherwise it would be too risk going on with the audit and giving an inappropriate audit opinion. Giving inappropriate audit opinion has risks not excluding being sued by the client which could lead to the firm being liable for professional negligence.

i. Audit risk high:

In the event that audit risk is considered to be high, the auditor will need to take the following actions:

- Reduce overall audit risk by increasing the amount of audit work that he will undertake. By so doing the auditor will reduce detection risk the only element under the control of the auditor. If detection risk is reduced then overall audit risk will also fall.
- If reducing detection risk does not result in a reduction in overall audit risk to acceptable levels the auditor should consider declining the appointment or resigning.
- The auditor will also assign more experienced audit team members in the event that audit risk is considered high.
- Throughout the audit, the auditor will concentrate his efforts on risky areas.

ii. Audit risk low:

The auditor will accept the appointment and carry out the work of gathering audit evidence. If the internal controls are sufficient and tested to be operating well throughout the period under review, the auditor may wish to place reliance on the effectiveness of the internal controls and hence reduce the amount of substantive tests carried out.

c) Materiality:

In carrying out his duties and at the planning stage, the auditor usually sets the materiality level. Information is material if its omission or misstatement could influence the economic decisions of users taken on the basis of the financial statements. Materiality depends on the size of the item or error judged in the particular circumstances of its omission or misstatement.

Auditors are concerned as to whether the financial statements are materially misstated such that they can mislead the users. As such the auditors are concerned only with material items. Materiality levels should be set by the auditor at the firm level as well as at the assertion level and is usually determined at the planning stage of the audit. The materiality level is set using experience and professional judgment. Errors or omissions above the materiality level should be investigated and corrected.

Generally the materiality level set will depend on the assessed risk of the client or account balance.

In the event that the risk of material misstatement is considered to be high then the materiality level will be set at a low level such that a lower amount may be considered as material because chances of things going wrong is high.

If on the other hand the risk of material misstatement is considered to be low, the materiality level will be higher.

It should be noted that materiality level set at the planning stage of the audit may be changed during the audit depending on the situation on the ground once the audit is in progress. This will happen when during the audit facts emerge that were not there when the materiality level was set up at the planning stage.

d) Ethical matters that should be considered by the auditor before considering to bid for offering services to Hardtimber Ltd:

Generally it is important that before an audit firm bids to offer audit services to a client all ethical matters should be considered. These are matters that will ensure that the auditor will not in any way breach the fundamental principles which must be adhered to throughout the audit.

In the case of the Hardtimber Ltd bid, the following matters will need to be considered:

- The firm will need to establish that the outgoing auditors were removed from office correctly. This will be done by seeking permission of Hardtimber Ltd to communicate with the outgoing auditors. If permission is denied then the firm should decline or not bid. If on the other hand permission is granted then the firm will write to the outgoing auditors to find out if there are any reasons why they should not accept appointment.
- The firm should ensure that they have the necessary skill and experience to be able to carry out an audit of a client in this industry which will be the first client in this industry.
- The firm should also ensure it has the necessary resources in terms of cash and time to undertake the proposed audit.

- The firm should reconsider the argument that they will offer a job to Dick Jones a former Finance Manager of Hardtimber as the engagement partner will pose ethical issues. Guidance states that at least two years must elapse before a former senior manager such as Dick can go and audit a company he worked for. This situation will result in a self review and self interest threat and that Dick may not be objective in the carrying out of his audit work.
- The intended recruitment of senior staff of the outgoing auditors may not be well accepted by Hardtimber Ltd in view of the fact that the previous auditors were removed largely because of issuing inappropriate audit opinions and in the event that the company sees the same people under a different firm may bring about suspicions in the quality of work carried out.
- The firm should also consider other matters other than the ones detailed above that may hinge on the independence of the firm and the individual audit team members and where there is a threat to the independence of the auditor necessary safeguards must be put in place.
- The firm may wish to check the integrity of management and those charged with governance. This could be done by obtaining references about management if not well known by the auditor.

e) Audit reports:

i. Forms of modifications:

ISA 705 *Modifications to the opinion in the independent auditor's report* provides guidance with regards to modifications. Modification of the opinion is given when the auditor has an issue of concern and as such cannot conclude and state that the financial statements show a true and fair view.

Generally the auditor will issue a modified audit opinion when he concludes that the financial statements as a whole are not free from material misstatements or the auditor is unable to obtain sufficient appropriate audit evidence to enable him conclude that the financial statements are fee from material misstatements.

Depending in the materiality and pervasiveness of the matter of concern, the auditor will issue any one of the three forms of modifications stated below:

A qualified opinion:

Generally there are two situations that could lead to a qualified opinion namely:

- Where the misstatement is material but not pervasive to the financial statements and
- Where the auditor is unable to obtain sufficient appropriate audit evidence and the effect may be material but not pervasive to the financial statements.

Not pervasive to the financial statements means that the financial statements will not be misleading to the users.

The modification takes the form of 'Except for'

An adverse opinion:

This is the worst form of opinion in that the auditor states that the financial statements do not show a true and fair view. In this case the auditor obtains sufficient and appropriate audit evidence upon which he bases his opinion. An adverse opinion will be issued in the situation where the matter in question is both material and pervasive to the financial statements.

The modification takes the form that 'the financial statements do not show a true and fair view'

A disclaimer of opinion:

In this situation the auditor is not in a position to form an opinion and this could be because of any of the following:

- The auditor has not obtained sufficient appropriate audit evidence to enable him firm an opinion and that the possible effect on the financial statements could be both material and pervasive to the financial statements.

This form of modification takes the form that 'we have not been able to obtain sufficient appropriate audit evidence to provide a basis for an audit opinion. Accordingly we do not express an opinion on the financial statements'.

ii. **Other matter paragraph**:

ISA 706 *Emphasis of matter paragraphs and other matter paragraphs in the independent auditor's report* provides guidance in this area.

This is a paragraph included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements but which in the opinion and judgment of the auditor the matters are relevant to the user's understanding of the audit, the responsibilities of the auditor or the auditor's report.

This paragraph in included in the audit report after the opinion paragraph and after the emphasis of matter paragraph. The paragraph should clearly state that the other matter is not required to be presented or disclosed in the financial statements.

SOLUTION TWO:

a) Published financial statements are used by various stakeholders for various reasons. Investors for example make their investment decisions based on information that is contained in the financial statements. It is important, therefore, that the financial statements that are issued can be relied upon.

The accounting profession has put in place various mechanisms which will help in increasing the reliability and hence credibility of the financial statements. Through the guidelines given by the IASs and the ISAs, the preparers of financial statements and the auditors are given guidelines which must be flowed uniformly by all and thereby reducing the subjectivity and increasing the reliability of the financial statements.

International Accounting Standards(IAS/IFRS):

Have been developed by the International Federation of Accountants (IFAC) and are followed by most of the world accounting bodies including the Zambia Institute of Accountants. All accountants who are members of ZICA are expected to follow the provisions of these accounting standards. Accounting standards deal with specific areas of controversy and are a guide to the preparers of financial statements on how they should deal with specific areas. In this way there is uniformity in the profession and reduce subjectivity whereby each prepare treats the same item differently.

International Standards on Auditing(ISA):

These are standards that are issued by the International Federation of Accountants and just like the International Accounting Standards are supposed to be followed by all members of professional bodies regulating accountants.

These standards are meant to guide auditors on how they should perform their work as regards specific areas. This means that all auditors will use the same methods in auditing specific areas and hence increasing the credibility of the financial statements. The auditors will form an opinion on the financial statements that have been audited to the level required by relevant statements on auditing.

b) The importance of ZICA seminars for members:

Accountants belong to a professional body which means that they are experts in this field. There are fundamental principles which must be followed by the members of the accounting profession whether students or members.

One of the fundamental principles is that of Professional competence and due care. This is to ensure that clients or employers of the members of the profession receive competent professional services based on current developments in practice, legislation and techniques.

In order to meet the above requirement, members among other matters obtain the necessary qualifications to be admitted into membership. Post qualification, it is necessary that the members are updated on the latest developments in the profession and it is for this reason that ZICA being the regulator of the accountants does from time to time organize seminars at which specific matters are dealt with.

Members are expected to attend such meetings and they need to attain a certain minimum number of hours doing relevant work and attending seminars such as those organized. Annually members are required to submit returns to ZICA to confirm that they have met this requirement.

c) Regulation of auditors by ZICA:

The Companies Act 1994 provides that ZICA is the sole regulator of auditors in that only auditors with a practicing certificate issued by ZICA may practice. The purpose of having accountants and auditors regulated is to ensure that they perform work that is of the highest standard and in compliance with legislation and other regulation. In this way the reports issued by the auditors can be relied upon by users of financial statements.

How regulation is carried out by ZICA:

- The institute issues annual Practicing certificates to firms wishing to practice as auditors and it is only firms with valid certificates that are allowed to practice.
- The certificates are issued only to firms that meet the necessary criteria.
- The institute has power under the Accountants Act of 2008 paragraph 23 to cancel a practicing certificate if the practitioner fails to meet the conditions or is found guilty o professional misconduct, convicted of an offence involving dishonesty, is declared of unsound mind, is an undercharged bankrupt or obtained the certificate through fraud, misrepresentation or concealment of a material fact.
- The institute can displine any member of the audit firm who is in breach of any legal or regulatory rules under the companies act or accountants act. The institute is able to achieve this through the legal requirements that all accountants working in Zambia must be members of ZICA.
- The institute can inspect and review the work of the auditor to establish whether the audits have been carried out in accordance with the international statements on auditing.

d) The Objectivity of the auditor and auditor independence:

One of the fundamental principles of the accountants is that they should observe integrity and objectivity in the performance of their work. The auditors should not be biased and influenced by others in making decisions and carrying out their work.

There is a debate concerning the issue of offering non audit services to audit assurance clients by audit firms. There is increasing concern that this affects the objectivity of the audit firm. An audit assurance is an engagement whereby the auditor gives positive assurance that the financial statements show a true and fair view. At the moment there are no regulations prohibiting audit firms from offering other services to their audit clients in Zambia.

Arguments for offering none audit services to assurance engagement clients:

- Clients will receive a whole range of services from the same firm of auditors rather than engage other firms to offer other services.

- It is argued that the auditing firm will have gained a lot of knowledge and experience about the client and hence be in a better position to give other services.
- The firm may negotiate reduced fees if the same firm offers both audit and non audit services.
- Client information, some of which is confidential, is disclosed only to one firm.
- The objectivity of the auditor is not affected by other services offered because accountants are professionals and they are expected to act professionally. Further, the use of Chinese wall can be implemented so that different teams carry out the other services and a different team undertakes the assurance engagement.

Arguments against offering other services to audit assurance clients:

- Clients may accept high fees for other services with a view to influence the auditors when carrying out their audit. This may be with a view to influence the opinion of the auditor.
- This results in higher fees being paid by the client as they have to negotiate fees with different practitioners.
- Client information is disclosed to more firms than is necessary. With increased competition clients prefer to disclose confidential information only to limited people or entities.
- The fees for other services may be material and may be reason for lack of objectivity of the auditor as they may not wish to lose a client from whom they earn substantial income.
- Auditors should not rely on one client and income from one client should not exceed the thresholds of 10% or 15% and not offering other services will ensure that the firm does not breach this requirement. The fear is that if the firm gets substantial income from one client their objectivity will be impaired.
- Because auditors will be independent in all aspects there will be objectivity in the carrying out of the audit work and this should in the long term translate in less companies failing.

<u>SOLUTION THREE:</u>

a) Suggestion by Mutinta that only tests of control should be carried out:

In an assurance engagement, the auditor is making a positive assurance and generally this means that he has to carry out substantial amount of work to support the opinion that he will make. This means that the auditor is required to carry out substantive audit procedures which must be evidenced in the working papers.

In carrying out his work the auditor may wish to place reliance on the internal controls that are put in place by management. Placing reliance could result in the auditor carrying out less detailed tests than if he did not place any reliance on the controls.

If the auditor intends to place reliance on the internal controls of the client in carrying out his work, he needs to test the said controls and obtain assurance that they are operating throughout the period under review. Usually in testing controls the amount of transactions tested is small as the objective is merely to confirm that the controls are operating as recorded.

The suggestion made by Mutinta cannot, therefore, be accepted as a way of carrying out the work of auditing Chemicalclean within the tight timetable.

The auditors should carry out substantive audit tests and in accepting any appointment the auditors will among other matters wish to gain an understanding of the timetable of the client in making the decision to accept appointment. Auditors should not use any shortcuts in arriving at their opinion and should carry out all the work necessary to enable them make an appropriate audit opinion. The firm may need to consider increasing the audit team but they should not overlook the related costs of such a measure.

b) Financial statement assertions:

Financial statement assertions can be described as strong statements that are made by management through the figures contained in the financial statements. These are generally classified into three categories namely assertions about transactions, assertions about account balances and assertions about disclosure and presentation.

For example using account balances assertions for a given set of financial statements, by including a figure of say K210 billion under inventory, management is making a number of assertions about this figure such as the assertion of existence meaning that the related inventory actually exists and rights and ownership meaning that the said inventory rightly belongs to the company that has included the figure in its statement of financial position.

Relevance of financial statement assertions to the auditor:

In carrying out his audit the auditor is merely testing the assertions made by management to establish whether they hold true. The auditor will develop his audit procedures bearing in mind the assertions being made by management in the figures and notes contained in the financial statements.

c) Financial statements pertaining to the figures in extract income statements:

1) Sales revenue K9.2 billion:

Assertion of cut off – this means that the sales have been recorded in the correct financial period. In other words the sales for the period to 31 March are recorded in the financial statements for the year ended 31 March 2011 and sales beginning 1 April are correctly recorded in the following financial period.

Audit procedures to test cut off:

- Obtain details of the last documents issued at the period end. This will usually be done during the inventory count i.e. last invoice number, last GRN number and last delivery note number.
- For a sample of sales invoices raised after the period end ensure that they relate to the subsequent accounting period.
- For a sample of sales invoices on the last day of the year compare with the delivery note to ensure dispatched during the year under review.
- For a sample of sales returns after the period end, examine the documentation and trace them to the related sales that were made.

- Review after date adjustments and ensure that they recorded correctly in the relevant financial period.

2) Opening inventory K2.3 billion

Financial statement assertion of accuracy – This figure will have been the closing inventory figure for the previous accounting period. The main assertion relating to this figure s that of accuracy meaning that the figure is the correct one brought forward from the previous financial period for the year ended 31 March 2010.

Audit procedures to test the assertion of accuracy:

- Agree the figure of K2.3 billion to the previous year working papers.
- Agree the figure to the brought forward figure for inventory in the general ledger control account.

3) Purchases K3.2billion

Financial statement assertion of occurrence – is the assertion that the transactions that have been recorded have occurred and pertain to the entity.

Audit procedures to test the assertion of occurrence:

- For a sample of payments made for goods/services purchased trace to relevant goods received documents.
- For a sample of GRNs trace and follow to the supplier invoices and the book of original entry.
- For a sample of purchases examine the supplier invoices and confirm in the name of the client.

4) Closing inventory K3.1billion

Assertion of existence – this means that the goods represented by the figure in the financial statements actually existed as at the period end.

Audit procedures to audit the existence assertion:

- Observe the physical inventory count conducted by the client.
- Ensure the count conducted in a manner that can be relied upon as a basis for inventory valuation at period end.
- Confirm any inventory held by third parties by obtaining confirmation from third parties.

Assertion of rights and obligations of inventory – meaning that the entity has a right and owns the inventory represented by the figure in the statement of financial position.

Audit procedures to audit the assertion of rights and obligations:

- Verify and ensure that inventory held for third parties not included in the inventory computation.
- Ensure that inventory sold and not dispatched excluded from inventory.
- Confirm that inventory held at third party locations is included in the year end inventory figure by reviewing the inventory listing.

Assertion of completeness of inventory – meaning that the inventory figure includes all inventory held at the period end.

Audit procedures to test completeness assertion:

- Complete the disclosure checklist to ensure that all disclosure relevant to inventory have been made.
- Trace the test counts conducted when witnessing inventory count to the detailed inventory listing.
- For inventory held by third parties ensure inventory included in final inventory by following confirmation to final inventory records.

Assertion of valuation and allocation – meaning that the inventory held in stock at the period has been valued in accordance with the accounting standards and appropriately allocated.

Audit tests to test the assertion of valuation and allocation:

- Obtain listing of inventory and agree to general ledger balance.
- Cast (add) the inventory listing to ensure that it is mathematically correct.
- For a sample of inventory items, vouch the supplier invoices to ensure inventory correctly valued.
- Confirm that an appropriate method of valuation is being used by discussing with management(e.g. FIFO or cost)
- Enquire from management of slow moving and obsolete items and ensure appropriate write down made where necessary.

Assertion of cut off – this means that the entity has recorded inventory in the correct accounting period at the period end.

Audit procedures to test cut off:

- Obtain details of the last Goods Delivery Notes (GDN) and Goods Received Notes (GRN) during the inventory count.
- For a sample of goods received and dispatched before and after the period end ensure recorded in the correct accounting period.

Assertion of accuracy – Meaning that the inventory figure has been correctly computed.

Audit procedures to test the assertion of accuracy:

- Obtain a copy of the inventory listing and cast it to ensure it is correct and check the extensions of quantity multiplied by the price.
- Trace the test counts to the inventory listing
- Ensure that the entity adjusts the general ledger to reflect the value of inventory at period end.

5) **Government grant K400 million**

Assertion of accuracy – meaning that the figure shown in the income statement is the correct amount that must be reflected.

Audit procedures to test assertion of accuracy:

- Review the conditions attached to the grant by reading any documentation from government.
- Ensure grant appropriately classified as revenue or capital grant.
- Review appropriateness of policy adopted by management on the treatment of the grant i.e. treated as a deferred credit or otherwise.
- Ensure all grant conditions are met through discussions with management.

6) **Interest cost K90 million**

Financial statement assertion of accuracy /completeness- That the amount of K90 million being the interest for the year is accurately calculated.

Audit procedures to test the assertion of accuracy of the interest cost figure:

- Inquire from management the basis upon which interest has been incurred.
- Obtain relevant documents relating to the loan agreement and ensure conditions met.
- Recalculate the amount of interest charged in accordance with the agreement.
- Ensure that any interest not paid but due at the period end accrued and included in the interest cost amount.
- Obtain management representation that all interest chargeable has been included.

7) **Taxation K1.2billion**

Financial statement assertion of accuracy – That the figure of K1.2billion is a reasonable estimate of the tax liability at the period end.

Audit procedures to audit the assertion of accuracy of the tax figure:

- Review the tax computations to ensure that provisional tax computed in accordance with the relevant tax rules.
- Review previous year tax estimates and compare with final tax assessment to determine the accuracy of management estimates.
- Review the post year payments of tax liability these will help determine the accuracy of the liability at the period end.

8) **Depreciation of plant and equipment K150 million**

Assertion of accuracy of the figure of depreciation – meaning that the figure included in the income statement has been correctly computed and is the correct charge for current year depreciation for plant and equipment.

Audit procedures for testing the assertion of accuracy of the depreciation figure:

- Ensure consistence of depreciation method used by the client.
- Confirm opening balances of the cost and related depreciation for plant and machinery to previous year working papers.
- Recalculate the depreciation charge using the appropriate rates and agree to figure in the relevant general ledger account.

9) **Loss on disposal of motor vehicles:**

Assertions of accuracy and completeness – this means that the figure of K20million being loss on disposal of motor vehicles has been correctly computed and includes all losses for all vehicles disposed of.

Audit procedures on loss on disposal of motor vehicles:

- Confirm all disposals have been authorized per company policy.
- Obtain from management details of all disposals of motor vehicles that have been made during the year under review.
- Recalculate the profit or loss for all vehicles sold.
  - Cost has been removed from the relevant general ledger account.
  - Related accumulated depreciation has also been removed and transferred to disposal account.
  - Confirm the cash received for the disposal by inspecting receipt documents.
  - Recompute the calculations and ensure all profits or losses included as appropriate.
  - The non current asset register has been updated for both the cost and accumulated depreciation for the motor vehicles disposed of.

<u>SOLUTION FOUR</u>

a) The board of directors is responsible for the running of the company through management. It is a supervisory body which is responsible for the success of the company. Corporate governance explains how companies are directed and run.

In response to the increase in corporate failures there is increasing regulation and guidance on best practice as regards how organizations should be run as well as the role of the board of directors. Generally the board should comprise a mixture of executive and non executive directors and should be well balanced in this regard. The non executive directors are expected to bring independent minds into the running of the company.

Composition of the board of Hung Kong Ltd:

Chang Li – Is currently the chief executive of the company as managing director. The recommendation that he should also be the chairman of the board of directors of Hung Kong Ltd is contrary to guidance on good corporate governance. It is recommended that the position of chief executive and chairman of the board should not be held by the same person. The role of the board is to supervise management and therefore having Chang as both board chairman and chief executive means that Chang will be monitoring his own performance and it is unlikely that he will be objective in his role as board chairman. Another name should be floated to take the role of chairman and Chang continues as chief executive. The compromise might be that Chang vacates and resigns as chief executive and then takes up the role of board chairman.

Andrew Nyirenda – Is currently the Human Resources Manager and there is no law that prohibits Andrew from sitting on the board of directors. It should, however, be noted that Andrew is an executive board member and he will not posses the objectivity that independent non executive board members bring to the board of directors.

John King – It is common that the Finance Director of any company will also sit on the board of directors as an executive board member. The Finance Director will help the rest of the board on any issues relating to the financial statements that the board may be concerned with. Just like Andrew Nyirenda the Finance Director will not be entirely objective in deliberations in the board in the sense that it is the financial statements prepared by that are prepared by him that will be under board scrutiny.

The problem comes in on the proposal that he chairs the audit committee. Good practice recommends that the audit committee should comprise non executive directors one of whom should have knowledge of finance. The audit committee reviews the financial statements and as in most organizations the internal audit department reports to the audit committee. This will not work well with John being the chairman of the audit committee as he is the one responsible for all matters relating to financial statements in his capacity as Finance Director. Another board member from among the non executive board members should take up this role.

Bruce Jung – It appears he will not contribute much to the board in view of the fact that he is relatively new and his understanding of English is poor. In the absence of the interpreter for any reason he will not benefit anything from the board deliberations and the board will also not benefit from his being a board member. He too is an executive board member who will not bring with him independent views on the operations of the company.

Prince Kadoli has no connections with Hung Kong Ltd other than the fact that he is a board member. He is the only non executive board member in the proposed board. Even if he runs business in an industry not related to Hung Kong's business, he may bring to bear and for the benefit of Hung Kong Ltd expertise in successfully running business.

One would question the motive of proposing him as a board member on the basis that he has the 'right' connections in government. Board members should be appointed on the basis of experience and knowledge that they will bring.

Conclusion:

Of the five proposed board members only one can be considered to be an independent non executive board member. This board will therefore not be balanced and it would be necessary to bring on board other board members who will serve as independent board members. The proposed composition will result in an ineffective board not in the interest of shareholders and other stakeholders.

b) Reliance on work of internal audit:

The internal audit department is one of the controls that are put in place by boards of most large and listed companies. The statutory auditors can place reliance on the work of the internal audit department depending on their assessment of the internal auditor's effectiveness. In placing reliance on the work of internal audit, the statutory auditors may reduce the amount of work they will carry out and thus reducing the total audit cost for the benefit of the client.

The statutory auditors may also request the internal auditors to attend inventory count on their behalf in areas where they have not been able to attend.

Matters to consider before placing reliance on work of internal audit dept of Hung Kong Ltd

Using the facts given in the scenario the following matters will be considered:

The technical competence of the internal audit team members:

The head of the internal audit department is James Phiri who is a ZICA technician certificate holder. James will not have studied any auditing during his earlier studies and this brings into question his understanding of the role and work of internal audit department. Further, none of the other audit team members is professionally qualified. It should be observed however that there is no requirement that internal auditors are qualified professional accountants but this is a good basis for assessing whether or not to rely on the work of internal audit department.

The independence of the internal audit team and reporting:

Internal auditors are employees of the entity and therefore lack the independence that the statutory auditors posses. Corporate governance guidance provides that in order to give the internal auditors some independence and hence objectivity they should report to the audit committee. Currently James and the internal audit department report to John and can only release reports on clearance from John. John being the Finance Director may dictate the work of internal audit and hence bring into doubt the reports of internal audit. With the proposal that John should be the chairman of the audit committee it brings more doubt on the quality of the work that internal audit department will do.

Management's reaction to internal audit reports:

If management implements the recommendations made by the internal audit department this will be a factor to the statutory auditors in deciding whether or not to rely on the work carried out by the department.

The quality of internal audit working papers and reports:

If internal audit has in place systems and maintains working papers for all its work the statutory auditor is more likely to place reliance on the work carried out by them. The audit reports produced by the internal audit department must be based on well documented evidence which can be verified.

How reliance on Hung Kong Ltd Internal audit may be applied:

If the firm concludes that the work of internal audit department can be relied upon, the firm may reduce the extent of the substantive testing to be carried out. Further, the firm may rely on the work of internal audit in carrying out certain work such as ensuring perpetual inventory work is carried out per company regulations or having internal auditors attend inventory count in locations not visited by the statutory auditors.

c) Independent non executive directors:

These are members of the board of directors who have no other connections with the company except that of being board members.

In the case at hand Prince Kadoli is an independent non executive director. Non executive board members are differentiated from executive board members in that they do not take part in the day to day running of the company whereas executive board members are actively involved in the running of the company.

Importance of non executive board members:

Because of their independence from the company, they bring an independent mind in monitoring the effectiveness of the executive management. They will normally have no interest and will be objective in terms of matters that are brought before the board. They will hold the executive management responsible for running the company. In this way it is hoped that no matters will be swept under the carpet and not actioned or considered by the board.

<u>SOLUTION FIVE</u>

a) Written representations – During the course of auditing auditors do obtain representations on certain matters from the management. Management representations form part of the evidence that is obtained by the auditor and forms part of the working papers.

ISA 580 *Written representations* gives guidance in this area. The standard gives instances where the auditor is expected to obtain such representations from management.

The following are the instances where the standard as a matter of routine requires auditors to obtain written representations.

Representations about management's responsibilities including:

- That the client management has fulfilled its responsibility for the preparation of the financial statements as agreed in the engagement letter and that the

financial statements have been prepared and presented according to the applicable financial reporting framework.

- Representations that management has provided the auditor with all relevant information agreed in the terms of the engagement and that all transactions have been recorded and are reflected in the financial statements.

Other written representations:

The ISA states that representations may be obtained covering the following matters:

- That the selection and application of accounting policies adopted by the entity are appropriate.
- Representations about any liabilities both actual and contingent.
- Representations about title to or control over assets, liens or encumbrances on assets or assets that have been pledged as collateral by the client company.
- Representations regarding aspects of laws, regulations and contractual agreements that may affect the financial statements including non compliance with such laws or regulations.
- Representations about any deficiencies in internal control that management is aware of and that they have been communicated to the auditor.
- Representations about significant assumptions used in making accounting estimates and that they are reasonable.
- Representations that all subsequent events requiring adjustment or disclosure have been duly adjusted or disclosed.
- Representations that management has disclosed the results of its assessment of the risk that the financial statements may be misstated as a result of fraud.
- Acknowledgement from management that it has provided the auditor with all relevant information agreed in terms of the audit engagement.
- Management has disclosed all information in relation to fraud or suspected fraud involving management, employees with significant roles in internal control and others where fraud could have a material effect on the financial statements.
- Management has disclosed all information in relation to allegations of fraud or suspected fraud communicated by employees, former employees, analysts, regulators and others.
- That management has disclosed all instances of non compliance or suspected non compliance with laws or regulations.

b) Composition of the audit team

i. Appointment of audit manager

If the firm is going to give an appropriate audit opinion it is important that all ethical matters are considered and adhered to. My appointment to be the audit manager of a client for whom I have recently worked for is inappropriate in that I will not be objective in the performance of my duties. I have just left the employment of Precious Stones and my first assignment is to be the audit manager for this company. Having held the senior position of Finance Manager at Precious Stones, most of the systems and the financial statements to be audited would have been prepared under my supervision. I will therefore be expected to review my own work resulting in a self review threat to my independence. Further, I am familiar with most of the staff of Precious Stones and this gives rise to a familiarity threat.

It is therefore not appropriate that I am put in charge of this audit. I would suggest to the partner that a manager who has no connections with Precious Stones be assigned this job and I am put in charge of another assignment where I have no connections that give rise to a threat of my independence.

Matters to consider in setting up audit team:

- Ensure that all proposed team members comply with the ethical requirements such as that of being independent of the client.
- The experience of the team members will be considered and team members with experience will work hand in hand with less experienced team members.
- Availability of audit team members considering other assignments that they may be involved in and that may collide with the current audit.

ii. Audit teams to carry out specific assignments are established from among the staff in the office. These are not permanent teams and audit staff may be changed and belong to other teams in future.

A typical audit team will comprise the following depending on the nature and size of the assignment:

- An engagement partner who is in charge and responsible for the assignment.
- An audit manager who will be more involved in the carrying out of the audit.
- One or more audit seniors depending on the size of the assignment.
- Audit assistants who will work under the supervision of the audit seniors and the number will depend on the amount of work or size of the assignment.

c) Quality control in the audit firm:

Quality control is important in the carrying out of an audit because it ensures that the work carried out is in accordance with auditing standards and the evidence gathered can be relied upon as a basis upon which the audit opinion will be arrived at.

i. Quality control at the firm level:

Quality control at this level is at a higher level than at the individual audit level. It involves any measures that are put in place by the firm to ensure that all work carried out meets the required standard and will include the following:

- Peer reviews may be carried out involving staff from different offices of the firm and review selected audit working papers.
- Review of the work carried out by an audit team by another member such as partner who was not involved in the audit work in the same office.
- Review of work carried out by an audit team by another partner of a different office for example a Kitwe partner reviewing work carried out by the Lusaka Office.
- The existence of a quality control manual applicable to all offices which is also updated as situations change.
- Holding combined quality control meetings on a regular basis at the firm level.
- Quality should be considered so important at the firm level such that a quality champion should be appointed so that he oversees quality in the firm.
- At the entity level the firm will ensure they recruit staff with requisite experience and the entity will ensure they maintain ongoing excellence through continuing professional development and coaching by more experienced staff.
- Staff with sufficient capabilities should be assigned to jobs.

ii. Quality control at the individual audit level of Precious Stones Ltd:

Quality control is so important that it should be observed throughout the carrying out of individual audits such as the one for Precious Stones and quality controls at this level will include the following:

- Holding pre audit meetings at which matters relating to quality are discussed by all audit team members.

- Work carried out by one level of team members reviewed by the supervisor and the review evidenced in writing.
- Audit working papers being reviewed by in independent auditor who was not involved in the audit.
- Having a quality control checklist for each assignment and ensuring that it is duly completed to avoid any omissions.
- The engagement partner should ensure that members of the engagement team comply with the ethical requirements.
- There should be procedures in place for consultations in case of difficult and contentious matters. Any differences should be resolved according to the firm's policy for such differences of opinion.

End of paper