

COMPETENCE PRACTICE EXAMINATION

FULL AUDIT

JUNE 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 1

Background

Global Development and Initiative International (GDII) is a Non- Governmental Organization that specializes in project designs, development and implementation in a number of countries across the world. Its headquarters is in London and has been operating for the past twenty - seven (27) years. In 2006, GDII signed an agreement with the Chinese Government to initiate and implement similar undertakings through the GDI - Zambia office. A separate Project Management Unit (PMU) was to be set to coordinate and manage the Economic Empowerment Project (EEP) within GDI-Zambia.

James Phiri & Associates (JP&A), a medium – sized firm of registered auditors has been auditing GDII for the past 7 years. During the design phase of the project in Zambia, GDII engaged JP&A to assist them in coming up with a project document for EEP putting more emphasis on the Log Frame that was considered critical for project implementation. The project document was done with the input of JP&A, approved and adopted by GDII for onward submission to the Chinese Government. Since then, there has been a sound professional relationship between GDI – Zambia, the EEP Team and JP&A. Similarly, in 2006, JP&A was involved in the monitoring and evaluation of the EEP and made a number of recommendations on how to improve the project implementation whose report was accepted. They were also involved in coming up with accounting systems and procedures in the initial phase of the project and have also provided advice on issues of treasury management.

GDII has requested that JP&A should undertake the audit of EEP for the financial year ended 2008 considering that they have had enough knowledge on the operations of both GDII and GDI - Zambia to which the partner has agreed. This was the first time EEP was being audited as a separate unit since its inception as EEP activities were audited as part of GDII.

At the initial planning meeting with the engagement partner, it has been agreed that the audit strategy should mainly focus on addressing issues pertaining to risk management of the project's operating effectiveness and efficiency considering that during the mid-term review, the project had overspent on most of its activities and also to ensure that the project funds utilization is in line with the planned activities. More so, to carry out test of control to obtain audit evidence as it relates to audit assertions on the following aspects:

- Procurement of goods and services for the project
- Project funds recognition
- Advances given to entrepreneurs
- Inter-project receivables
- Exchange gains

During the brief discussion with the project team, the Project Coordinator emphasized that the continuation of the project is depended on a successful outcome of the audit. The partner has asked you as audit manager to manage the audit of the project. The audit manager has produced the following working papers for review:

Work paper	Reference number
Understanding the entity and knowledge of the project	10/1
Procurement of goods and services for the project	20/4
Recognition of project funds	30/1
Advance payments to entrepreneurs	50/3
Inter-project receivables/ Exchange gains	70/1

Client: GDI	Prepared by: JAZ	10/1 1/3
Year end: 31/12/07	Date: 30/11/07	
Subject: Understanding the entity and knowledge of the project		

1. Introduction

GDII is a leading NGO in the world and has been ranked as one of the most successful NGOs with the capacity to handle numerous projects in different countries. The NGO was formed by Mr. White Blue an economist by profession. Its headquarters is in London and have been operating for the past twenty- seven (27) years. Presently, it operates in 50 countries across the world including Zambia. GDII signs contracts with a number of Donors whose interest are to assist in advancing global development initiatives especially in developing countries. This is done by initiating various developmental projects aimed at assisting countries in improving their Gross Domestic Product and Per Capital Income of its citizens.

The current directors of GDII are:

- Mr. White Blue (CEO and chairman)
- Mr. Petty Wills (CFO) – Joined December 2006
- Mr. Jonnes Way – Finance Manager
- Ms Jude Jere – Human Resource
- Mrs. Petros Tidd (Project Mobilization Officer)

A Mr. Charles Panos who used to be **CFO resigned** in 2006 and joined JP&A as Partner in-charge of project audits.

For each project established in a particular country, a project coordinating team is put in place to act as a secretariat for all activities in that country.

In 2006, GDII signed an agreement with the Chinese Government to initiate and implement similar undertakings in Zambia in the form of EEP. This is to be implemented through GDI – Zambia.

2. Operating environment

GDII operates pool accounts that are maintained in London for all the funds it receives from donors and keeps ledgers for each of the projects to assist in the monitoring of the flow of funds. Funds are received in various currencies and each currency has its own pool account maintained. Funds for each project including those for EEP are disbursed as and when a request is made from the Project Management Unit (PMU) in a particular country implementing a particular project. Once funds are accessed, the PMU is expected to produce financial statements to account for the funds by preparing auditable financial statements that are later consolidated in London as part of GDII group financial statements in order to determine the performance and position of GDII. The PMU is supposed to prepare bankable documents on how the project is to be implemented such as

a project proposal showing clearly budgets, log frame and work plans. Most of the activities carried out by EEP are those relating to supporting medium and small-scale entrepreneurs venturing in small projects and businesses aimed at creating employment of up to 50 employees.

Client: GDI	Prepared by: JAZ	10/ 1 2/3
Year end: 31/12/07	Date: 30/11/07	
Subject: Understanding the entity and knowledge of the business (cont...)		

In terms of authority for implementation of project activities, the Country Representative and Finance Director of GDI – Zambia and EEP coordinator are the key people vested with the authority of approving all payments relating to the project. No payment can be made locally without the knowledge of the Country Representative. However, larger transactions above \$100,000 require approval in London Headquarters. The GDI-Zambia country office provides backup staff support through a direct cost recovery based on how much work GDI – Zambia staff have done that relates directly to EEP.

Prospective entrepreneurs prepare proposals that are later submitted to the appointed bank to scrutinize them and assess their credibility. Once the proposals have been approved, the Secretariat of the EEP is informed and facilitates the release of funds to successful entrepreneurs by making funds transfer. Funds are disbursed from GDII in London directly to the respective accounts of each successful entrepreneur. However, accounting for the funds is

done by the EEP that prepares quarterly accounts and financial statements at the end of the year meaning that EEP is able to prepare full-fledged accounts. The accounts are then audited and submitted to GDII for consolidation.

3. Outputs

The outputs of the project are mainly focused on the creation and supporting of small and medium entrepreneurs and ensure that they are operating successfully as expected in the country. This is verified by the number of employment created in relation to the targets set.

4. Outsourcing arrangements

Due to the nature of the project, funds are supposed to be transferred to various entrepreneurs upon submitting bankable and approved project proposals to the banks. Banks scrutinize the proposals and select those considered to be suitable in line with the GDII funds assessment requirements. Funds are disbursed through the banks to successful applicants.

Banks therefore ensure that the risk associated to lending of funds is minimized considering that the type of clientele falls in the high-risk category.

5. Accounting policies

In line with the GDII requirements, the financial statements of GDI – Zambia including that of EEP are supposed to be prepared in accordance with the International Financial Reporting Standards (IFRS). However, the EEP accounting policies in terms of accounts preparation follow both the cash and accrual basis of accounting.

Client: GDI	Prepared by: JAZ	10/1 2/3
Year end: 31/12/07	Date: 30/11/07	
Subject: Understanding the entity and knowledge of the business (cont...)		

Client: GDI	Prepared by: JAZ	10/1
Year end: 31/12/07	Date: 30/11/07	

Subject: Understanding the entity and knowledge of the business (cont...)	3/3
-------------------------------------------------------------------------------------	------------

For instance, all items of expenditure are stated at historical cost and are recognized when a payment is made. Cash is recognized when received in the London pool account. Advances to entrepreneurs' are treated as receivables and are accrued accordingly until when retirement has been done. Outstanding obligations are accrued as payables.

It is expected that the current accounting policies will continue in the foreseeable future.

6. Materiality

The guidelines on materiality were based on the variation of expenditure either as a single activity and/or as aggregation of activities. A variation of above 5% between activities and/or aggregate of activities is considered high and required some detailed explanation by the PMU.

Similarly, non-compliance with clauses in the contract agreement such as corrupt practices, non-adherence to reporting requirements and disbursement procedures are considered to be material to the sponsor and the sponsor could terminate the contract by way of notice.

Client: GDI	Prepared by: JAZ	20/4 1/1
Year end: 31/12/07	Date: 30/11/07	
Subject: Procurement of goods and services for the project		

NO	Description
Ordering of goods and services	
A1	All procurements above a certain threshold go through the Tender Committee. However, smaller purchases are done by obtaining three quotations from registered suppliers.
A2	Orders are initiated by the individual officers based on work needs through a requisition based on the procurement plan. These are then forwarded to the procurement officer to facilitate preparation of an order.
A3	The procurement officer prepares all orders for subsequent authorization. These are sent to the project coordinator for approval and authorization. Once authorized, the procurement officer does the ordering of the goods and services by sending an electronic copy to the supplier/print out.
A4	The procurement officer can make changes to the order in the event that the ordered goods were not available with the supplier.
A5	The procurement of goods and services are based on the demand for them and an authorized database of suppliers of goods and services is maintained
A6	Goods not received after one month are reviewed and canceled by the procurement officer.
A7	All returns are recorded based on the credit note issued by the supplier
Receipts of goods	
B1	Goods are received by the procurement officer and subjected to inspection by an independent person by taking custody of them
B2	Receipt of goods is acknowledged through a Goods Received Note (GRN), which is issued immediately before goods are taken for custody. They are only accepted if the goods received match with the order
B3	The stores officer takes custody of the goods and records them on stock cards.
B4	Rejected goods are returned back immediately to the supplier,

B5		Goods not received within the required period are noted and recorded
Accounting of goods		
C1		At a time when a purchase order is made, a copy is sent to accounts
C2		All invoices that accompany the goods delivered or sent after the goods have been dispatched are matched with the purchase orders to authenticate the transaction and subsequent payment
C3		Once the invoice has been matched with the order, a payment is made which is authorized by the Finance director and signed for by other signatories
C4		The invoice is posted to the purchases and general ledger respectively
C5		All credit notes that are received pertaining to goods returned due to various reasons are posted to the purchases and general ledger
C6		The cost accountant ensures that invoices are posted in the right period

Client: GDI	Prepared by: JAZ	30/1 1/1
Year end: 31/12/07	Date: 30/11/07	
Subject: Recognition of project funds		

Policy

It is the EEP policy to recognize project funds received in the GDII pool account in London as receipts only when information is provided that funds in the pool account from the Chinese Government have been received in the pool account. Project funds are released as advances to beneficiaries (working paper 50/3).

(i) Procedures for releasing funds to entrepreneurs

It is the practice of GDII to release funds to beneficiaries upon receiving a well-signed transfer voucher from GDI-Zambia on behalf of the EEP. For amounts less than \$100,000, either the

Project Coordinator or the Country REP should have signed the voucher or if it is above \$100,000, then the voucher must be signed by the Country REP and a director at GDII in London.

(ii) End of year cash balances

It is also the policy of EEP to recognize its end of year balances as receivables and for funds advanced to other projects has Inter-project receivables considering that the cash balance for a particular project cannot be verified easily due to the fact that all funds are found in a pool account. Only the overall cash balance could be determine by GDII when consolidating the financial statements for all project it runs in various countries. Available information also suggests that some inter-project receivables have been outstanding for quite some time.

Client: GDI	Prepared by: JAZ	50/3 1/1
Year end: 31/12/07	Date: 30/11/07	
Subject: Advance payments to entrepreneurs		

As part of the policy on releases of funds, funds to beneficiaries are released as advances and are required to be retired at the end of the year before further funds could be released for the coming year. It is estimated that \$6 million will be released to successful entrepreneurs by the end of the project period of 9 years. No repayments are required as long as records suggest that the money has been used in accordance with the project guidelines and indicator show that

the organization is in operation and fulfilling the purpose of employment creation and contributing to the GDP and per capital income.

Discussions with a Mr. Opportune one of the beneficiaries and owns Leather Ltd, a turnery company in the central part of Kabwe have revealed that very little has been done for the company that was registered. No person has been employed apart from family members. An amount of \$500,000 was given to the company the highest ever in the history of the project. The EEP upon discovering the developments immediately initiated a claim to recover the entire \$500,000 from the Leather Company. Negotiations have been going on for some time now and the likelihood of recovery is very slim.

Audit work performed to date

1. Discussions with the EEP Project Coordinator

1.1 Little progress has been made to recover the money as the CEO insists that the developments that led to not living up to the required expectations were beyond their control.

1.2 The CEO has requested that the company be given more time to operate considering that the supply of leather to the company has improved.

1.3 The company has accumulated arrears in terms of salaries and leave days for workers. However, a provision has been made for this.

2. When the issue was taken further to the Country REP, additional evidence was obtained indicating that in fact the Finance Director of GDI – Zambia, owns Leather Ltd. When the Finance Director was interrogated, he agreed that he is part of the directors in the company but was quick to point out that he does not play an active role in as far as running of day-to- day operations of the company.

Client: GDI	Prepared by: JAZ	70/1 1/1
Year end: 31/12/07	Date: 30/11/07	
Subject: Inter-project receivables, exchange gains & interest		

It is a practice by the GDII to lend money to other projects whose funds have not yet been received yet from the sponsoring partner. \$200,000 has been paid from the EEP funds to facilitate the procurement of materials considered to be critical for the smooth running of the project in Congo before the Congo project is funded. Due to the war that was intensified, the project site was abandoned and activities have come to a stand still. It is unlikely that the money will be paid back considering that the main sponsor has withheld funding for the Congo project.

The following issues were noted:

1. That the receivables pertaining to the Congo project have not been adjusted in the EEP financial statements.
2. Due to currency conversions from Yen to the dollar, in London, exchange gains of \$100,000 were supposed to be captured in the EEP financial statements. This was not done and the issue ignored.
3. Interest of \$50,000 was not recognized in the EEP

QUESTION 1

REQUIRED

SECTION A

1. In line with the IFAC Code of ethics for Professional Accountants to which ZICA subscribes, and with reference to the background, the introduction and working paper 10/1, describe those items that create threats to the independence of JP & A in relation to the audit of EEP.

(8 Marks)

2. Based on working paper **20/4** on procurement of goods and services for the project, prepare an audit programme to test the operating effectiveness of the key controls detailed in the working paper. The audit programme should provide you with audit evidence pertaining to the ordering, receipt and accounting for goods for the project. The audit programme should be prepared in a tabular format and should contain the following:

- (i) Reference number of the control activity on working paper 20/4
- (ii) Description of the control objective(s)
- (iii) Controls, and
- (iv) Description of tests of control to address the controls and control objective(s)

Note: Only key controls on which you would place reliance should be dealt with in your answer bearing in mind the need to be cost efficient.

(35 Marks)

SECTION B

3. With reference to working paper 30/1, 50/3 and 70/1, outline what matters could be of interest and to be considered when auditing project funds.

(30 Marks)

4. Describe some audit procedures that should be performed in respect of the issues highlighted in 3 above and as they relate to working papers 30/1, 50/3 and 70/1. The audit procedures should assist in ensuring that the matters are addressed to obtain appropriate audit evidence for the audit of EEP 2007 financial statements.

(Note: only important procedures should be stated)

(27 Marks)

Total

(100 Marks)

QUESTION 2

Introduction:

Your firm has successfully tendered for the audit of Sobi Ltd a Zambian privately owned national transporting company involved in the haulage and distribution of various commodities. This is a long established company that provides assorted services in a timely manner and expected quality.

Pett & Partners is a firm of registered auditors and have been associated with audits of transport companies for quite some time. A Mr. Reter Lobby, a partner who was associated with these audits is about to retire. You have been nominated as a partner to takeover from him and subsequently manage the audit of Sobi Ltd schedule to commence in February 2009.

According to the information contained in the permanent file for Sobi, the planning materiality for the audit will follow the following guide.

Income statement	Revenue	0.5 – 1%
	Profit & Loss	5 –10%
Balance sheet	Total assets	1 – 2%

These will assist in arriving at a suitable range for preliminary materiality.

In order to facilitate the calculation of the preliminary materiality, the financial statement risk, analytical procedures and other information needed for a thorough audit, Sobi Ltd has provided two sets of financial statements for 2007 and 2008 respectively. For the purpose of the audit, the partner in-charge has labeled them as working paper **FS/1**.

Operations:

Due to the nature of the business, Sobi Ltd has Controllers of transport at designated places that manage the transport on a day-to- day basis in accordance with the company policies. Each Controller is also responsible for preparing and submitting monthly accounting returns to head office

Of late, Sobi Ltd has been receiving complaints from its customers pertaining to the service provision and has been threatening to take Sobi Ltd to court because of what is considered careless handling of fuels and related wastes that have been polluting the environment in the surrounding compound. The other complaint relates to the slow pace of service delivery and lack of quick response. This has become a recurring problem and a major cause of customer dissatisfaction especially that customers are required to pay in advance before a service is provided. Once a payment is made to Sobi Ltd, no refund is allowed but in the event that the paid for service cannot be provided, a customer could still demand for a similar service to be provided based on the originally paid for service.

The Environmental Council of Zambia has intervened and issued instructions on how it expects Sobi Ltd to handle the fuels and other wastes. In the event that it does not abide or comply with the instructions, its industrial licence is likely to be withdrawn at a point of renewal. The renewal is expected to be done in early 2009. Sobi Ltd has found it very difficult to carry out the instructions considered to be beyond what they could do but has promised to try.

Sobi Ltd has also invested heavily in both properties and equipment to guarantee substantial generation of income. This is in consideration that the demand for the transport services at one time exceeded the supply by more than 40%.

Title of working paper	Working paper Reference
Income Statement & Balance Sheet for 2007 & 2008	F/S 1
Notes to the financial statements	F/S 2
Important developments for Sobi Ltd	D 2

Client: Sobi LTD	Prepared by: Pessy	FS/1 1/1
Year 31/12/08	end: Date: 15/12/08	
Subject: Income Statement & Balance Sheet for 2007 & 2008		

2008

2007

Draft

Actual

K'000 000

K'000 000

Income Statement

Revenue (Note1)	161,500	144,400
Materials expenses (Note 2)	88, 000	74,700
Staff Costs	40,600	35,600
Depreciation & Amortization	8,500	9,500
Other expenses	19,600	23,200
Finance costs	<u>2,900</u>	<u>2,200</u>
Total expenses	<u>159,600</u>	<u>145,200</u>
Profit/(Loss) before tax	1,900	(800)

Balance Sheet

Intangible assets (Note 3)	7,200	6,200
Tangible assets (Note 4)		
Property	55,100	57,800
Vehicles & Transport equipment	16,400	16,000
Other equipment	7,400	9,300
Inventory	600	500
Trade receivables (Note 5)	13,700	13,400
Cash and cash equivalents	<u>3,400</u>	<u>2,800</u>
Total Assets	<u>103,800</u>	<u>106,000</u>
Provisions		
Restructuring & waste dump (Note 6)	9,700	10,800
Tax provision	3,000	3,300
Liabilities		
Finance lease liabilities (Note 7)	5,400	4,400
Trade payables	13,800	13,100
Other liabilities (Note 8)	<u>8,500</u>	<u>7,900</u>
Total liabilities	<u>40,400</u>	<u>39,500</u>

Client: Sobi LTD	Prepared by: Pessy	FS/2 1/1
Year end: 31/12/08	Date: 15/12/08	
Subject: Notes to the financial statements for 2007 & 2008		

Notes:

(1) Revenue is net of rebates to major customers that increase with the volume of consignments transported. Rebates are calculated on cumulative sales for the financial year and awarded quarterly in arrears.

(2) Material expenses include fuel, repair materials, transportation and vehicle maintenance costs.

(3) Purchased intangible assets, including software and industrial licences, are accounted for using the cost model. Internally generated intangible assets, mainly software developed for customers to generate consignment documents, are initially recognized at cost if the asset recognition criteria are satisfied.

(4) Movements on tangible non-current assets have been drafted as follows:

Property Equipment	Vehicles & Transport	Other Equip	Total
Historical cost	K'000 000	K'000 000	K'000 000
Opening balance 1.1.2008		75,700	25,600
119, 100			17,800
Additions	1,400	2,700	1,100
5,200			
Disposals	<u>(2,500)</u>	<u>(2,600)</u>	<u>(1,400)</u>
Closing balance 1.12.2008	<u>74,600</u>	<u>25,700</u>	<u>17,500</u>
<u>117,800</u>			
Depreciation & impairment losses			
Opening balance 1.1 2008		17,900	9,600
36,000			8,500
Depreciation & impairment loss	2,400	1,900	2,500
6,800			
Disposals	<u>(800)</u>	<u>(2,200)</u>	<u>(900)</u>
<u>(3,900)</u>			
Closing balance 31.12 2008	<u>19,500</u>	<u>9,300</u>	<u>10,100</u>
<u>38,900</u>			
Carrying amount at 31.12.2008	55,100	16,400	7,400
78,900			
Carrying amount at 31.12.2007	57,800	16,000	9,300
83,100			

Depreciation is charged using straight – line method assuming the following useful lives:

Property	6 – 60 years
Vehicles and transport equipment	3 – 8 years
Other equipment	3 – 15 years

Client: Sobi LTD	Prepared by: Pessy	FS/2 1/2
Year end: 31/12/08	Date: 15/12/08	
Subject: Notes to the financial statements for 2007 & 2008 cont...		

(5) Trade receivables are carried at their principal amount, less allowances for impairment.

(6) The restructuring provision relates to employee termination and other obligations arising on the closure and relocation of distribution depots in June 2007.

(7) Finance leases are capitalized at the date of inception of the lease at fair value or the present value of the minimum lease payments, if less.

(8) Other liabilities include amounts due to employees for accrued wages and salaries, overtime, sick leave, maternity pay and bonuses.

Client: Sobi LTD	Prepared by: Pessy	D/2
Year end: 31/12/08	Date: 15/12/08	
Subject: Important development in Sobi Ltd		

The following issues form part of Sobi 2008 financial year and have arisen during the preparatory stages of the final audit. A schedule of points has been brought to your attention for further comments.

(a) In January 2008, Sobi Ltd bought the right to use a dumping site for a period of 15 years for K3.378 billion. Sobi Ltd expects that the amount of scrap that it will need to dump will increase annually and that the site will be completely filled after just 10 years. Sobi Ltd has charged the following amounts to the income statement for the year to 31 December 2008:

- v K61.4 million licence amortization calculated on a sum – of – digits basis to increase the charge over the useful life of the site; and
- v K100 million annual provision for restoring the land in 15 years' time

(b) In June 2008, Sobi Ltd has received a letter from the Local Council that it will not allow Sobi Ltd to empty waste fuels into a river because the water used by the local communities was still contaminated despite Sobis' effort to have the waste disinfected with chemicals. Sobi Ltd made a provision of K0.8 billion for the technological upgrading of its disinfectant machine and also included a K45 million for the penalties imposed as other provision. This is included in the same figure of provisions.

NOTE: The revenues, profit before tax and total assets are as per income statement and balance sheet in working paper F/S 1

QUESTION 2

REQUIRED

SECTION A

1. Based on the introductory information and working paper F/S 1;

(a) Identify and explain the business risks associated to Sobi Ltd, and
(12 Marks)

(b) Explain how each of the risk identified in (a) above may link to financial statements risk.

(13 Marks)

Note: (Analytical review procedures requiring the detailed calculation of ratios are not needed)

2. Based on working paper F/S 1 and the introductory information, determine the figures for each year as they relate to the materiality calculation guide to assist you come up with a preliminary materiality. You should also justify the suitability of your assessed materiality.
(20 Marks)

3. Based on working papers F/S 1 and F/S 2, identify and explain the financial statement risks to be taken into account in planning the final audit.

Note: A detailed calculation of ratios is not needed

(15 Marks)

SECTION B

4. As partner in-charge of the audit of Sobi Ltd, **comment on the matters** that you should consider in relation to working paper **D/2** and correspondingly **state the audit evidence** that you should expect to find in undertaking your review of the audit working papers and financial statements of Sobi Ltd for the year ended December 2008.

(40 Marks)

Note: 20 marks for the comments on the matter and 20 marks for audit evidence.

Total

(100 Marks)