CHARTERED ACCOUNTANTS EXAMINATIONS

PROFESSIONAL LEVEL

P4: AUDIT AND ASSURANCE SERVICES

THURSDAY 18TH JUNE 2015

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

INSTRUCTIONS TO CANDIDATES

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

2. This paper is divided into TWO sections:

   Section A: One (1) compulsory question.

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

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

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

5. 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 has accepted to be auditor for a company which has been audited by another firm of auditors for many years. This will be the first time that your firm will audit the financial statement of this company.

One of your senior audit assistants is concerned that you will have to form an opinion on financial statements which include opening balances which were audited by a different firm. He also does not understand why the audit senior spends time reading through other information contained in the financial statements when no audit work has been conducted on this information.

Required:

(i) Describe the work of the auditor with regards opening balances of an audit client being audited for the first time. (5 marks)

(ii) Explain the duty of the auditor on other information clearly explaining why the auditor should concern himself with other information. (4 marks)

(b) You are the Audit Manager in your firm of ZICA Chartered Accountants. Following massive advertising by your firm a number of prospective audit clients have indicated the intention to appoint your firm to be their auditor.

The following matters arose following the advert:

1. In response to an advertisement for audit services your firm gave false information in the bid documents in order to enhance the chances of winning the tender. It was indicated that your firm has the necessary skills and experience to offer audit services to this client. It has now transpired that your firm has failed to recruit new staff that could be used to conduct this audit.

   This prospective client has indicated that it wants your firm to be its new auditor.

2. This is one of your existing clients to whom your firm offers consultancy services. John one of your firm's consultants has been involved in the valuation of inventory for this client. Inventory is a material figure in the financial statements of this company.

Your firm has been approached by Dick the CEO of this company requesting that in addition to the consultancy work your firm should also audit the financial statements. The CEO is very happy with the valuation services you are offering and it is their hope that by having the same firm offer both services there can be financial savings. He has also requested that John should be appointed engagement partner.

3. This is a medium sized listed company. The Chief Finance Officer of this company is a former partner in your firm of Chartered Accountants. You have learnt that the CFO is the one who supported your bid to offer audit services and he is also a very good friend of your audit partner.

4. This company intends to change auditors because it is not happy with the current auditors. Your firm has been requested to give a second opinion on the just ended audit. Your agreeing to giving a second opinion has been put as a condition of your firm being appointed auditors of this company. You have been informed that due to tight deadlines, your firm should not contact the current auditors of this company.

5. This client is involved in money laundering activities. This came to the attention of your firm through press reports. Despite your firm having bid the highest the company has shortlisted your firm. This is because the senior partner in your firm is a close friend with the CEO of the company. They have indicated to you that they do not wish that your firm should communicate with the outgoing auditors.

Required:

Discuss any ethical and other professional matters in each of the above cases clearly stating what action your firm should take. (15 marks)

(c) You have been appointed audit manager for the audit of Nyumba Real Estates Ltd and this will be the first time your firm will be auditing a company in the real estate industry. The following information has been provided to you by your partner. He has requested you that as part of the planning for the audit of Nyumba Real Estates Ltd, you should identify the risks in Nyumba Real Estates Ltd and write a report.

Nyumba's Real Estates Ltd's main business is the managing of properties on behalf of individuals and corporate customers. Its main source of income is through commissions that are earned from managing properties on behalf of its clients.

The conditions are that all rental payments are made directly to Nyumba Real Estate Ltd who in turn pays the landlords the amounts due less the commission agreed upon. Previous experience has shown that Nyumba Real Estate sometimes delays in paying the landlords because of its poor cash flow position. This has resulted in the company having to pay interest for delayed payments.

Two years ago the company decided to diversify and went into the business of construction of its residential properties for sale and let. In order to achieve this, the company obtained a long term loan from a local development bank amounting to $5 million with a flexible interest rate of 2% above LIBOR and the loan is payable in US $. The company offered its office building as security for the loan.

The Town and country planning department has passed legislation that all new developers must first obtain an environmental impact assessment clearance report before commencing to develop their properties. Nyumba Real Estate Ltd has been waiting for the issuance of this clearance from the Zambia Environmental Management Agency (ZEMA) for one year and loan repayments are due in two months' time. Nyumba Real Estate has started clearing the land while waiting for the certificate in contravention of the requirement above.

There is a noted increase in the number of players in the property industry. Among the newcomers is Ching Hung Inc, a Chinese Construction company that has been given permission to build cheap and affordable prefabricated housing units. These houses have an estimated life of forty years and have proved very popular among the middle class. In conjunction with a local building society, Ching Hung has been able to sell houses to low and middle class workers.

Robert who has been Finance Manager of Nyumba Real Estate Ltd for the last ten years has left the company. He has been replaced by Esther who recently qualified as a ZICA Chartered Accountant. The Financial Statements for the year under review have not yet been finalised.

At the time Robert was leaving he had just signed a contract with a supplier of accounting software for the supply of a new accounting package which will be installed in the year under review. You have learnt that there will be a direct change-over to the new accounting system.

Required:

Write a report to your partner in which you are required to:

Discuss the business and other risks that must be considered by your firm at the planning stage of the audit of Nyumba Real Estate Ltd. (16 marks)

[Total: 40 marks]

SECTION B

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

QUESTION TWO

You are the Audit manager responsible for the audit of Bwino Co Ltd, a large client involved in the manufacture of cement. The draft financial statements for the year ended 30 August 2014 shows profit before taxation of K3.2m (2013-K2.8m) and total assets of K30.5m (2013-K24m). The audit work for the year ended 30 August 2014 is near completion and you are reviewing the draft report which has been prepared by the audit senior. You are aware that Bwino Co Ltd took a seven year non-cancellable lease on a suite of offices on its eighth floor.

The lease payments are K180,000 and are paid annually in advance. The value of lease calculated as K800,000 has been recognized as a lease asset. The lease asset is being amortized on a straight-line basis over a period of eight years. You are further aware that management has not given the audit team access to the records concerning lease agreements.

An extract from the draft audit report prepared by the audit senior is shown below:

Basis of opinion (extract).

Evidence that is available to us in respect of the classification of the lease was limited because of restrictions imposed over the work by management. As a result of this, we have been unable to verify the appropriateness of the amount capitalized, and we are worried that the asset may have been over-valued. Because of the materiality of the item and the lack of integrity shown by management, we have been unable to form an opinion on the financial statements.

Opinion (extract):

Disclaimer on view given by financial statements.

Because of the lack of evidence that we could gain over the tangible asset, we are unable to form an opinion as to whether the financial statements are properly prepared in accordance with relevant financial reporting framework.

Required:

(a) (i) Discuss on the matters relating to the lease classification. (3 marks)

(ii) Describe the audit procedures in relation to leases. (3 marks)

(iii) Appraise the draft audit report of Bwino Co for the year ended 30 August 2014, prepared by the audit senior. (4 marks)

(b) There has been a growing need for those charged with governance to know how the company's activities impact on the environment and require them to explain to the users of financial statements what measures management has put in place regarding the environment in which they operate.

Required:

Explain briefly the audit evidence that auditors expect to find in relation to environmental information and suggest two (2) audit procedures for verifying such evidence. (5 marks)

(c) Nugget, a limited liability company undertakes construction contracts which include offices, factories and schools. Its major customers include the government and private companies. The statement of accounting policy for construction contracts for Nugget limited states that 'revenue should be recognized on the basis of the degree of completion calculated as a percentage of costs incurred so far plus estimated costs to completion'. IAS 11 *Construction contracts* gives guidance on long-term contracts.

Required:

Describe five (5) audit procedures that should be undertaken to audit Nugget's contract profits or losses. (5 marks)

[Total: 20 marks]

QUESTION THREE

(a) There has been an increase in the number of people bringing action against the auditors for professional negligence. The following scenarios have been brought to your attention for advice by two of your non-audit clients.

Makulu Limited:

This is a public limited liability company which has been run successfully for the past ten years. The auditors of Makulu Limited have issued unmodified audit opinions for the past five years. Jim bought shares in Makulu limited because the share price has been increasing.

One year ago the company experienced liquidity problems resulting in losses being incurred and the share price dropping from K8.90 per share to K0.98 per share and it is feared that the company will go into liquidation. Jim is considering taking legal action against the auditors for professional negligence for issuing unmodified opinions for a company that is technically bankrupt. Jim claims that he relied on the audited financial statements of Makulu Ltd to buy shares in Makulu Ltd.

Magoye Plc:

Magoye Plc is a company listed on the Lusaka Stock Exchange. The share price of the company has been increasing steadily over the years. Relying on the audited financial statements, one major supplier of Magoye Plc gave extended credit.

The audit for the year ended 31 December 2013 has just been concluded and an unmodified opinion issued. Magoye Plc presented the audited financial statements to one of its major suppliers. The supplier relied on the audited financial statements to decide to give extended credit to Magoye Plc. Magoye Plc went into liquidation before settling a debt of K500,000 to its supplier. The supplier intends to bring action against the auditors for professional negligence.

Required:

Advise Jim and the Bank on their intended legal action against the auditors of Makulu Ltd and Magoye Plc respectively. (10 marks)

(b) ISA 560 *Subsequent events* gives guidance to the auditor with regards events after the reporting period. The audit of one of your audit clients has just been concluded and the audit report signed and the financial statements issued.

The following matters come to the attention of your firm of Chartered Accountants after the issue of the financial statements.

Included in the accounts receivables figure at the period end is an amount of K300,000.00 which is an amount due from a customer. No allowance for receivables was made at the period end and soon after the issue of the financial statements the liquidator of this company issued a press statement that all creditors would only get K0.45 per kwacha in full settlement of the amounts owed.

At the period end there was a pending court case. Management was of the view that the outcome of the case would be in favour of the company. The auditors also concluded that the case was strong in favour of the company and so management's view that no provision should be made was supported. Before the audit report was issued the Supreme Court passed judgment against the company and the company was fined K500,000.00 and the amount material to the financial statements.

You are concerned about the going concern assumption of the company. Management in their report of the directors has stated that in their opinion the company is a going concern and will be able to meet its debts in the foreseeable future. Your firm decides to obtain a management representation with regards the going concern assumption. The senior managers have all taken leave after the audit and the only person available is the financial accountant who has only been with the company for less than six months and this will be the first time that he will be making representations to the auditors.

Required:

(i) Discuss the reliability of the written representation that your firm has obtained from the Financial Accountant. (4 marks)

(ii) Evaluate the above events and where relevant state the effect on your audit opinion. (6 marks)

[Total: 20 marks]

QUESTION FOUR

(a) Your firm of Chartered Accountants is the auditor of Rock Mining a company in the coal mining industry.

You are the manager in charge of the audit and you are chairing a pre-audit meeting with members of the audit team. You have assigned staff to attend inventory count of components and spares of Rock Mining.

You have informed the team that for the mined coal, your firm does not have the necessary skills to undertake the physical verification and subsequent valuation. Rock Mining has engaged Reliable Consultants to carry out the valuation of coal on its behalf.

Jane the audit senior on this audit has informed the meeting that she is aware of the fact that Rex the senior consultant of Reliable Consultants and the Chief Executive Officer of Rock Mining jointly run another business.

Required:

(i) Discuss the impact of the valuation report from Reliable Consultants on your audit opinion. (3 marks)

(ii) Discuss the matters that your firm will consider in placing reliance in the valuation carried out by Reliable Consultants and the action that your firm will take to address any concerns your firm might have. (6 marks)

(b) Most successful organizations world over are those that have good corporate governance systems in place. Most countries have adopted the provision of the Organization for Economic Corporation and Development (OECD) guidelines to come up with their own codes containing corporate governance guidelines. In Zambia the Bank of Zambia issued Corporate Governance Guidelines that apply to financial institutions.

Most of these guidelines are principle based rather than rule based. There are many laws and regulations that organizations are required to follow and non-compliance can result in criminal action against the organizations.

Required:

(i) Compare principle based codes and rule based regulations. (3 marks)

(ii) State why most of the codes of best practice are principle based rather than rule based. (3 marks)

(iii) Briefly explain each of the five (5) Organizations for Economic Corporation and Development (OECD) principles of good corporate governance. (5 marks)

[Total: 20 marks]

QUESTION FIVE

East Park City Council has been in existence as a local authority for a period of seven years now. Most of its income is generated from ground rates, rentals of its housing stock and levies from a public bus station. Other income is from fees it collects from public car parks it manages.

Due to changes in government policies, almost half of the council's income has been halved due to the fact that most of the housing stock had been sold to the sitting tenants resulting into loss of its main revenue.

A large number of households have stopped paying for garbage collection. Consequently its financial position and profitability has deteriorated leading to financial institutions and creditors reducing the granting of loans and overdraft facilities. Utility companies have also cut off water and power supplies to the main water treatment plant. The council has not paid wages and salaries for many months and this has resulted in industrial unrest and staff threatening to go on strike.

John Kenta, the mayor, has argued in one of the council meetings that he proposes other sources of income such as lease finance or listing on the stock exchange.

The major concern of the mayor concerning listing are the listing requirements which include the requirement to have financial statements audited by external auditors and also the setting up of an audit committee. The council will also be required to prepare prospective financial information which currently is not prepared.

Required:

(a) State three (3) indicators that independent auditors would use to confirm the status of the client's going concern at East Park City Council. (3 marks)

(b) State three (3) objectives and principles of public sector audit at East Park City Council. (3 marks)

(c) Explain four (4) arguments against setting up an audit committee in an organization as proposed by John. (4 marks)

(d) Explain five (5) audit procedures that an independent auditor can use to obtain audit evidence on any prospective financial information for East Park City Council. (5 marks)

(e) Briefly describe five (5) benefits of agreed upon procedures over independent auditor's substantive procedures. (5 marks)

[Total: 20 marks]

END OF PAPER

P4 AUDIT AND ASSURANCE SOLUTIONS

SOLUTION ONE

a) Opening balances and other information:

i. Opening balances affect the current financial statements as they are added to the current transactions. If the opening balances are misstated this will affect the closing balances being audited.

In a case such as this one, where the auditors did not audit the previous year's financial statements, it is necessary that audit procedures are carried out on the opening balances.

ISA 510 *Initial audit engagements – opening balances* provides guidance to the auditor in this area.

The following audit work shall be performed on the opening balances:

- Confirm whether the prior period's closing balances have been brought forward to the current period. This could be done by confirming the current opening balances to the previous year working papers.
- Determine whether the opening balances reflect the application of appropriate accounting policies as those of the current year.
- Where the previous financial statements were audited by another auditor as in this case, review the predecessor auditor's working papers to obtain evidence regarding the opening balances.
- Evaluate whether current year audit procedures provide evidence relevant to the opening balances. For example cash receipts in the current year could provide evidence of receivables and the end of the previous year.

ii. Duty of the auditor – other information contained in financial statements:

The financial statements of most organizations include other information for which the auditor has no obligation to report on. This includes information such as the report of management or the board of directors, financial ratios, employment data and selected quarterly data.

ISA 720 *The auditor's responsibilities relating to other information in documents containing audited financial statements* sets out the requirements of the auditor in this area.

Generally the auditor is expected:

- To read the other information in order to identify material inconsistencies if any in the other information and the audited financial statements.
- The auditor will discuss with management any such inconsistencies and determine whether the other information or the financial statements require to be amended.

Why auditor concerned about other information:

Auditors are concerned about other information because they do not wish inconsistencies with the financial statements to occur. Material inconsistencies may raise doubts about the audit conclusions drawn from audit evidence obtained and also about the auditor's opinion on the financial statements.

Inconsistencies between other information and the audited financial statements also bring doubt on the reliability of the financial statements. The two should not be contradictory.

b) Ethical matters:

Matter 1:

One of the fundamental principles of the Code of ethics for Professional Accountants is that of integrity. This principle states that the accountant who includes the auditor should be straight forward and honest in their professional and business relationships.

This means that among other things the accountant should not mislead others in their business relationships. By giving misleading information in response to an advert for the provision of audit services, the firm is in breach of this principle. By stating that the firm has the necessary skills to undertake the audit they have misled the prospective client and for this reason the client has selected the firm to be the preferred firm to offer audit services.

In view of the fact that the firm does not have the necessary skills and has failed to recruit the necessary skills, it should not take up the appointment.

It should be pointed out that non-compliance with the Code of Ethics could result on displinary action being taken against the firm in general and in particular against the member of the professional organization such as the partner who was responsible for the bid to offer audit services.

Matter 2:

The issue at hand is the provision of assurance services to a client the firm is currently giving other services. There is no regulation that prohibits an audit firm from providing audit services and other services to the same client.

The problem that arises in this case is that of self-review. John, who undertakes the valuation, is the one the client would like to be assigned to this audit as engagement partner. This means that John will have to give an opinion on the financial statements which include figures that he has previously determined. This brings about a threat to independence and objectivity.

Further, the auditors should be free to decide who should be assigned to an audit client. This should not be under the influence of the client to be.

In this case, unless the firm can apply suitable safeguards such as assigning a different person as engagement partner, the firm should not take up this assignment.

Matter 3:

The issue that arises in this matter is that of familiarity between the audit partner and the Chief Finance officer of this client. This is compounded by fact that the two are friends and the CFO is the one who influenced the firm to be offered the assignment.

This relationship will bring into question the independence of the partner and subsequently his objectivity. It is also possible that an intimidation threat may arise because of the previous relationship of the two since the new CFO was a partner in the same firm.

Unless the firm has another partner who can be assigned to this audit the firm should not take up the appointment.

Matter 4

A second opinion is one where an auditor other than the one who undertook the audit is required to give an opinion on matters that he did not audit.

Generally auditors should be very careful before agreeing to give second opinions on financial statements which they have not audited. This is because the auditor is at risk of giving inappropriate opinion as he is unlikely to be aware of the relevant facts.

Further, by giving a condition that the firm should give a second opinion if they are to be considered brings into question the integrity of management. It is possible that serious disagreements may arise in future if the appointment is accepted.

In the event that the auditor feels it could give a second opinion, it is important that he communicates with the current auditor so as to obtain the relevant facts relating to the situation. Refusal that the firm contacts the current auditors again raises questions on management.

The firm should decline to give a second opinion in view of the above issues.

Matter 5:

Clearly the integrity of the management of this prospective client is brought into question. Generally when taking up a new assignment auditors will wish to communicate with the outgoing auditors as a matter of professional etiquette. This is in order to find out whether the outgoing auditors have any reasons professional or otherwise why your firm should not accept appointment. In this case the prospective client has refused the firm to contact the outgoing auditors and the firm may not make this contact unless allowed by the prospective client and so the appointment should be declined.

Further, the integrity of management is brought into question going by the reports of money laundering activities. This is a criminal offence and the auditors should not accept to audit financial statement of a company involved in money laundering activities. This possibly explains why the CEO has recommended this firm because he possibly thinks the firm will not report money laundering activities to competent authorities because of the friendship that exists between the CEO and the firm's senior partner.

c) Nyumba Ltd – Risks that should be considered:

Report:

To: The Staff partner

From: Audit Manager

Date: 12 May 2014

Nyumba Ltd Risks identified:

I have reviewed the information given to me concerning Nyumba Ltd. The following are the risks that I have identified. I will be available for a discussion of the risks identified with you at a time that is convenient to you.

- Since tenants pay the full amounts to Nyumba Ltd there is a risk that Nyumba Ltd may treat all the amounts received as revenue instead of only taking the commission that it receives. This could result in revenue of Nyumba Ltd being overstated.
- The delays in paying landlords the amounts due to them could result in increased interest to be paid worsening the already poor cash flows of the company. Further, there is a risk that landlords could take action against the company for delayed and non-payments. This may have implications on the going concern aspects of the company.
- Nyumba Ltd runs the risk of paying high interest on the loan on which flexible interest is charged at LIBOR + 2%. In the event that interest rates keep on rising then the company could face difficulties in repaying the loan. The interest charges may result in the company eroding its margins.
- By offering its only building as security for the loan the company faces the risk of the charge being executed in the event of failure to pay back the principle amount or interest. The company seems to be facing cash flow difficulties and so this risk is much higher.
- Zambia Environmental regulations require that the environmental impact assessment should be carried out before commencement of construction. Nyumba Ltd is in contravention of the regulations by commencing to clear land before issuance of clearance by ZEMA. The company risks being sued by ZEMA for contravening regulations. This could result in heavy penalties being charged and non-issuance of the clearance which will have consequences on the intended development.
- The coming in of a new competitor in this industry could affect the business prospects of Nyumba Ltd. There is a likelihood that demand for houses for Nyumba Ltd may decline. If this happens then the company may face serious challenges in repaying the loan as well as liquidity for company operations.

- There is a risk of financial statements being incorrect because of the sudden resignation of Robert the Finance Manager. Esther the replacement to Robert has little experience in the preparation of financial statements and the financial statements have not been concluded at the time Robert is leaving the company.
- The acquisition of a new accounting package will increase the risk of errors in the financial statements. This is compounded by the fact that there will be no parallel running with the existing system. The auditors will need to take extra care and apply professional scepticism throughout the audit in view of this risk.

I trust that the above meets your requirements.

Audit Manager

SOLUTION TWO

a) Matters relating to lease classification:

i. The key issue is that the lease has been misclassified as a finance lease when it should have been treated as operating lease. If this is the case, the lease payments should have been expensed as incurred. Any circumstances specific to the company which might mean that the management would wish to capitalize the lease even if it was an operating lease.

The capitalized asset of K800, 000 represents 2.6% of the total assets. If the cost had been capitalized, the total assets could have been materially over-stated. Wrong classification would lead to profits being materially misstated. The potential impact on the profits is likely to be material. The lease payment of K180, 000 represents 5.6% of the profit before tax which in themselves would not normally be assessed as material in addition, the impact of not charging theses costs is offset by amortization of K114, 286 and finance costs.

Even if the accounting treatment is in accordance with IAS 17.it still requires that finance leases should be expensed in the Income Statement of the comprehensive Income on a straight-line basis.

Whether the lease is a finance lease or an operating lease. This depends on the economic substance of the lease. It is assessed by establishing the extent to which risks and rewards of ownership are transferred to Bwino Co.

ii. Procedures in relation to Leased Assets:
   - Confirm whether or not Bwino Co is responsible for the rates, maintenance, repairs and insurance.

- Establish whether circumstances exist under which legal title eventually transfers to Bwino Co and whether there is an option to extend the leases for all or a substantial part of the useful life.

iii. The draft audit report contains a disclaimer of opinion. I.S.A 705 modifications in the auditor's report, indicates that such an opinion should be given where the matter is both material and pervasive, so that the auditor cannot reach an opinion on the financial statements as a whole. However this could be a harsh decision at this moment. This matter is certainly material to the statement of financial position. In this case it would be appropriate to qualify the auditor's opinion 'except for' on the basis of an inability to obtain sufficient appropriate audit evidence as a result of a limitation on the scope of the audit.

Content of the report.

The 'basis of opinion' paragraph should be shown immediately above the 'opinion' paragraph, as appears to be the case from the extract given. However the paragraph heading are not worded correctly. ISA 705 requires them to be headed 'basis of disclaimer of opinion' and 'disclaimer of opinion 'respectively.

'Basis of opinion' paragraph should be more precise. It should refer to the relevant accounting standard (I.A.S), and should explain that a limitation has been imposed by management in respect of lease costs. It should explain that management did not allow access to the treatment of lease, and the auditor has been unable to determine whether the accounting treatment of the costs is correct.

The paragraph should then quantify the effect on the financial statements, stating that it is recognized on the statement of financial position at K800, 000, and if they are treated as expense, this would turn the profit of K3.2m to K2.4m

The paragraph also contains the unprofessional words 'we are worried that the asset may be overvalued', which is not appropriate to an auditor's report. A lack of management integrity is referred to, and although the auditor should have considered the possible effects of this, it is inappropriate to refer to this in the report.

The opinion paragraph itself should use the specific form of words set out in ISA 705, including the statement that the auditor has been unable to obtain sufficient appropriate audit evidence and that he is therefore unable to express an opinion.

b) **The environmental audit evidence can be found in** :

- Financial statement-effects of transactions affecting the environment are usually disclosed in the financial statement.
- Documents that are filled with environmental regulators annually by the clients/companies.

Audit procedures.

- Obtain a copy of the company's, environmental policy and review it.
- Environmental policy and review it.
- Assess whether the policy is likely to achieve its objectives meet. The Zambian standards, legal requirements and safety to key customers.
- Test implementation and adherence to the environmental policy is by discussing with those charged with governance and observe the implementation of the policy and walk through tests.

c) **Audit procedures regarding contracts.**

- Obtain a copy of the calculation and check the additions and calculations
- Assess whether the basis of calculation is comparable with prior years.
- He/she should then verify the figures in the calculation of:

  Revenue to certification of work completed to date
  -total contract price to original contracts
  -cost of work completed to invoices also payroll/clock cards/wage rates
  -payments on account to remittance invoices
- He should discuss with management if there is any chance of a loss arising on the contract.
- Confirm whether any expected excess of the total contract revenue should be recognized as an expense immediately.

SOLUTION THREE

a) Advise to Jim on suing Makulu Ltd:

Generally the auditors get into a contract with the company such as Makulu Ltd in this case. For this reason the auditors owe a duty of care to the company. The company means all the shareholders as a whole and not individual shareholders.

The duty of care by the auditor to the company as a whole implies that it does not matter that it may not be expressly stated in the agreement between the auditor and the company.

In order to succeed in any action three things must be established as follows:

- That there is a duty of care by the company to the injured – for a company such as in this case this is implied.
- It must be proved that there was a breach of the duty of care by the auditors and
- The litigants suffered loss as a result of the breach of the duty of care.

If any of the above three conditions are breached, the action will not succeed in court.

In the case of Jim he wishes to sue in his individual capacity and therefore his action cannot succeed because the duty of care is owed to the company as a whole meaning all the shareholders. Therefore Jim is advised against taking action against Makulu Ltd in his individual capacity. He may wish to influence all the shareholders so that all of them sue as a company to whom the auditors owe a duty of care.

Advice to the Bank on suing Magoye Ltd:

The general rule is that auditors do not owe any duty of care to third parties. The duty of care is owed to the company. This means that even if third parties rely on the published and audited financial statements they will not be able to bring any action against the company even if they suffer loss.

The argument is that it would be difficult for auditors if all and sundry could bring legal action against the auditors. The leading case here is the Caparo case where it was held that the auditors of public company accounts owed no duty of care to members of the public at large who relied upon the accounts to purchase shares.

This decision narrowed down the auditors' potential liability to third parties. Therefore, members of various groups including suppliers, potential investors or others will not be able to sue the auditors for negligence by virtue of their placing reliance on audited annual financial statements.

Going by the decision in the Caparo case the supplier is advise that he will not be able to succeed in an action against the auditors. The supplier is advised to take action against their customer with whom they have contractual obligations.

b) Events after period end:

i. Written representation from the financial accountant:

Representation from management are part of written evidence that the auditor obtains as part of audit evidence to support specific assertions.

ISA 580 Written representations gives guidance in this area to the auditor. Generally representations should be obtained by auditors from management with appropriate responsibilities for the financial statements and knowledge of the matter for which written representations are required.

In the case on hand, all the senior management staff are on leave and only the financial accountant who is new is available and representations have been obtained from him. The fact that all senior staff take leave before the conclusion of the audit brings into question the integrity of management and suspicion could be that they are avoiding answering audit queries.

The reliability of the representations obtained from the financial Accountant is brought into question. The auditor should communicate this situation to those charged with governance and endeavour to get representations from staff with the requisite knowledge of the matter at hand.

ii. Events after period end:

IAS 10 *Events after the reporting period* deals with the treatment in the financial statements of events both favourable and unfavourable occurring after the period end.

ISA 560 *Subsequent events* gives guidance to the auditors on their responsibilities regarding subsequent events. The objective of the auditors is to confirm that management has complied with the provision of IAS 10 in preparing the financial statements.

Receivable outstanding – K300 000

At the period end is a figure of K300 000 included in receivables for which no provision has been made. Subsequent to the year end and before the conclusion of the audit and issue of the audit report there is evidence that the customer who owes this amount is under liquidation.

Only K135 000.00 (K300 000X0.45) is recoverable out of the total amount of K300 000 receivable at the year end. The balance of K165 000 will require to be written off particularly because the liquidator has stated how much all creditors will receive.

Effect on audit report:

If management agrees to write off the K165 000 then the auditor will issue an unmodified opinion and they may comment on this in the emphasis of matter paragraph. If on the other hand management declines to make the necessary amendments, the effect on the audit report will depend on the materiality and pervasiveness of the amount to the financial statements.

If considered material but not pervasive then a qualified opinion may be issued. If however the matter is considered to be both material and pervasive to the financial statements then an adverse opinion may be appropriate.

Court case – K500 000

The outcome of the case after the period end gives evidence of conditions that existed at the period end. The decision for the company to pay K500 000 has been made by the highest court in the land and so there is no room for appeal.

The fact that at the yearend it was decided that no provision should be made is immaterial. After passing the judgment the auditors should discuss with management and request that a full provision for K500 000 should be made in the financial statements.

Effect on auditor report:

This will depend on management response to the auditors' suggestion that the financial statements should be emended.

- If management agrees to make the necessary provision the auditors will issue an unmodified opinion.
- If on the other hand management decline to adjust then the auditor will issue either a qualified or adverse opinion depending on the auditor's assessment of the materiality and pervasiveness of the matter to the financial statements.

SOLUTION FOUR

a) Rock Mining Company:

i. Reliable Consultants have been engaged by Rock Mining and is therefore a management expert. The work that will be done by this company is to verify the figure of inventory that will be used in the financial statements of Rock Mining.

The valuation report that will be issued by the consultants will form part of the working papers that the auditors will keep. If the figures determined by the consultant and Rock Mining agree then this will give satisfaction to the auditors that inventory is not materially misstated.

As regards the audit opinion, this is the responsibility of the engagement partner. The report that is issued by the consultants will be part of the evidence that the auditors

will use in arriving at their opinion. The auditors cannot refer to the valuation report in their report and they are fully responsible for their opinion.

ii. Valuation of coal – Rock Mining

The matters that the firm will consider in placing reliance on valuation by Reliable Consultants:

- The qualifications of Reliable Consultants in varying out work of this nature.
- Membership to relevant professional body that Reliable consultants belong.
- Any other clients for whom Reliable Consultants has carried out valuation of such inventory.
- The assumptions that the consultants have used in arriving at the quantities and value of inventory.
- The independence of the valuer from the company so that he maintains his objectivity.

Concern:

The fact that the valuer and the CEO of Rock Mining jointly run another business raises concerns about the independence of the valuer and hence his objectivity.
It is therefore unlikely that the value that will be determined by Reliable Consultants will be reliable.

The auditors may then decide to engage their own expert to carry out the valuation on its behalf. This will be an auditor expert who will be engaged by the auditor.

b) Principle and rule based principles& OECD

(i)&(ii) Principle versus rule based:

Principle based codes:

These are codes that have best practice that organizations are expected to follow. They apply on a comply or explain basis. This means that organizations are encouraged to comply with them and in the event that they do not follow they should explain why they have not complied.

Such codes are flexible and have an advantage that they can apply across many countries and application will depend on the situation. Many jurisdictions can adopt these to suit individual situations.

Rule based principles:

The guidelines under this method are contained in statute and must be followed without exception. The problem is that of application and enforceability in different jurisdictions. It is not easy to have rules that can be followed and enforced across many jurisdictions.

(iii) OECD Principles of good corporate government:

- The rights of shareholders:

  That the shareholders have the right to participate and vote in general meetings of the company, elect and remove members of the board and obtain relevant and material information on a timely basis.

- The equitable treatment of shareholders:

  All shareholders of the same class of shares should be treated equally, including minority shareholders and overseas shareholders. There should be no restrictions to cross border shareholdings.

- The role of stakeholders:

  Rights of shareholders should be protected. All stakeholders should have access to relevant information on a regular and timely basis.

- Disclosure and transparency:

  Timely and accurate disclosure must be made of all material matters regarding the company, including the financial situation, any risk factors and other issues regarding employees and other stakeholders and governance structures and policies.

- The responsibilities of the board:

  The board shall be responsible for the strategic guidance of the company and for the effective monitoring of management. Board members should act on a fully informed basis, in good faith, with due diligence and care in the best interests of the company and shareholders.

SOLUTION FIVE

a) **Conditions or indicators casting significant doubt on going concern.**

Financial indicators.

- **Net liabilities or net current liabilities**. This can only arise when the current liabilities are more than current assets/
- Indicators of withdrawals of financial support by lenders means that confidence in terms of the company's ability to settle the debts as they fall due has reduced. The company will have to struggle to raise funds in the short term possibly by changing from credit sales system to a cash system. This could also send a message to its customers who may choose to buy from other businesses.

Operating.

- Loss of key personnel. Staff are always involved in the planning and designing of new products for a company. Other competitors will be interested to employee them in order to obtain a competitive advantage
- Loss of key customers, license or market

Others.

- Noncompliance with capital and other legal requirement
- Uninsured or unsecured calamities when they occur

b) **Public sector organizations include central government**.

Public sector organization are those that are formed by the government or government agency and provide services that generally needed by the community for their wellbeing.

The audit help to ensure that public funds have been spent on proper authorized purposes and legally within statutory powers .Organizations are to institute and operate controls in order to limit the possibility of corrupt practices, fraud and poor administration. The overall purpose is accountability.

c) **Cost**- members of the audit committee need to paid allowance and other benefits and administrative which can be a drain on the company resources.

Selection criteria. It is not easy to find member with the right balance of skills and audit competencies in non-executive director.

The establishment of such a formalized reporting structure may dissuade auditors to concentrate on matters of fact than judgment.

Other members of the audit team may feel demoralized or their positions threatened by the presence of audit committee members.

Bureaucracy can cause delays as reporting procedure is lengthened

Suitability. Audit committees may only be suitable in large listed companies in which it becomes almost mandatory to have an audit committee among other committees such as remuneration and appointment committees.

d) Prospective financial information is based on assumption about events that may occur in the future and possible actions by the entity.

Audit procedures:

Profit forecast.-verify projected income figures to suitable evidence which may involve comparisons of the basis of projected income to similar existing projects in the firm and review the current market price for that product or service.

Projected expenditure-there is likely to be more evidence of expenditure in form quotations or estimates, market rates for advertising interest rates assumptions compared to that of the bank costs of depreciation relating to capital expenditure and useful life of non-current assets.

Cash forecasts-auditors should review cash forecasts to ensure the timings involved are reasonable and consistent with any previous forecasts.

Capital expenditure-projected costs should be verified to estimates and quotations where possible.

e) In agreed upon procedures the auditor provides a limited level of assurance that the information subject to review is free of material misstatement by way of a negative assurance. It also saves time and the opinion expresses is not positive while substantive procedures take a lot of time in coming up with audit evidence and much more formalized and used to form evidence as basis for independent audit opinion on which the user of the stamen will have to rely on.

END OF SOLUTIONS