

COMPETENCE PRACTICE EXAMINATION

FULL AUDIT

DECEMBER 2009

TIME ALLOWED: 5 HOURS

INSTRUCTIONS TO CANDIDATES

1. This paper has Two Questions.
2. You are required to attempt ALL the two questions
3. Each question has Sections:

Question one has two Sections: A and B
Question two has two sections: A and B
4. All the two questions carry equal marks.
5. The Examination is divided into sessions of $2\frac{1}{2}$ hours each. There will be a 30 Minutes break in between the sessions.
6. Please use your Membership number and your National Registration Card number on the front of the answer booklet. Your name must NOT appear anywhere on your answer booklet.
7. This is an open book examination.

QUESTION ONE

Baby Wear Ltd manufactures and sells baby wear products of all types to retail shops around Zambia. The factory is based in Lusaka.

STATEMENT OF ACCOUNTING POLICIES:

a) INVENTORIES

Inventories are valued at the lower of cost and net realisable value. Cost comprises the cost of purchase plus the costs of conversion. The cost of conversion comprises:

- Cost specifically attributable to units of production
- Production overheads
- Other overheads attributable to bringing the product or services to its present location and condition

b) TANGIBLE NON-CURRENT ASSETS

Non-current assets represent resources controlled by Baby Wear Ltd as a result of past events and from which economic benefits would be derived in the future. Non-current assets are initially measured at cost and subsequently measured at fair value. Under the fair value model assets are carried at fair value less accumulated depreciation and any accumulated impairment losses. The fair value model is only used to the extent that fair values can be measured reliably.

Depreciation is based on the carrying value of the non-current assets in the statement of financial position and is designed to write off the assets over their useful economic life using the following rates:

NON-CURRENT ASSET	RATE
Buildings	2% - Straight line
Equipment and Fittings	25% - Reducing balance
Motor vehicles	20% - Reducing balance

You are a partner in TP Case Partners, a ZICA registered firm of chartered accountants. On 30th August, 2009, your firm TP Case Partners received an invitation from Baby Wear Ltd for your firm to audit the financial statements for the year ended 30th September 2009. As part of your client acceptance procedures, your firm carried out specific client screening procedures before accepting the engagement.

Client screening

- An evaluation of Baby Wear Ltd to obtain reasonable assurance of its management and directors as to whether they can be trusted. This was done by making enquiries of third parties and reviewing relevant available information about the client such as press reports
- Communicating with the previous auditors to make specific enquiries regarding matters that may affect the decision to accept the engagement. This was done with full permission and co-operation from Baby wear Ltd

A summary of client screening findings are summarised at working paper (BW-CS/1)

Acceptance of engagement

After evaluating the results of the client screening, you firm decided to accept the engagement on the basis that the associated client screening risks could be managed. Subsequently, a meeting was held with Baby Wear Ltd at which the letter of engagement was agreed and signed. Your first task was to attend the inventory count scheduled 30th September 2009.

Inventory count and preliminary planning

Your staff attended the inventory count and produced **working paper reference (BW-IC/2)**. Immediately after the inventory count, you then proceeded to undertake preliminary procedures involving understanding of the business of Baby Wear Ltd, including their accounting and internal control systems.

You established that Baby Wear has implemented the Pastel accounting package and most of the transactions are processed using this software. You decided to adopt a rotational policy of reviewing internal controls in detail and for the year ended 30th September, you decided to review the sales system in detail. **The sales system is summarised at working paper (BW-RSS/3)**. After reviewing the sales system, your staff carried out preliminary analytical review procedures in order to determine materiality. This was to be based on draft financial statements summarised at **(BW-DFS/5)**

You are the lead partner on this assignment and as the team leader your role is to undertake preliminary planning, and to guide your team in obtaining reasonable assurance that:

- a) Proper acceptance procedures are carried out
 - b) Adequate inventory procedures are carried out
 - c) Adequate understanding of accounting systems and internal controls relating to sales
- Preliminary analytical procedures are carried out to support the determination of an appropriate materiality level whose guidelines are provided at **(BW-MG/4)**

WORKING PAPERS

SUBJECT:	CLIENT SCREENING	REFERENCE
PREPARED BY:	Madison Kunda	BW –CS/1
DATE:	12TH October 2009	

TP Case & Partners is only two years old and has little experience in the baby wear industry, especially on the manufacturing side. The client list comprises three medium size companies and one sole trader. With the invitation from Baby Wear Ltd, TP Case & Partners can look forward to significant increase in their income.

a) Three of the five directors have been a subject of investigation by the Task Force, following allegations that they were also executive directors in Daiwo Ltd, a company involved with the importation of baby kits at the ministry of health. It was recently discovered that material amounts had been paid to Daiwo Ltd for which baby kits had not yet been delivered. However, Baby Wear Ltd is adamant that it has now changed its culture, and is hoping that TP Case & Partners would become the new auditors as part of this new ethical outlook

b) As the investigations by the Task Force have not yet been exhausted, it is possible that appointed auditors may be expected to answer queries from the Task Force, and if necessary disclose required documents and other records to them.

c) The Directors are particularly interested in TP Case & partners helping them implement a more effective internal control system, and are also expected to provide financial advice to directors in their individual capacity.

SUBJECT:	INVENTORY COUNT	REFERENCE
PREPARED BY:	Jerome Dube	BW – IC/2
DATE:	4th October 2009	

Baby wear has raw materials, consumables and work in progress as well as finished goods at its factory base in Lusaka. Finished goods are stored in a separate warehouse located about 10 kilometers from the factory base. Baby wear does not hold inventory owned by third parties.

On 30th September 2009, employees of the company physically counted the inventory at both of the company's sites and members of your audit team were in attendance.

The company had significant quantities of finished goods inventories held by independent retail stores under its sale or return system. Under this system, inventories is displayed for sale at retail shop premises but remains the property of Baby Wear Ltd until it is sold by the retailers. Any garment not sold within three months are returned to Baby Wear Ltd for bulk sale at heavily discounted prices

Some quantities of finished goods inventories were stated at net realisable value in the financial statements of the company for the previous year.

SUBJECT:	REVIEW OF THE SALES SYSTEM	REFERENCE
PREPARED BY:	Jerome Dube	BW – RSS/3
DATE:	4th October 2009	

You are reviewing the planning for the audit for the year ended 31 March 2009 and you are to consider the audit work which should be performed on the company's sales system. Although most sales are on credit, there are some customers who are too small and whose purchases are to infrequent to have a sales ledger account with Baby Wear Ltd. They are able therefore to order goods and pay in cash for the goods when they collect items

Your team has ascertained the following system for credit sales and cash sales:

Credit sales

- a) Cash and cheques for credit sales are received in the post, which is opened by two people. They make a record of all the cheques and cash received, which are then handed over to the cashier
- b) The cashier records the moneys received in the cash book, banks them and reports them to the sales accounts department
- c) The sales accounts department posts the cash and cheques received in the sales ledger
- d) Credit notes are sent to customers and posted to the sales ledger only after they have been authorised

Cash sales

- a) The customer places an order with the sales department, the sales department enters the order in the Pastel system and it processes and prints out a pre-numbered multi-copy advice note

- b) The order is put together by the despatch department and this is handed over to the customer along with the copy of the advice note
- c) The customer submits the advice note to the cashier, who enters the advice into the pastel system and the system prints out an invoice
- d) The cashier receives payment from the customer by cash or by cheque
- e) Receipt details are entered into the pastel system and a cash receipt is produced.
- f) The money is banked by the cashier

SUBJECT:	MATERIALITY GUIDELINES	REFERENCE
PREPARED BY:	Jerome Dube	BW – MG/4
DATE:	4th October 2009	

MATERIALITY GUIDELINES

According to TP Case & Partners' policies and procedures, materiality is determined using appropriate calculations at the preliminary stage of an audit. A range of values is calculated and then an average is taken with bias towards the high values or lower values depending on the results of the risk assessment.

A basis quantifying what may be indicative of being material that is used in is as follows:

CRITERIA	INDICATIVE PERCENTAGE
Revenue	0.5% - 1%
Profit before tax	5% - 10%
Total Assets	1% - 2%

SUBJECT:	DRAFT FINANCIAL STATEMENTS	REFERENCE
PREPARED BY:	Jerome Dube	BW – DFS/5

DATE:	4th October 2009	
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As part of your planning procedures, you have been presented with the following summary draft financial statements for Baby Wear Ltd for the period ended 30th September 2009, including related information from the previous year.

STATEMENT OF FINANCIAL POSITION

	2009 (K'Million)	2008 (K'Million)
Tangible non-current assets (at net book value)	22,350	22,175
Inventories : Raw materials	1,100	1,000
Work in progress	400	500
Finished goods	5,500	4,000
Receivables	4,800	5,200
Payables	(2,800)	(3,000)
Bank overdraft	(1,900)	(1,400)

STATEMENT OF COMPREHENSIVE INCOME

	2009 (K'Million)	2008 (K'Million)
Revenue	28,000	25,500
Cost of sales *	(20,000)	(18,700)
	-----	-----
	8,000	6,800
Distribution cost *	(2,800)	(3,000)

Administration expenses *	(1,900)	(1,400)
	-----	-----
Profit before tax	2,500	1,500
	=====	=====
*Total depreciation included in these figures	2,000	1,800

QUESTION 1

SECTION A

1) Using the results of client screening at working paper **(BW-CS/1)** and the comments from your partner, List and brief describe FIVE professional ethical matters that should have been resolved in accepting the invitation to become auditors of Baby Wear Ltd for the year ended 30th September 2009
(15 marks)

2) With reference to working paper **(BW-IC/2)**:

(a) Identify THREE possible causes for finished goods inventories being stated at net realisable value in the financial statements of Baby Wear Ltd in the previous year, and explain the reasons why the inherent risk associated with inventory in the financial statements of Baby Wear Ltd would be assessed as 'high'

(10 marks)

(b) List and briefly explain FIVE important tasks that members of your audit team should have carried out when they attended Baby Wear's inventory count on 30th September. For each task identified explain the purpose of carrying it out.

(15 marks)

3) With reference to working paper **(BW-RSS/3)**:

a) Explain the reasons why two people should open mail containing cash and cheques from customers and state the audit procedures you would undertake while attending the mail opening and follow up of the cheque banking

(10 marks)

b) Point out the weaknesses in the cash system. In order to check that there is no material fraud or error in operation, list and briefly describe what audit procedures you would perform on this system

(10 marks)

SECTION B

4) Using the information in the financial statement extracts in working paper **(BW-DFS/5)**:

a) Carry out an analytical review of the financial statement extracts. From your review list FOUR items you believe would require particular investigation during the audit, and explain in each case why you believe they require such investigations

(20 marks)

b) For each item detailed in your list above, list two audit enquiries specific to Baby Wear that you would make in order to satisfy yourself that the figure appearing under each heading had been properly stated.

(10 marks)

5) Using the guidelines in working paper **(BW-MG/4)** and your responses to the requirements in question (4) above, compute possible materiality figures and recommend with reasons, your selection of a suitable monetary planning materiality figure to be used during the audit of Baby Wear Ltd for the year ended 30th September 2009

(10 marks)

(Total: 100 marks)

QUESTION TWO

You are a senior audit manager in Gabman Professional Services, a ZICA registered auditing firm. You have just read the following in the Times of Zambia:

ZIC/ROD/SA/03/09: REQUEST FOR PROPOSALS FOR PROVISION OF EXTERNAL AUDITING SERVICES

1. Background

The Zambia Insurance Corporation (ZIC) group of companies wishes to engage a well established and experienced audit firm to provide auditing services to ZIC Limited and its subsidiaries as part of the group good governance management. The service provision is intended to run for a period of 12 months subjected to renewal depending on the performance of the service provider.

2. Purpose of the assignment

The objective of the assignment is to identify, evaluate and appoint an Audit firm capable of performing the audit of the ZIC Group of Companies. This may also include other relevant consultancy services as may be required.

3. Scope of work

The External Auditors will be required to perform the necessary audit work to enable them to express an audit opinion for 31st December 2009 in the financial statements of the ZIC Limited and its subsidiaries (in the ZIC group of companies) by end of February 2010. Among other technical requirements are as follows:

- The Auditor should include in their technical proposal their proposed methodology for doing the assignment
- The Auditor should include any other technical information relevant to the provision of auditing services
- The Auditor should amplify on ability to execute the proposed assignment
- The Auditor should submit in full, details pertaining to key staff for the assignment to include the years they served the firm participating in this tender
- The Auditor should submit a detailed company profile listing staff qualifications and experience, and
- The Auditor should provide details of similar past and present auditing assignments executed or running

4. **Conduct of work**

The conduct of the work will mainly be performed at Head Office in Lusaka and regional offices on the Copperbelt and Livingstone. However, where necessary, visitations might be made to other operational area offices around Zambia.

5. **Capacity and experience**

- Total number of audit staff that provide audit related services in terms of partners, managers and others
- Provide up to date Curriculum Vitae of all partners and managers that will form part of the audit team. The CVs should indicate a minimum level of experience (supervisor, manager etc)
- Provide details of technical departments (or equivalent departments) specialising in the tax, management consultancy as well as Information Systems Technology
- Provide details of the firm's audit engagements in similar assignments during the past 5 years, preferably in the insurance sector

6. **Duration of the assignment**

The firm will be appointed for a period of one year subject to confirmation by the shareholders based on evaluation of the effectiveness as well as independence and objectivity of the external auditors.

7. **Submission of proposals**

The mode of submission of the proposals is through a two-envelope system where the technical and financial proposals will be sealed separately and clearly marked "**Technical Proposal**" and "**Financial Proposal**".

Shortly afterwards, Kelvin Bulwani, the managing director of ZIC calls you to find out if you had seen this advertisement and has expressed the confidence that you would stand a very good chance of winning the tender. Kelvin is your brother in marriage who is married to your wife's young sister. You also happen to be very good friends.

After much consideration, you convince your partner to submit a proposal to ZIC. You have specifically directed that a lower than market rate fee should be proposed. You have assessed that if you win the tender, ZIC would be one of the few high profile clients on your data base. The lower fee to be quoted would be more than made up from a wide range of other services expected to be provided.

Subsequently and mainly based on a lower fee quoted, your firm has been appointed to audit the financial statements of ZIC group for the year ended 31st December 2009.

Following the requirement to separate the provision of life and other business insurance services, ZIC has identified a company in the same business Damson Re-insure (DRI), as a

target for acquisition in the current year. DRI provides diverse insurance services, including bonded warehousing services.

As senior manager for the audit of ZIC and its subsidiaries for the year ended 31st December 2009, you have been asked to examine the management accounts and budget forecasts. Kelvin Bulwani, the managing director of ZIC, believes that despite its current cash flow difficulties, DRI's current trading performance is satisfactory and future prospects are good. The chief executive of DRI is Paul Sokotwe.

The findings of your examination are as follows:

- a) Budget forecasts for DRI, for the accounting year to 31st December 2009 and for 2010 reflect a rising profit trend.
 - b) DRI's results for the first half year to June 2009 reflect K2 billion profit from the sale of a bonded warehouse that had been carried in the books at historical cost. There are plans to sell two similar properties later in the year and outsource warehousing.
 - c) About 10% of DRI's insurance revenue is generated from Chindo Investment Holdings (CIH), a limited liability company. Two members of the management board of DRI hold minority interests in CIH. Insurance premium rates negotiated between DRI and CIH appear to be at arm's length basis.
 - d) DRI's management accounts for the six months to 30 June 2009 have been used to support an application to the bank for an additional loan facility to refurbish the executive administration offices. These management accounts show receivable balances that exceed the figures in the accounting records by K1.5 billion. This excess has also been reflected in the first half year's profit. Upon enquiry, you have established that allowances, to reduce receivables to estimated realisable values, have been reduced to assist with the loan application.
 - e) Although there has been a recent downturn in insurance business, Paul Sokotwe has stated that he is very confident that the negotiations with the bank will be successful as DRI has met its budgeted profit for the first six months, Paul believes that increased demand for general insurance, especially in the vehicle and housing market, in the forthcoming months will enable results to exceed the budget.
 - f) DRI is presently audited by Jacob Muma Accountants. It is the intention of ZIC to continue using Jacob Muma for the audit of the DRI financial statements components. For the year ended 31 December 2009, Jacob Muma Accountants have indicated that the financial statements of DRI are likely to be modified due to potential going concern problems. However, ZIC has indicated that it would provide any assistance to DRI as appropriate.
- Your firm has put in place suitable quality controls policies and procedures in compliance with the Zambia Institute of Chartered Accountant (ZICA) provisions. These deal with various matters, including tendering procedures.

QUESTION 2

SECTION A

1) Prior to the submission of your tender:

a) Discuss FOUR ethical and professional matters that should have been taken into account as part of the process of accepting the assignment to audit ZIC, stating clearly the significance of each matter.

(12 marks)

b) For each matter discussed above, suggest a suitable course of action that should have been undertaken and come to a conclusion as to whether your firm should have accepted the assignment.

(18 marks)

2) Apart from professional ethical issues in (1) above:

a) List and briefly describe FIVE other commercial matters that should be considered before a firm must decide whether to participate in such a bid or not.

(10 marks)

b) One of the reasons why your firm was selected was because of the relatively lower fee quoted. Apart from the lower fee, suggest FIVE other reasons why your firm may have been preferred to other firms.

(10 marks)

SECTION B

3) With reference to findings of your examination:

a) State the audit evidence that your team should be expected to focus on in relation to these findings

(15 marks)

b) Explain what impact the acquisition of Damson Re-insure will have on the planning and overall conduct of your audit of ZIC group for the year to 31st December 2009 .

(15 marks)

4) As DRI's financial statements will be audited by Jacob Muma Accountants for the year ended 31st December 2009:

a) Discuss to what extent you would rely on the work of Jacob Muma Accountants for your audit of the group financial statements of ZIC for the year ended 31st December 2009.

(10 marks)

b) Evaluate the impact of the proposed modified opinion on the financial statements of Damson Re-insure on your overall opinion for the group, taking into account the willingness of ZIC to provide required financial assistance to Damson Re-insure.

(10 marks)

(Total 100 marks)

END OF EXAMINATION