CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P4: AUDIT AND ASSURANCE SERVICES

THURSDAY 19 JUNE 2014

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

INSTRUCTIONS TO CANDIDATES

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

2. This paper is divided into TWO sections:

   Section A: One (1) compulsory question.

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

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

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

5. 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.

(a) Your firm of Chartered Accountants is the auditor of Kaleya Insurance Ltd. Kaleya Ltd is in the financial services industry and is regulated by the Insurance Control Board and subject to the Insurance Services Act which stipulates the accounting requirements of the companies in this industry.

Kaleya Ltd prepares financial statements annually to 31 December and the company complies with the International Financial Reporting Standards. Kaleya Ltd holds its Annual General Meeting every year, two months after the period end. Auditors are appointed for a term of three years and your firm was appointed auditor at the last Annual General Meeting.

Required:

Using the above information, describe the elements of an assurance engagement such as the one, your firm has got into with Kaleya Ltd. (10 marks)

(b) Auditors are required to obtain sufficient appropriate audit evidence which will form the basis of their opinion. If the auditors have a matter of concern which they fail to resolve and agree with management, they issue an unmodified audit opinion with an Emphasis of Matter paragraph.

(i) Discuss the above statement. (6 marks)

(ii) Distinguish between an Emphasis of Matter paragraph and any other matters paragraph in an auditor's report. (4 marks)

(c) ISA 315 *Identifying and Assessing the Risks of Material Misstatements through Understanding the Entity and its Environment* requires the auditor to perform risk assessment procedures which include obtaining an understanding of the entity and its environment, including its internal controls.

Your firm of Chartered Accountants is the auditor of Efficient Electronics (EE) Plc. and you are the audit manager in charge of this audit. EE Plc has been your audit client for many years and you are now planning for the forthcoming audit.

The following information relates to EE Plc:

EE Plc is an electronics company which has been in existence for many years. It is a locally owned and listed company, which is in the manufacture of television sets. For many years this company has been protected from competition by the government imposing heavy taxes on imported television sets.

EE Plc sells its sets through a network of stores selling under franchise and located in all provincial headquarters. The last few years have seen a rapid increase in sales of television sets largely because of the increase in solar power usage throughout the country. In response to this increase in demand and the prospects of exports to a

neighboring country, EE Plc has trebled production in the last two years and currently has two years' stock of television sets.

There is a global agreement that all countries should migrate from analogue television to digital television by the end of 2015. The effect of this change is that only television sets which have in built digital tuners will be able to receive the digital satellite signal. All television sets that do not have an inbuilt tuner will require that a set top box convertor be fitted to enable the set to receive the signal.

The television sets manufactured by EE Plc have no provision for the convertor to be fitted. Management are concerned that they have a large stock of unconvertible televisions sets which they do not know what to do with.

The following events have taken place in the recent past:

The government has removed duty on all digital satellite compliant televisions sets. This is because there is currently no local manufacturer of such sets.

The demand for non-compliant sets such as those manufactured by EE Plc has reduced in the last few months and is expected to reduce further as the deadline for migration approaches.

Management of EE Plc has gone on an aggressive advertising campaign and has reduced the selling price of their sets by 20%. They have gone further to sell large numbers of sets on a consignment basis to the provincial outlets with the hope that stock levels of non-compliant sets will drop. In the financial statements EE Plc is treating the sets sent on consignment as sales even though there is a provision that sets may be returned if not sold after three months.

There is new legislation that has been passed by the government requiring companies to implement minimum wages for staff. This has further exerted pressure on the poor cash flow position of EE Plc. The company has decided to shed off staff and offer separation packages in the following year. At the end of the year under review, a provision for redundancy pay has been made based on old salaries of employees.

A board decision has been made by EE Plc board that the company immediately switches from manufacturing non-compliant sets to manufacturing sets with built in tuners. Consultants have advised that this will require fresh investment in equipment and most of the existing equipment will be redundant as it cannot be used in the manufacture of compliant sets.

EE Plc will require obtaining a long term loan to enable it purchase the necessary equipment in order to commence production of compliant sets. The company has an existing loan which is due for repayment in two years' time. This loan is secured by a fixed charge on the buildings where the company is situated. In the event that the company fails to settle the debt on the due date, the lender is likely to enforce the charge.

EE Plc has substantial sum in receivables because it was selling the sets on 30 days credit to the outlets. In view of the reduced demand in the sets, the outlets are not able to settle their debts on the agreed dates.

Required:

(i) Define a 'significant risk' and list six (6) factors which could indicate that a risk might be significant. (4 Marks)

(ii) Identify and describe four (4) risks in EE Plc that you identify as you plan the audit. (8 Marks)

(iii) Relate the risks identified in (ii) above to their related financial statements assertion in the financial statements. (4 Marks)

(iv) State the audit procedures that you will undertake for each of the risks identified. (4 Marks)

(Total: 40 Marks)

SECTION B

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

QUESTION TWO

(a) Auditors base their opinion on the conclusions arrived at from the evidence that they gather during the audit. Evidence is gathered in various ways with most of the evidence being obtained directly by the auditor through various audit procedures that are conducted. Auditors also obtain management representations in certain situations and these become part of the evidence in arriving at an audit opinion.

Auditors carry out audits of the financial statements of many different companies in different industries. They sometimes use the services of experts to gather sufficient appropriate audit evidence.

Required:

(i) Discuss the meaning of management representations and list six (6) items that could be included in a management representation letter. (5 Marks)

(iii) Distinguish between management experts and auditor experts, stating clearly the extent of the auditor expert's responsibility over the audit opinion. (5 Marks)

(b) Tweende Buses is a transport company that has grown rapidly over the last few years. It has achieved fast growth through acquiring its buses through finance leases offered by one of its bankers. Tweende Buses is your audit client and you are the audit senior in your firm. You are reviewing the working papers on tangible non current assets for the year ended 31 March 2013.

Included in the total of non -current assets is a figure of K314.0m relating to finance lease assets. During the year, there have been additions amounting to K24.0m relating to buses acquired on a finance lease.

The statement of comprehensive income includes a charge for finance costs relating to the finance leases of K5m. The total assets of Tweende Buses at the year-end amounted to K985m, the profit after tax for the year is K26.85m.

Required:

(i) Comment on the matters that you should consider in respect of the audit of finance lease assets and expenses. (4 Marks)

(ii) State the audit evidence you should obtain to verify the figure of finance lease assets in the financial statements of Tweende Buses Ltd. (6 Marks)

(Total: 20 Marks)

QUESTION THREE

(a) Your firm of Chartered Accountants has just put in place quality control policies and procedures. You have been appointed to be in charge of quality for all audits carried out.

The audit of the financial statements of Magoye Ltd for the year ended 31 April 2014 is under way. As part of your new role of Quality Control Manager, you visit the audit team and reviewed the working papers.

You observed the following matters from your review:

- There is no record on file to show that a pre audit meeting was held with the engagement partner before the commencement of the audit. You establish from the audit senior that the partner was on leave at the commencement of the audit and he sent an e-mail that the audit should commence and a meeting would be held on his return from leave. To the date of your visit, no meeting had been held.

- Sharon is the Accountant in charge of the audit and she is leading a team of three audit assistants. One of the audit assistants has been on this audit previously but the other two are newly recruited trainees. The Accountant in charge was absent during your visit and you were informed that she only spends a few hours daily at this client. A review of the time sheets for the Accountant in charge shows that she is busy on another assignment and she spends more time at this other client.

- She has delegated supervision of the audit to the experienced assistant and requested him to report any problems to her.

- The audit is nearing completion and there is no evidence of work done having been reviewed. On enquiry from the Accountant in Charge, she informs you that

she is aware that the work needs to be reviewed and that she only needs to spend a day to review the work done and then she will pass on the working papers to the Audit Manager for further review.

- The experienced audit assistant was responsible for ensuring that inventory valuation was carried out in line with the accounting standards. He was not clear with the valuation of work in progress and the amount involved is material. His efforts to get the involvement of the Accountant in Charge failed as she kept saying that she was busy and would resolve the matter later. Towards the end of the audit, the Accountant in Charge could not resolve this matter and decided to refer the matter to the Audit Manager. The Audit Manager was on leave and stated that, he would not like to cut short his leave and asked the Accountant in Charge to conclude and that she should not bring this matter to the attention of the Engagement Partner.

Required:

Identify and comment on the implications of your findings on the quality control policies and procedures of your firm. (10 Marks)

(b) Auditors obtain audit evidence through various means. One way in which auditors obtain audit evidence is through obtaining third party confirmations.

You have been requested to make a presentation at a training workshop for newly recruited audit assistants. The majority of these have no practical audit experience.

Required:

(i) Explain four (4) financial statement assertions that are tested through third party confirmations. (4 Marks)

(ii) State six (6) situations where external confirmations by the auditor are appropriate. (6 Marks)

(Total: 20 Marks)

QUESTION FOUR

(a) Transnational audits are audits of financial statements which may be relied upon outside an entity's home jurisdiction. This could be for purposes of lending, investment or regulatory decisions.

Required:

Discuss three (3) features of a transnational audit that may constitute a high level of audit risk in such an engagement. (6 marks)

(b) You are one of the audit managers in your firm of Chartered Accountants. In addition to your current duties, you have been given additional responsibilities of being in charge of quality matters in your firm. This includes ensuring that ethical issues are addressed in all the audits carried out by your firm.

In a meeting with other audit managers on three audits, a number of ethical matters were discussed as follows:

1. Kafubu Ltd is one of your recently acquired clients. Kafubu is a coal mining company and this is the first time your firm is auditing a company in this industry. Chibwe joined your firm as audit senior two years ago and he previously worked for Kafubu Ltd as Chief Financial Officer for five years.

   The Managing Director of Kafubu Ltd is Chisanga who is the father to Chibwe and in order to comply with ethical guidelines, your firm appointed Chitalu to be in charge of the audit as audit senior. Since the audit manager does not spend much time at the client premises, it was decided that Chibwe takes the role of Audit Manager because of his previous experience with Kafubu Ltd.

2. Kaleya Ltd is an old client of your firm. The year-end of Kaleya Ltd is 31 March and the date today is 14 April 2013. Kaleya Ltd is part of a group of companies which has set 20 May 2013 as the final date by which the financial statements of all subsidiary companies should be finalized.

   You have received a letter from the Managing Director of Kaleya Ltd requesting your firm to second one of your audit staff to finalize the preparation of the financial statements in readiness for the audit. The only person available to do this is Chintu who is also going to be the audit senior on this audit.

3. Your firm has been approached to be the auditor of Lunsemfwa Ltd. The outgoing auditors are Goodwill Chartered Accountants whose services have been terminated by Lunsemfwa Ltd at short notice. You have been informed that Lunsemfwa Ltd has called an Extra-Ordinary General Meeting at which your appointment will be ratified. Due to the tight time table for the forthcoming audit, Lunsemfwa Ltd have prepared an engagement letter and the general meeting will simply ratify the appointment.

   Lunsemfwa Ltd has written a letter to Goodwill Chartered Accountants and they have made a copy of the letter available to you for your information. In the letter to Goodwill Chartered Accountants it is stated that the termination of their services will be discussed at the Extra-Ordinary General meeting but Goodwill Chartered Accountants will not be allowed to attend the meeting.

Required:

Identify and evaluate the ethical and other professional issues, in respect of:

(i)	Kafubu Ltd.	(4 marks)
(ii)	Kaleya Ltd	(5 marks)
(iii)	Lunsemfwa Ltd	(5 marks)

(Total: 20 Marks)

QUESTION FIVE

(a) Auditors carry out audits with a view to expressing an opinion on the financial statements. Auditors also carry out other services where the objective is not necessarily to form an opinion on the financial statements. Such assignments include review engagements and due diligence reviews.

In an audit assignment, auditors are required to comply with International Standards on Auditing (ISAs) in order for them to carry out an effective audit.

Required:

i) Explain how International Standards on Auditing help the auditors conduct an efficient and effective audit of the financial statements of a client. (4 Marks)

ii) Explain the benefits of a due diligence review to a company acquiring another. (6 Marks)

(b) Auditors follow a risk based approach in the performance of the audit. This approach ensures that any possible misstatements are identified and dealt with appropriately. For this reason, it is necessary that before carrying out an audit, the auditors assess the risk of material misstatements of the financial statements on work that has been carried out in relation to risk.

Auditors identify risk through understanding the entity and its environment. It is important that the auditors record the work that they carry out in the risk assessment. ISA 330, *The auditor's responses to assessed risks* contains a number of documentation requirements.

Required:

i) Discuss the risk based approach to auditing clearly stating why auditors use this approach. (4 Marks)

ii) In relation to documentation of work carried out by the auditors, state six (6) matters in relation to work carried out during risk assessment that should be documented. (6 Marks)

(Total: 20 Marks)

END OF PAPER

Suggested Solutions –P4

SOLUTION ONE

a) Kaleya Insurance Ltd
Elements of an assurance engagement:

The situation in the scenario qualifies to be an assurance engagement. Assurance comes in the sense that the auditor gives assurance on the financial statements. Generally an assurance engagement has five elements as follows:

A three party relationship:

In the scenario the three parties are the intended users who are the shareholders who appoint the auditor, the responsible party being the Kaleya Insurance who are the ones who prepare the financial statements and the practitioners who are the auditors.

The subject matter:

That is being evaluated in this case are the financial statements which Kaleya prepares annually.

Suitable criteria:

This is the criteria against which the subject matter is evaluated or measured in order to reach an opinion. In the case at hand the criteria are the international reporting standards according to which the financial statements must conform.

Evidence:

Is the basis upon which the auditors arrive at an opinion. They gather the evidence during the interim and final audit visits that they undertake.

An assurance report:

This is the report that the auditor issues at the end of the audit and it forms part of the financial statements which are considered by the company at the annual general meeting.

(10 marks)

b) Evidence:

i. Unresolved issue:

ISA 700 *Forming an opinion and reporting on financial statements* gives guidance on issuing an unmodified opinion. According to the ISA auditors issue an unmodified opinion when the auditor concludes that the financial statements are prepared, in all material respects, in accordance with the applicable financial reporting framework.

Going by the above, an unmodified report will be issued when the auditor does not have a matter of concern. In the case at hand the auditor has a matter of

concern and therefore it would not be appropriate to issue an unmodified opinion.

ISA 705 *Modifications to the opinion in the independent auditor's report* gives guidance when the auditor intends to issue a modified opinion. A modified opinion would have been appropriate in this case.

The form of modification will depend on the materiality and pervasiveness of the matter.

- In the event that the auditor considers the matter to be material but not pervasive to the financial statements, he would issue a qualified opinion.
- If on the other hand the auditor considers the matter to be material and pervasive to the financial statements then he would issue an adverse opinion.

(6 marks)

ii. Emphasis of matter paragraph:

ISA 706 *Emphasis of matter paragraphs and other matter paragraphs* gives guidance in these two paragraphs.

This is a paragraph that is used by the auditor to emphasize a matter that is appropriately treated and disclosed in the financial statements by management but the auditor is of the view that it is so important to the users of financial statements that he should make mention of it. This the auditor does in the emphasis of matter paragraph.

Important to note that introducing this paragraph does not make the report modified. The auditor will need to make reference to where this matter is contained in the financial statements.

Other matter paragraph:

This is a matter included in the auditor's report that refers to a matter other than those presented or disclosed in the financial statements, that in the judgment of the auditor is relevant to the user's understanding of the audit and he considers it necessary to draw the attention of users to that matter.

In the content of this paragraph the auditor should clearly state that the matter is not required to be presented and disclosed in the financial statements. This paragraph does not make the report modified.

(4 marks)

c) Efficient Electronics:

i. Risk:

Significant risks:

A significant risk is an identified and assessed risk of material misstatement that, in the auditor's judgment, requires special audit consideration.

The following factors indicate that a risk might be significant:

- It is a risk of fraud.
- Its relationship with recent economic, accounting or other developments.
- There is a high degree of subjectivity in the related financial information.
- It results from an unusual transaction.
- It results from a significant transaction with a related party.
- The related transaction is very complex.

Marking Key
(1 mark explanation of significant risk = 1)
($^1/_2$ mark for each item x 6 = 3)

(ii/iii/iv) Risks in EE Plc and the related financial statement assertions and audit procedures:

Risk one:

Dealing in electronic goods means that the possibilities of obsolescence are high due to rapid changes in technology. The situation at hand in the scenario is an example of where the entity will have to bear the change in technology.

Financial statement assertion affected:

There is a possibility that inventory at the period end may be misstated. In accordance with IAS 2 Inventories, inventory should be valued at the lower of cost and net realizable value. The net realizable value for the non-compliant television sets is lower than the cost. Management may be inclined to value the inventory at cost so that they show a higher profit.

Audit procedures:

- Obtain the valuation workings for closing inventory and ensure they are in line with the guidance in IAS 2.
- Examine post year-end sales values to determine the accuracy of the net realizable figures used.

Risk two:

There is a risk that inventory may not be accounted for fully. Sets have been sent to the agents on a sale and return agreement such that those that have not been sold for over three months should be returned. This stock belongs to EE Plc and there is a risk that it will be excluded from inventory at the period end.

Financial statement assertion affected:

The valuation of the inventory at the period end will be affected by any items that are excluded from the inventory at the period end.

Audit procedures:

- Review the inventory count instructions to ensure they are adequate as a basis of inventory valuation at the period end.
- Ensure adequate instructions available for dealing with inventory with the outlets.
- Attend the year-end inventory account to ensure it is conducted in accordance with the inventory count instructions.

Risk 3:

EE Plc runs the risk of not being able to finance its operations. The drop in sales due to the fact that the televisions are non-compliant coupled with the reduction in selling prices may mean that the company will not be able to generate sufficient income for its operations.

Financial statement assertion:

The impact of poor cash flow on EE Plc is the going concern assumption. Indicators are that the company has serious operational problems which could affect its ability as a going concern.

Audit procedures:

- Discuss with management how they hope to get out of this problem. Possibly obtain management representation on the future plans that they have to save the company.
- Review management assumption on the fact that the company is a going concern.

Risk four:

There is a risk that EE may treat all transfers to the outlets as sales when the agreement is that any sets not sold within three months may be returned. There is need to have a clear understanding on the accounting for such transfers.

Financial statement assertion:

Sales in the financial statements may be misstated due to sets still being held by the outlets but treated as sales by EE Plc.

Audit procedures:

- Obtain an understanding of the accounting for sets sent on a consignment basis and ensure sales only recognized when the outlets sells to a third party.
- Seek third party confirmation from the outlets to confirm quantity of sets sent on sale and return basis that are still held by the outlet at the period end.
- Confirm with EE Plc that items still being held by the outlets is not treated

Risk five:

The new legislation requiring companies to pay minimum wages means that EE Plc has no option but to comply. The company has decided to lay off some employees and has provided for redundancy pay based on the old salaries. There is a risk that the company will not provide sufficient funds and therefore the charge to the income statement will be less than it should be.

Financial statement assertion:

The figure for provisions is likely to be misstated at the period end due to the use of old salaries in making the provision for redundancy pay.

Audit procedures:

- Discuss with management and find out how they hope to deal with the provision that they have made based on the old salaries.
- Discuss with the legal advisor of the company with the permission of the client and obtain his view.
- Check the computation of the redundancy pay provision for accuracy.

Risk six:

The company has an existing loan which is maturing in two years' time. With the cash flow problems that the company is facing, it is unlikely that it will be able to repay the loan on the due date. The loan is secured with a fixed charge on the buildings and in the event of default, it is likely that the lender will enforce the charge.

Financial statement assertions:

If the lender enforces the charge then it means that the company will cease operations because the buildings will be possessed. This has implications on the going concern assumption of the company.

Audit procedures:

- Obtain and review the loan agreement.
- Discuss with management on how they hope to deal with the situation in view of the deteriorating cash position.

Risk seven:

EE Plc faces the risk of not recovering its debt to the outlets. This is in view that EE extended 30 days credit to its customers and now they too have substantial quantities of sets that cannon sell due to the fact that they are non-compliant. This will worsen the cash flow position of EE Plc.

Financial statement assertion:

The receivables and allowances for receivables figures may be misstated in the financial position.

Audit procedures:

- Circularize receivables at the period end to confirm the balances at the period end.
- Review the age analysis for receivables at the period end and discuss with management the allowances for receivables on old outstanding balances.

Marking Key

(identification and description of risks 2 x 4)

(relating the identified risks to financial assertions in FS, 1 mark each)

(audit procedures for each risk, 1 mark each)

SOLUTION TWO

a) Audit evidence:

i. **Meaning of management representations**:

Auditors receive representations during the audit. Some representations may be unsolicited and in response to specific questions. Some ISAs require than representations be made and given to the auditor.

Representations made by management are part of the audit evidence that the auditor obtains during the course of the audit. Usually it is required to support oral evidence obtained during the audit.

Items that could be included in a management representation:

- Communication to the auditor of all deficiencies in internal control of which management is aware.

- Representations about specific assertions in the financial statements such as the basis for estimating a provision arising from a legal case pending.
- Significant assumptions used by management in making accounting estimates are reasonable.
- Related party relationships and transactions have been appropriately accounted for and disclosed.
- All subsequent events requiring adjustments or disclosure have been appropriately accounted for and disclosed.
- The effects of uncorrected misstatements are immaterial, both individually and in aggregate, and a list of these is attached with the letter.
- Acknowledgement by management of its responsibilities to prepare financial statements.
- Acknowledgement to the auditors that management has provided the auditor with all relevant information agreed in terms of the audit engagement.
- Acknowledgement that all transactions have been recorded and are reflected in the financial statements.
- Appropriateness of selection and application of accounting policies.

Marking Key

(2 marks explanation of management letter)

($^1/_2$ mark for each item x 6 = 3)

ii. **Experts:**

In the context of auditing and accounting, an expert is anyone with expertise in a field other than auditing and accounting. Accountants sometimes use the services of experts and whose figures may be contained in the financial statements.

Management experts:

A management expert is one who is appointed by management to carry out some work on their behalf. The work that the expert carries out will result in figures that will be used in the preparation of the financial statements by management.

For example management and the preparers of financial statements may engage an expert to carry out a revaluation of company assets on its behalf. The revaluation figures will be used by management to adjust the carrying values of the relevant assets.

Auditor expert:

An auditor expert is engaged by the auditor to carry out an assignment on his behalf. The auditor may need to engage an expert to carry out some work in the process of gathering evidence to support specific assertions.

For example the auditor may require the services of an actuary to determine the sufficiency of insurance premiums for future benefits.

Comment on Auditor expert's responsibility over the audit opinion missing….

Marking Key

(2 marks for management and auditor expert explanation)

(1 mark for stating the auditor expert's responsibility over audit opinion)

b) Tweende Transport:

i. **Matters consider in the audit of lease assets and expenses:**

Materiality:

- The amount of non-current assets recognized and the finance lease payable are material in relation to the total assets and the profit for the year.

Accounting treatment:

- Need to consider whether the leases have been classified correctly as finance leases in line with the provisions of IAS 17 *Leases.*
- To be correctly capitalized as finance leases means that they are in substance assets rather than expenses. The substance of the transaction is considered rather than the legal form.
- To be capitalized, it means that Tweende Buses must have the risks and rewards of ownership of the buses considering the following factors:
  - Have the responsibility for repairs and maintenance.
  - The transfer of legal title in the name of Tweende Buses at the end of the lease term.
  - The lease is for most of the asset's useful life.
  - The present value of the minimum lease payments is substantially all of the assets' fair value.
- The leases result in finance charges against profit and loss and calculated using the actuarial method.

(4 marks)

ii. **Audit evidence:**

- Obtain a copy of the workings of Tweende Buses in relation to finance leases.
- Verify the workings by checking the additions and calculations of the workings.
- To verify and confirm that the leases entered into are classified correctly as finance leases, review the lease contracts for indicators of the transfer of the risks and rewards of ownership, such as:
  - That Tweende Buses is responsible for repairs and maintenance of the buses.
  - That legal title will be transferred to Tweende Buses at the end of the lease term.
  - Confirmation that the lease period is for the major part of the assets' useful life.
  - That the present value of the minimum lease payments is substantially all of the assets' fair value.
- Recalculate the finance charge charged against profit and loss and that the method used is in line with IAS 17.
- Confirm the interest rate used in the calculations to the lease agreement.
- Recalculate the depreciation charges applied to the non-current assets.

(6 marks)

SOLUTION THREE

a) Implications of findings on quality control in Magoye Ltd:

Quality control is an important matter in the performance of audits. This ensures that an audit firm carries out an audit of the highest standard which can be relied upon as a basis for arriving at an appropriate audit opinion.

The facts given in the scenario are what exists in a specific audit of a client. Guidance on quality control at an individual audit level is given ISA 220 *Quality control for an audit of financial statements.*

The following observations are made with regard to the audit of the financial statements of Magoye Ltd.

No pre audit meeting held:

This is a meeting normally held before commencement of the audit and includes all member of the audit team on a particular assignment.

The fact that no meeting has been held with the partner is indicative of the fact that there is no proper direction of the audit by the partner. The partner is responsible for directing the audit and it is at a meeting such as this where important issues including the following are discussed:

- The responsibilities of the audit team members including issues relating to objectivity and professional skepticism.
- The objective of the work to be carried out
- Risk related issues.

Supervision by the Sharon the audit senior:

The fact that Sharon is busy on other assignments and is rarely at the premises of the client is indicative of poor supervision of this audit. The audit senior is in charge of the day to day work and delegating this responsibility to an audit assistant is not correct.

Review of audit work:

Audit work should be reviewed and finally the audit partner will need to review all the working papers to enable him form an opinion. Due to deadlines and the fact that review points may come up, it is expected that work is reviewed as it is done. Waiting until the audit is nearing completion may result is issues remaining unresolved.

It will be appropriate for the audit senior to review work as it is completed.

Unresolved issue of inventory valuation:

Audit firms should have in place policies and procedures on consultations during the performance of audits.
The partner is responsible for ensuring that there are procedures to follow in case of a disagreement or a matter that requires consultations. This incident suggests that the firm does not have effective procedures in place to resolve any such issued.

Conclusion:

The firm should ensure that it carries out its work and enforces necessary quality control procedures as stated in ISA 220 *Quality control for an audit of financial statements*.

Marking key

1 mark for introduction on quality		*1*
1 mark per relevant point max 2 – No pre-audit meeting	*2*	
1 mark per relevant point max 2 – Supervision by audit senior	*2*	
1 mark per relevant point max 2 – Review of audit work	*2*	
1 mark per relevant point max 2 – Conflict resolution		*2*
1 mark for any conclusion made		*1*

b) Third party confirmations:

i. Assertions tested by third party confirmations:

Rights and obligations:
The issue or matter being confirmed through third party confirmation belongs to the entity or the obligations are those of the entity.

Valuation:
The amount in the financial statements is fairly stated.

Completeness:
The figures in the financial statements include all mounts that should be included therein.

Cut off:
At the period was correctly conducted with amounts being recorded in the correct accounting period.

Valuation and allocation:
That assets and liabilities are included in the financial statements at appropriate amounts.
Accuracy:
That amounts and other data relating to recorded transactions and events have been recorded appropriately.

Marking Key

1 mark per assertion explained	*4*

ii. Situations third party confirmations appropriate:

ISA 330 The auditor's responses to assessed risks and ISA 505 External confirmations give guidance in the area of third party confirmations.

External confirmations appropriate in following situations:

- Accounts payables balances.
- Accounts receivable balances.

- Inventories held by third parties.
- Bank balances and other information from bankers.
- Loans from lenders.
- Property title deeds held by lawyers.
- Investments held for safekeeping by third parties.

Marking Key
1 mark per situation identified *6*

SOLUTION FOUR

a) Transnational audits:

Features that may constitute to a high level of risk in transnational audits:

Regulation and oversight of auditors differ from one country to another:

In some countries auditors are self-regulated while in other countries a legislative approach is used. There is a risk that auditors of transnational groups may not be sufficiently aware of the requirements of all the relevant countries.

Differences auditing standards:

Although International Standards on Auditing are now in operation in many countries, these standards are usually modified by individual countries. Further, not all countries have adopted the standards.

Variability in audit quality in different countries:

It may be the case that the quality of auditing required may differ between relevant countries. There is a risk either that the auditor does not perform an audit that is up to the required standard in some countries or that the audits performed on some overseas subsidiaries are not to the standard required to express an opinion on the group financial statements.

Marking Key

2 marks each x 3 = 6 marks

b) Ethical matters:

i. Kafubu Ltd:

This being the first time the firm will audit a client in this industry, it must ensure that it has the necessary skills to undertake this audit. From the facts given in the question, it is clear that the only person who has experience in this industry is Chibwe.

There is an ethical issue regarding having Chibwe as part of the audit team on this assignment. Chibwe has been assigned audit manager for this assignment. The fact that he will not spend much time at the client's premises does not remove the threat to his independence that arises from

the relationship he has with the Managing Director of Kafubu who is his father. Chibwe is still part of the audit team through his role as audit manager. He has a self interest in that his father is the managing Director of Kafubu. There is also an intimidation threat because the of the father son relationship.

The safeguard to remove this threat is to remove Chibwe from this assignment. Another person who has no independence threat should be made audit manager on this audit. In the event that there is no one else who can take the position of Chibwe, the firm should seek legal advice and may need to consider resigning from the assignment.

ii. Kaleya Ltd:

Auditors on the audit team as well as the firm should be independent of the client company if they are to be objective in carrying out their work.

It is managements' responsibility to prepare the financial statements. The duty of the auditors is to form an opinion on the financial statements prepared by management.

Although auditors do offer other services to their audit clients, it is not appropriate to second a member of staff who is on the audit team. Chintu cannot therefore be seconded to finalize the financial statements and later be on the audit team as audit senior. This will result in a self-review threat. It will be necessary to find someone else to second and if Chintu is the only one capable of doing the work for the client then if he is seconded he should not be part of the team to audit the financial statements of Kaleya Ltd.

iii. Lunsemfwa Ltd

The firm should only accept appointment as auditors of Lunsemfwa Ltd if all ethical matters regarding removal and appointment of auditors have been followed.

It is clear that the company has not complied with ethics as required and specifically:

- The outgoing auditors are entitled to attend the meeting at which their termination of office will be discussed. They are entitled to speak on matters pertaining to their removal. By restricting Goodwill Chartered Accountants from attending the meeting this is contrary to expected conduct.
- A letter of engagement is supposed to be written by the auditors after satisfying themselves that all requirements have been met. The letter engagement letter from Lunsemfwa is not accepted as an appointment for the auditors.
- An appointment of the auditors is only effective if a valid resolution is passed and ratification as in this case will be invalid.

- As proposed incoming auditors, we should communicate with Goodwill Chartered Accountants. If as is the case permission is not granted for our firm to communicate with them we must decline the appointment.

Marking Key

i)	*Kafubu*	*= 4 marks*
ii)	*Kaleya*	*= 5 marks*
iii)	*Lunsemfwa*	*= 5 marks*

SOLUTION FIVE

a)

i) **International Standards on Auditing:**

- These are standards that are issued by the International Federation of Accountants after wide consultations.
- The standards give guidance to auditors on the work they should perform during the audit.
- Because they are applicable in the jurisdictions of most of the countries of the world they help ensure that the standard of audits is the same worldwide. This way the accountancy profession is able to provide services of consistently high quality in the public interest.
- The standards reduce subjectivity and therefore aid the auditor in the conduct of an audit more efficiently.
- Compliance with ISAs can be used as a defence in an action for negligence.
- ISAs are reviewed as necessary by IFAC and so auditors do not need to worry about the relevance of the standards. By following auditing standards the auditors will be suing latest and relevant standards thereby reducing the risk of not detecting material misstatements in the financial statements.

Example:
ISA 230 *Audit documentation* gives guidance on documentation the auditor is expected to maintain arising from the audit work carries out.

Marking Key
1 mark per relevant point x 4 = 4 marks

ii) **Benefit of due diligence review to acquiring company:**

Due diligence is a specific type of review engagement commonly performed when one company is acquiring another. This is largely because of the large sums of money involved in acquisitions.

Both the acquiring company and the one being acquired can require that a due diligence review be carried out by independent auditors.

Benefits of a due diligence review to the acquiring company:

- The acquiring company will have all the necessary facts about the acquisition and that the perceived business opportunities are real.
- The acquiring company will gain confidence on the valuation of assets and liabilities in the financial statements of the target company.
- Due diligence review will reveal any misleading statements made by the target company.
- The due diligence report will help in the negotiations of the price for the acquisitions.
- Review may include people due diligence to confirm whether the target company has the staff with necessary skills that it claims to have.
- Regulatory due diligence will highlight possible non compliance with laws and regulations which may have future impact on the operations of the entity after takeover.

Marking Key

1 mark per valid benefit x 6 = 6 marks

b)

i) **Risk based auditing:**

Risk based approach to auditing refers to the developing of audit techniques that are responsive to risk factors in an audit. At the planning stage of the audit the auditors will plan to identify the risks that exist in a particular client's business. This will be done in accordance with the provisions of ISA 315 *identifying and assessing the risks of material misstatement through understanding the entity and its environment.*

Reasons why auditors use risk based approach:

- Risky areas are the ones where material misstatements of the financial statements may exist.
- Approach ensures that greatest effort will be directed at areas in which the financial statements are more likely to be misstated
- By directing more effort to risk areas, the chance of detecting errors by the auditor is improved.
- Risk based auditing is more cost effective for the auditor in that less time is spent on testing 'safe' areas.
- The approach helps the auditor is assigning staff with relevant experience and skill to more risky areas.

Marking Key

1 mark for discussion on risk based approach =1
1 mark for any 3 reasons for use of risk based approach x 3 =3

ii) **Documentation requirements – Risk assessment:**

- The significant risks identified and any related controls evaluated.
- The identified and assessed risks of material misstatement.
- The overall responses to address the risks of material misstatement.
- The nature, extent and timing of further audit procedures linked to the assessed risks at the assertion level.
- The discussions among the audit team members concerning the susceptibility of the financial statements to material misstatements, including any significant decisions reached.
- Key elements of the understanding gained of the entity and the risk assessment procedures carried out.

Marking Key

1 mark per matter stated x 6 = 6 marks

END OF PAPER